

WELLPOINT INC
Form 10-Q
July 23, 2008
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period ended June 30, 2008

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number: 001-16751

WELLPOINT, INC.

(Exact name of registrant as specified in its charter)

INDIANA

(State or other jurisdiction of

incorporation or organization)

120 MONUMENT CIRCLE

INDIANAPOLIS, INDIANA

(Address of principal executive offices)

Registrant's telephone number, including area code: (317) 488-6000

35-2145715

(I.R.S. Employer

Identification Number)

46204-4903

(Zip Code)

Not Applicable

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(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for at least the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

Title of Each Class	Outstanding at July 16, 2008
Common Stock, \$0.01 par value	511,334,207 shares

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For the Period Ended June 30, 2008
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Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****WellPoint, Inc.****Consolidated Balance Sheets**

<i>(In millions, except share data)</i>	June 30, 2008 (Unaudited)	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	\$ 2,273.8	\$ 2,767.9
Investments available-for-sale, at fair value:		
Fixed maturity securities (amortized cost of \$1,619.7 and \$1,814.5)	1,632.4	1,832.6
Equity securities (cost of \$2,005.4 and \$1,732.7)	1,908.8	1,893.7
Other invested assets, current	40.7	40.3
Accrued investment income	163.0	165.8
Premium and self-funded receivables	3,203.4	2,870.1
Other receivables	1,274.6	996.4
Income tax receivable	53.1	0.9
Securities lending collateral	715.4	854.1
Deferred tax assets, net	669.0	559.6
Other current assets	1,106.2	1,050.4
Total current assets	13,040.4	13,031.8
Long-term investments available-for-sale, at fair value:		
Fixed maturity securities (amortized cost of \$13,031.9 and \$13,832.6)	12,781.1	13,917.3
Equity securities (cost of \$45.2 and \$43.4)	45.4	45.1
Other invested assets, long-term	789.9	752.9
Property and equipment, net	1,014.2	995.9
Goodwill	13,539.8	13,435.4
Other intangible assets	9,084.0	9,220.8
Other noncurrent assets	681.1	660.8
Total assets	\$ 50,975.9	\$ 52,060.0
Liabilities and shareholders equity		
Liabilities		
Current liabilities:		
Policy liabilities:		
Medical claims payable	\$ 6,270.3	\$ 5,788.0
Reserves for future policy benefits	65.3	63.7
Other policyholder liabilities	1,620.2	1,832.2
Total policy liabilities	7,955.8	7,683.9
Unearned income	1,054.6	1,114.6
Accounts payable and accrued expenses	2,834.4	2,909.6
Security trades pending payable	13.8	50.6
Securities lending payable	715.4	854.1
Current portion of long-term debt	19.2	20.4
Other current liabilities	1,965.0	1,755.0
Total current liabilities	14,558.2	14,388.2
Long-term debt, less current portion	9,750.1	9,023.5
Reserves for future policy benefits, noncurrent	659.0	661.9
Deferred tax liability, net	2,919.6	3,004.4
Other noncurrent liabilities	1,834.5	1,991.6

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Total liabilities	29,721.4	29,069.6
Commitments and contingencies Note 14		
Shareholders equity		
Preferred stock, without par value, shares authorized 100,000,000;		
shares issued and outstanding none		
Common stock, par value \$0.01, shares authorized 900,000,000;		
shares issued and outstanding: 512,060,500 and 556,212,039		
	5.1	5.6
Additional paid-in capital	17,078.8	18,441.1
Retained earnings	4,396.8	4,387.6
Accumulated other comprehensive (loss) income	(226.2)	156.1
Total shareholders equity	21,254.5	22,990.4
Total liabilities and shareholders equity	\$ 50,975.9	\$ 52,060.0

See accompanying notes.

Table of Contents**WellPoint, Inc.****Consolidated Statements of Income****(Unaudited)***(In millions, except per share data)*

	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
Revenues				
Premiums	\$ 14,344.9	\$ 13,935.9	\$ 28,579.3	\$ 27,693.3
Administrative fees	966.0	923.4	1,935.6	1,847.9
Other revenue	166.1	154.3	328.7	313.6
Total operating revenue	15,477.0	15,013.6	30,843.6	29,854.8
Net investment income	217.6	253.4	450.3	500.0
Net realized (losses) gains on investments	(27.8)	0.9	(73.4)	1.1
Total revenues	15,666.8	15,267.9	31,220.5	30,355.9
Expenses				
Benefit expense	11,955.6	11,405.4	24,072.1	22,835.2
Selling, general and administrative expense:				
Selling expense	445.1	429.6	889.4	852.6
General and administrative expense	1,773.5	1,830.7	3,577.8	3,539.3
Total selling, general and administrative expense	2,218.6	2,260.3	4,467.2	4,391.9
Cost of drugs	118.5	113.9	237.4	220.4
Interest expense	116.5	100.1	235.5	203.0
Amortization of other intangible assets	71.6	70.9	143.1	141.7
Total expenses	14,480.8	13,950.6	29,155.3	27,792.2
Income before income tax expense	1,186.0	1,317.3	2,065.2	2,563.7
Income tax expense	435.5	482.1	726.6	945.4
Net income	\$ 750.5	\$ 835.2	\$ 1,338.6	\$ 1,618.3
Net income per share				
Basic	\$ 1.44	\$ 1.37	\$ 2.52	\$ 2.65
Diluted	\$ 1.44	\$ 1.35	\$ 2.50	\$ 2.61

See accompanying notes.

Table of Contents**WellPoint, Inc.****Consolidated Statements of Cash Flows****(Unaudited)***(In millions)*

	Six Months Ended June 30	
	2008	2007
Operating activities		
Net income	\$ 1,338.6	\$ 1,618.3
Adjustments to reconcile net income to net cash provided by operating activities:		
Net realized losses (gains) on investments	73.4	(1.1)
Loss on disposal of assets	0.5	1.1
Deferred income taxes	26.0	(228.1)
Amortization, net of accretion	238.2	232.5
Depreciation expense	51.9	63.0
Share-based compensation	89.5	102.1
Excess tax benefits from share-based compensation	(13.6)	(127.1)
Changes in operating assets and liabilities, net of effect of business combinations:		
Receivables, net	(612.9)	(198.9)
Other invested assets, current	(0.3)	10.0
Other assets	(94.9)	(39.1)
Policy liabilities	269.0	484.8
Unearned income	(59.8)	677.8
Accounts payable and accrued expenses	(196.2)	(319.9)
Other liabilities	64.2	201.9
Income taxes	(35.1)	254.9
Other, net	6.8	(25.2)
Net cash provided by operating activities	1,145.3	2,707.0
Investing activities		
Purchases of fixed maturity securities	(4,000.4)	(5,396.2)
Proceeds from fixed maturity securities:		
Sales	3,732.8	3,828.4
Maturities, calls and redemptions	1,142.9	444.9
Purchases of equity securities	(1,049.8)	(817.1)
Proceeds from sales of equity securities	792.8	1,232.0
Changes in securities lending collateral	138.7	(80.5)
Purchases of subsidiaries, net of cash acquired	(116.5)	
Proceeds from sales of subsidiaries, net of cash sold	5.0	
Purchases of property and equipment	(156.0)	(120.1)
Proceeds from sales of property and equipment	11.3	7.6
Other, net	(43.8)	(21.6)
Net cash provided by (used in) investing activities	457.0	(922.6)
Financing activities		
Net proceeds from (repayment of) commercial paper borrowings	196.2	(296.7)
Proceeds from long-term borrowings	525.0	1,478.3
Repayment of long-term borrowings	(5.9)	(5.4)
Changes in securities lending payable	(138.7)	80.5
Changes in bank overdrafts	104.5	(145.9)
Repurchase and retirement of common stock	(2,875.2)	(1,957.7)
Proceeds from exercise of employee stock options and employee stock purchase plan	84.1	538.4

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Excess tax benefits from share-based compensation	13.6	127.1
Net cash used in financing activities	(2,096.4)	(181.4)
Change in cash and cash equivalents	(494.1)	1,603.0
Cash and cash equivalents at beginning of period	2,767.9	2,602.1
Cash and cash equivalents at end of period	\$ 2,273.8	\$ 4,205.1

See accompanying notes.

Table of Contents**WellPoint, Inc.****Consolidated Statements of Shareholders' Equity****(Unaudited)***(In millions)*

	Common Stock				Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
	Number of Shares	Par Value	Additional Paid-in Capital	Retained Earnings		
January 1, 2008	556.2	\$ 5.6	\$ 18,441.1	\$ 4,387.6	\$ 156.1	\$ 22,990.4
Net income				1,338.6		1,338.6
Change in net unrealized gains on investments					(380.4)	(380.4)
Change in net unrealized losses on cash flow hedges					(0.3)	(0.3)
Change in net periodic pension and postretirement costs					(1.6)	(1.6)
Comprehensive income						956.3
Repurchase and retirement of common stock	(46.5)	(0.5)	(1,546.6)	(1,328.1)		(2,875.2)
Issuance of common stock under employee stock plans, net of related tax benefits	2.4		184.3			184.3
Adoption of EITF 06-4				(1.3)		(1.3)
June 30, 2008	512.1	\$ 5.1	\$ 17,078.8	\$ 4,396.8	\$ (226.2)	\$ 21,254.5
January 1, 2007	615.5	\$ 6.1	\$ 19,863.5	\$ 4,656.1	\$ 50.1	\$ 24,575.8
Net income				1,618.3		1,618.3
Change in net unrealized gains on investments					(45.2)	(45.2)
Change in net unrealized losses on cash flow hedges					(1.2)	(1.2)
Change in net periodic pension and postretirement costs					4.0	4.0
Comprehensive income						1,575.9
Repurchase and retirement of common stock	(24.4)	(0.3)	(806.7)	(1,150.7)		(1,957.7)
Issuance of common stock under employee stock plans, net of related tax benefits	12.7	0.2	796.2			796.4
Adoption of FIN 48				(1.6)		(1.6)
June 30, 2007	603.8	\$ 6.0	\$ 19,853.0	\$ 5,122.1	\$ 7.7	\$ 24,988.8

See accompanying notes.

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WellPoint, Inc.

Notes to Consolidated Financial Statements

(Unaudited)

June 30, 2008

(In Millions, Except Per Share Data)

1. Organization

References to the terms we, our, us, WellPoint or the Company used throughout these Notes to Consolidated Financial Statements refer to WellPoint, Inc., an Indiana corporation, which name changed from Anthem, Inc., or Anthem, effective November 30, 2004, and unless the context otherwise requires, its direct and indirect subsidiaries.

We are the largest health benefits company in terms of medical membership in the United States, serving 35.3 million members as of June 30, 2008. We offer a broad spectrum of network-based managed care plans to large and small employer, individual, Medicaid and senior markets. Our managed care plans include preferred provider organizations, or PPOs; health maintenance organizations, or HMOs; point-of-service, or POS, plans; traditional indemnity plans and other hybrid plans, including consumer-driven health plans, or CDHPs; hospital only and limited benefit products. In addition, we provide a broad array of managed care services to self-funded customers, including claims processing, underwriting, stop loss insurance, actuarial services, provider network access, medical cost management and other administrative services. We also provide an array of specialty and other products and services such as life and disability insurance benefits, pharmacy benefit management, or PBM, specialty pharmacy, dental, vision, behavioral health benefit services, long-term care insurance and flexible spending accounts. We are licensed to conduct insurance operations in all 50 states through our subsidiaries.

We are an independent licensee of the Blue Cross and Blue Shield Association, or BCBSA, an association of independent health benefit plans, and serve our members as the Blue Cross licensee for California and as the Blue Cross and Blue Shield licensee for: Colorado, Connecticut, Georgia, Indiana, Kentucky, Maine, Missouri (excluding 30 counties in the Kansas City area), Nevada, New Hampshire, New York (as the Blue Cross Blue Shield licensee in 10 New York City metropolitan and surrounding counties and as the Blue Cross or Blue Cross Blue Shield licensee in selected upstate counties only), Ohio, Virginia (excluding the Northern Virginia suburbs of Washington, D.C.) and Wisconsin. We also serve customers throughout various parts of the country as UniCare.

2. Basis of Presentation

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles, or GAAP, for interim financial reporting. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments, including normal recurring adjustments, necessary for a fair statement of the consolidated financial statements as of and for the three and six months ended June 30, 2008 and 2007 have been recorded. The results of operations for the three and six months ended June 30, 2008 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2008. These unaudited consolidated financial statements should be read in conjunction with our audited consolidated financial statements for the year ended December 31, 2007 included in our Annual Report on Form 10-K.

Certain prior year amounts have been reclassified to conform to the current year presentation.

3. Investments

In accordance with Statement of Financial Accounting Standards (FAS) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, we classify the fixed maturity and equity securities in our investment

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portfolio as available-for-sale or trading and report those securities at fair value. We classify our investments in available-for-sale fixed maturity securities as either current or noncurrent assets based on their contractual maturities. Certain investments, which we intend to sell within the next twelve months, are carried as current without regard to their contractual maturities. Additionally, certain of our investments, which are used to satisfy contractual, regulatory or other requirements, continue to be classified as long-term, without regard to contractual maturity. The unrealized gains or losses on both our current and long-term fixed maturity and equity securities classified as available-for-sale are included in accumulated other comprehensive income as a separate component of shareholders' equity, unless the decline in value is deemed to be other-than-temporary and we do not have the intent and ability to hold such securities until their full cost can be recovered, in which case such securities are written down to fair value and the loss is charged to realized losses in current operations. We evaluate our investment securities for other-than-temporary declines based on quantitative and qualitative factors. We recorded realized losses from other-than-temporary impairments of \$121.0 and \$68.1 for the three months ended June 30, 2008 and 2007, respectively. We recorded realized losses from other-than-temporary impairments of \$197.9 and \$107.8 for the six months ended June 30, 2008 and 2007, respectively.

4. Goodwill and Other Intangible Assets

As further described in Note 12, Segment Information, we revised our reportable segments effective January 1, 2008. The reporting units for goodwill and other intangible assets were not affected by the change in our organizational structure. Therefore, no impairment test of goodwill and other intangible assets with indefinite lives was required as a result of the change in our organizational structure during the first quarter of 2008 under FAS 142, *Goodwill and Other Intangible Assets*.

During the first quarter of 2008, we revised our earnings guidance for 2008 primarily related to higher than anticipated medical costs, lower than expected fully-insured enrollment and the changing economic environment. As a result of this revised outlook, we performed an impairment review of our goodwill balances. No impairments were noted and no impairment charges were recorded. In addition, during the first quarter of 2008, we were notified by the state of California that premium increases for our Medi-Cal business were being repealed due to budgetary constraints. As a result of this notification, we also performed an impairment review of our intangible assets related to the State-Sponsored reporting unit. No impairments were noted and no impairment charges were recorded. These impairment reviews require a significant degree of management judgment and the use of subjective assumptions. The carrying amount of goodwill by reportable segment at June 30, 2008 was \$10,029.8, \$3,337.5, and \$172.5 for the Commercial, Consumer and Other segments, respectively.

5. Capital Stock***Stock Repurchase Program***

Under our Board of Directors' authorization, we maintain a common stock repurchase program. Repurchases may be made from time to time at prevailing market prices, subject to certain restrictions on volume, pricing and timing. The repurchases are effected from time to time in the open markets through negotiated transactions and through plans designed to comply with Rule 10b5-1 under the Securities Exchange Act of 1934, as amended. During the six months ended June 30, 2008, we repurchased and retired approximately 46.5 shares at an average per share price of \$61.86, for an aggregate cost of \$2,875.2. During the six months ended June 30, 2007, we repurchased and retired approximately 24.4 shares at an average per share price of \$80.36, for an aggregate cost of \$1,957.7. The excess of cost of the repurchased shares over par value is charged on a pro rata basis to additional paid-in capital and retained earnings. As of June 30, 2008, \$1,423.2 remained authorized for future repurchases. Subsequent to June 30, 2008, we repurchased and retired approximately 0.8 shares at an aggregate cost of approximately \$34.6, leaving approximately \$1,388.6 for authorized future repurchases at July 16, 2008. Our stock purchase program is discretionary as we are under no obligation to repurchase shares. We repurchase shares under the program when we believe it is a prudent use of capital.

Table of Contents**Stock Incentive Plans**

A summary of stock option activity for the six months ended June 30, 2008 is as follows:

	Number of Shares	Weighted- Average Option Price per Share	Weighted- Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2008	22.9	\$ 59.76		
Granted	5.9	66.40		
Exercised	(1.6)	32.36		
Forfeited or expired	(1.4)	74.19		
Outstanding at June 30, 2008	25.8	62.08	6.1	\$ 102.4
Exercisable at June 30, 2008	15.4	54.14	5.3	\$ 96.0

A summary of the status of nonvested restricted stock activity, including restricted stock units, for the six months ended June 30, 2008 is as follows:

	Restricted Stock Shares And Units	Weighted-Average Grant Date Fair Value per Share
Nonvested at January 1, 2008	1.5	\$ 75.42
Granted	0.9	69.38
Vested	(0.6)	64.66
Forfeited	(0.2)	76.22
Nonvested at June 30, 2008	1.6	73.50

6. Earnings per Share

The denominator for basic and diluted earnings per share for the three and six months ended June 30, 2008 and 2007 is as follows:

	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
Denominator for basic earnings per share - weighted-average shares	519.7	608.9	531.2	610.4
Effect of dilutive securities - employee and director stock options and non-vested restricted stock awards	2.9	9.0	3.9	10.1
Denominator for diluted earnings per share	522.6	617.9	535.1	620.5

During the three months ended June 30, 2008 and 2007, weighted-average shares related to certain stock options of 18.9 and 6.1, respectively, were excluded from the denominator for diluted earnings per share because the stock options were anti-dilutive. During the six months ended June 30, 2008 and 2007, weighted-average shares related to certain stock options of 15.3 and 4.2, respectively, were excluded from the

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denominator for diluted earnings per share because the stock options were anti-dilutive.

During the six months ended June 30, 2008, we issued approximately 0.9 restricted stock units under our stock incentive plans, of which 0.2 restricted stock units are contingent upon us achieving specified annual return

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on equity targets for 2008. These 0.2 restricted stock units have been excluded from the denominator for diluted earnings per share and will be included only if and when the contingency is met.

7. Income Taxes

As of June 30, 2008, as further described below, certain of our tax years remain subject to examination by the Internal Revenue Service, or IRS, and various state and local authorities. In addition, we continue to discuss certain industry issues with the IRS.

As of June 30, 2008, our 2006, 2005 and 2004 tax years are being examined by the IRS. In addition, we have several tax years for which there are ongoing disputes. We joined the IRS Compliance Assurance Process, or CAP, in 2007. The objective of CAP is to reduce taxpayer burden and uncertainty while assuring the IRS of the accuracy of tax returns prior to filing, thereby reducing or eliminating the need for post-filing examinations.

During the three months ended June 30, 2008 and 2007, we recognized income tax expense of \$435.5 and \$482.1, respectively, which represents effective tax rates of 36.7% and 36.6%, respectively. During the six months ended June 30, 2008 and 2007, we recognized income tax expense of \$726.6 and \$945.4, respectively, which represents effective tax rates of 35.2% and 36.9%, respectively. The 170 basis point reduction in the effective tax rate during the six months ended June 30, 2008 was primarily due to settlements of audit issues and associated amounts.

8. Hedging Activity

Fair Value Hedges

For the three months ended June 30, 2008 and 2007, we recognized income (expense) of \$5.4 and \$(1.7), respectively, from fair value hedges, which was recorded as a reduction (increase) to interest expense. For the six months ended June 30, 2008 and 2007, we recognized income (expense) of \$9.5 and \$(3.1), respectively, from fair value hedges, which was recorded as a reduction (increase) to interest expense.

Cash Flow Hedges

The unrecognized loss for all cash flow hedges included in accumulated other comprehensive income at June 30, 2008 was \$8.4.

9. Long-Term Debt

On April 29, 2008 we borrowed \$525.0 under a three-year senior term loan agreement, the proceeds of which may be used for general corporate purposes. The interest rate on this term loan is based on either (i) the LIBOR rate plus a predetermined percentage rate based on our credit rating, or (ii) the base rate as defined in the term loan agreement.

We have an authorized commercial paper program of up to \$2,500.0, the proceeds of which may be used for general corporate purposes. At June 30, 2008, we had \$1,994.4 outstanding under this program.

We have a senior revolving credit facility, or the facility, with certain lenders for general corporate purposes. The facility, as amended, provides credit up to \$2,500.0 (reduced for any commercial paper issuances) and matures on September 30, 2011. The interest rate on this facility is based on either (i) the LIBOR rate plus a predetermined percentage rate based on our credit rating at the date of utilization, or (ii) a base rate as defined in the facility agreement. Our ability to borrow under this facility is subject to compliance with certain covenants. There were no amounts outstanding under this facility as of June 30, 2008 or during the six months then ended. At June 30, 2008, we had \$505.6 available under this facility.

Table of Contents**10. Fair Value Measurements**

In September 2006, the Financial Accounting Standards Board, or FASB, issued FAS 157, *Fair Value Measurements*, or FAS 157. FAS 157 does not require any new fair value measurements; rather, it defines fair value, establishes a framework for measuring fair value in accordance with existing GAAP, and expands disclosures about fair value measurements. We adopted FAS 157 on January 1, 2008. The adoption of FAS 157 did not have an impact on our financial position or operating results. Assets and liabilities recorded at fair value in the consolidated balance sheets are categorized based upon the level of judgment associated with the inputs used to measure their fair value. Level inputs, as defined by FAS 157, are as follows:

Level Input:	Input Definition:
Level I	Inputs are unadjusted, quoted prices for identical assets or liabilities in active markets at the measurement date.
Level II	Inputs other than quoted prices included in Level I that are observable for the asset or liability through corroboration with market data at the measurement date.
Level III	Unobservable inputs that reflect management's best estimate of what market participants would use in pricing the asset or liability at the measurement date.

The following table summarizes fair value measurements by level at June 30, 2008 for assets and liabilities measured at fair value on a recurring basis:

	Level I	Level II	Level III	Total
Cash equivalents	\$ 1,746.2	\$	\$	\$ 1,746.2
Investments available-for-sale:				
Fixed maturity securities	250.8	13,944.5	218.2	14,413.5
Equity securities	1,844.8	103.5	5.9	1,954.2
Other invested assets, current	40.7			40.7
Derivatives (reported with other noncurrent assets)		38.4		38.4
Total assets	\$ 3,882.5	\$ 14,086.4	\$ 224.1	\$ 18,193.0
Derivatives (reported with other noncurrent liabilities)	\$	\$ 2.7	\$	\$ 2.7
Total liabilities	\$	\$ 2.7	\$	\$ 2.7

A reconciliation of the beginning and ending balances of assets measured at fair value on a recurring basis using Level III inputs for the three months ended June 30, 2008 is as follows:

	Level III Fair Value Measurements		
	Fixed Maturity Securities	Equity Securities	Total
Beginning balance at April 1, 2008	\$ 257.9	\$ 6.1	\$ 264.0
Total gains and losses			
Realized in net income	(6.9)		(6.9)
Unrealized in accumulated other comprehensive income	(18.0)	(0.1)	(18.1)
Purchases, sales, issuances and settlements	(14.8)	(0.1)	(14.9)
Transfers in (out) of Level III			
Ending balance at June 30, 2008	\$ 218.2	\$ 5.9	\$ 224.1

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Change in unrealized losses included in net income related to assets
still held

\$ (6.0)

\$

\$ (6.0)

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A reconciliation of the beginning and ending balances of assets measured at fair value on a recurring basis using Level III inputs for the six months ended June 30, 2008 is as follows:

	Level III Fair Value Measurements		
	Fixed Maturity Securities	Equity Securities	Total
Beginning balance at January 1, 2008	\$ 0.9	\$ 6.1	\$ 7.0
Total gains and losses			
Realized in net income	(6.9)		(6.9)
Unrealized in accumulated other comprehensive income	(18.0)	(0.1)	(18.1)
Purchases, sales, maturities, calls and redemptions	(14.8)	(0.1)	(14.9)
Transfers into Level III	257.0		257.0
Ending balance at June 30, 2008	\$ 218.2	\$ 5.9	\$ 224.1
Change in unrealized losses included in net income related to assets still held	\$ (6.0)	\$	\$ (6.0)

During the six months ended June 30, 2008, certain mortgage-backed and asset-backed securities were thinly traded due to concerns in the securities markets and the resulting lack of liquidity. Consequently, broker quotes or other observable inputs were not always available and the fair value of these securities were estimated using internal estimates for inputs including, but not limited to, prepayment speeds, credit spreads, default rates and benchmark yields.

11. Retirement Benefits

The components of net periodic benefit (credit) cost included in the consolidated statements of income for the three months ended June 30, 2008 and 2007 are as follows:

	Pension Benefits		Other Benefits	
	2008	2007	2008	2007
Service cost	\$ 7.6	\$ 9.2	\$ 1.4	\$ 1.7
Interest cost	25.0	25.4	8.2	8.9
Expected return on assets	(38.7)	(38.6)	(0.9)	(0.8)
Recognized actuarial loss		0.1	1.3	0.7
Amortization of prior service (credit) cost	(0.2)	0.2	(2.4)	(0.9)
Curtailement (gain) loss	(1.4)	6.1		(0.6)
Net periodic benefit (credit) cost	\$ (7.7)	\$ 2.4	\$ 7.6	\$ 9.0

The components of net periodic benefit (credit) cost included in the consolidated statements of income for the six months ended June 30, 2008 and 2007 are as follows:

	Pension Benefits		Other Benefits	
	2008	2007	2008	2007
Service cost	\$ 15.2	\$ 18.8	\$ 2.9	\$ 4.1
Interest cost	49.9	51.0	16.4	17.5
Expected return on assets	(77.4)	(76.2)	(1.8)	(1.6)
Recognized actuarial loss		0.4	2.6	1.8

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Amortization of prior service (credit) cost	(0.4)	0.4	(4.8)	(1.6)
Curtailement (gain) loss	(1.4)	6.1		(0.6)
Net periodic benefit (credit) cost	\$ (14.1)	\$ 0.5	\$ 15.3	\$ 19.6

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For the year ending December 31, 2008, no contributions are expected to be necessary to meet the Employee Retirement Income Security Act, or ERISA, required funding levels; however, we may elect to make discretionary contributions up to the maximum amount deductible for income tax purposes. No contributions to retirement benefit plans were made during the three or six months ended June 30, 2008.

During the three months ended June 30, 2008, we incurred a curtailment gain of \$1.4 within one of our supplemental pension plans.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements*, or EITF 06-4. EITF 06-4 requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants' employment or retirement. The required accrued liability is based on either the post-employment benefit cost for the continuing life insurance or the future death benefit depending on the contractual terms of the underlying agreement. We adopted EITF 06-4 on January 1, 2008, and recorded a cumulative effect adjustment of \$1.3 as a reduction of retained earnings effective January 1, 2008.

12. Segment Information

Our organizational structure has three strategic business units: a Commercial Business unit, a Consumer Business unit and a Comprehensive Health Solutions Business unit. Based on our organizational structure, we are organized around three reportable segments: Commercial; Consumer; and Other. We revised our reportable segments during the first quarter of 2008 in accordance with a new organizational structure implemented on January 1, 2008, which reflects how the chief operating decision maker evaluates the performance of our business. Segment disclosures for 2007 have been reclassified to conform to the 2008 presentation.

Our Commercial and Consumer segments both offer a diversified mix of managed care products, including PPOs, HMOs, traditional indemnity benefits and POS plans, as well as a variety of hybrid benefit plans, including CDHPs, hospital only and limited benefit products.

Our Commercial segment includes Local Group (including UniCare), National Accounts and certain other business operations (dental, vision, life and disability and workers' compensation). Business units in the Commercial segment provide a broad array of managed care services to self-funded customers, including claims processing, underwriting, stop loss insurance, actuarial services, provider network access, medical cost management and other administrative services.

Our Consumer segment includes Senior, State-Sponsored and Individual business. Senior business includes services such as Medicare Part D, Medicare Advantage and Medicare Supplement, while State-Sponsored includes our Medicaid business.

Our Other segment includes the Comprehensive Health Solutions Business unit that brings together our resources focused on optimizing the quality of health care and cost of care management. The Comprehensive Health Solutions Business unit includes provider relations, care and disease management, behavioral health, employee assistance programs and our PBM business, which includes NextRx, and our specialty pharmacy, PrecisionRx Specialty Solutions. Our Other segment also includes results from our Federal Government Solutions, or FGS, business. FGS business includes the Federal Employee Program, or FEP, and National Government Services, Inc., or NGS, which acts as a Medicare contractor in several regions across the nation. The Other segment also includes other businesses that do not meet the quantitative thresholds for an operating segment as defined in FAS 131, *Disclosures about Segments of an Enterprise and Related Information*, as well as intersegment sales and expense eliminations and corporate expenses not allocated to the other reportable segments.

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Financial data by reportable segment for the three and six months ended June 30, 2008 and 2007 is as follows:

	Commercial	Consumer	Other and Eliminations	Total
Three Months Ended June 30, 2008				
Operating revenue from external customers	\$ 9,517.1	\$ 4,144.0	\$ 1,815.9	\$ 15,477.0
Intersegment revenue			697.5	697.5
Elimination of intersegment revenue			(697.5)	(697.5)
Operating gain	820.7	223.7	139.9	1,184.3
Three Months Ended June 30, 2007				
Operating revenue from external customers	\$ 9,533.4	\$ 3,808.9	\$ 1,671.3	\$ 15,013.6
Intersegment revenue			565.8	565.8
Elimination of intersegment revenue			(565.8)	(565.8)
Operating gain	928.8	212.0	93.2	1,234.0
Six Months Ended June 30, 2008				
Operating revenue from external customers	\$ 19,005.3	\$ 8,244.0	\$ 3,594.3	\$ 30,843.6
Intersegment revenue			1,362.8	1,362.8
Elimination of intersegment revenue			(1,362.8)	(1,362.8)
Operating gain	1,704.4	99.5	263.0	2,066.9
Six Months Ended June 30, 2007				
Operating revenue from external customers	\$ 18,989.0	\$ 7,535.3	\$ 3,330.5	\$ 29,854.8
Intersegment revenue			1,074.5	1,074.5
Elimination of intersegment revenue			(1,074.5)	(1,074.5)
Operating gain	1,843.9	356.0	207.4	2,407.3

A reconciliation of reportable segments operating revenues to total revenues reported in the consolidated statements of income for the three and six months ended June 30, 2008 and 2007 is as follows:

	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
Reportable segments operating revenues	\$ 15,477.0	\$ 15,013.6	\$ 30,843.6	\$ 29,854.8
Net investment income	217.6	253.4	450.3	500.0
Net realized (losses) gains on investments	(27.8)	0.9	(73.4)	1.1
Total revenues	\$ 15,666.8	\$ 15,267.9	\$ 31,220.5	\$ 30,355.9

A reconciliation of reportable segments operating gain to income before income tax expense included in the consolidated statements of income for the three and six months ended June 30, 2008 and 2007 is as follows:

	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
Reportable segments operating gain	\$ 1,184.3	\$ 1,234.0	\$ 2,066.9	\$ 2,407.3
Net investment income	217.6	253.4	450.3	500.0
Net realized (losses) gains on investments	(27.8)	0.9	(73.4)	1.1
Interest expense	(116.5)	(100.1)	(235.5)	(203.0)
Amortization of other intangible assets	(71.6)	(70.9)	(143.1)	(141.7)

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Income before income tax expense	\$ 1,186.0	\$ 1,317.3	\$ 2,065.2	\$ 2,563.7
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Table of Contents**13. Comprehensive Income**

The components of comprehensive income for the three and six months ended June 30, 2008 and 2007 are as follows:

	Three Months Ended June 30		Six Months Ended June 30	
	2008	2007	2008	2007
Net income	\$ 750.5	\$ 835.2	\$ 1,338.6	\$ 1,618.3
Change in net unrealized losses on investments	(219.1)	(97.3)	(380.4)	(45.2)
Change in net unrealized losses on cash flow hedges	(0.2)	(0.6)	(0.3)	(1.2)
Change in net periodic pension and postretirement costs	(0.8)	3.3	(1.6)	4.0
Comprehensive income	\$ 530.4	\$ 740.6	\$ 956.3	\$ 1,575.9

14. Commitments and Contingencies**Litigation**

In July 2005, we entered into a settlement agreement with representatives of more than 700,000 physicians nationwide to resolve certain cases brought by physicians. The cases resolved were known as the CMA Litigation, the Shane Litigation, the Thomas Litigation (*Kenneth Thomas, M.D., et al. vs. Blue Cross Blue Shield Association, et al.*) and certain other similar cases brought by physicians. Final monetary payments were made in October 2006. Following its acquisition in 2005, WellChoice, Inc., or WellChoice, was merged with and into a wholly-owned subsidiary of WellPoint. Since the WellChoice transaction closed on December 28, 2005, after we reached settlement with the plaintiffs, WellChoice continued to be a defendant in the Thomas (now known as Love) Litigation and was not affected by the prior settlement between us and plaintiffs. The Love Litigation alleged that the BCBSA and the Blue Cross and Blue Shield plans violated the Racketeer Influenced and Corrupt Organizations Act, or RICO. On April 27, 2007, we, along with 22 other Blue Cross and Blue Shield plans and the BCSBA, announced a settlement of the Love Litigation. The Court granted final approval of the settlement on April 20, 2008. The settlement did not have a material effect on our consolidated financial position or results of operations.

Prior to WellPoint Health Network Inc. s, or WHN s, acquisition of the group benefit operations, or GBO, of John Hancock Mutual Life Insurance Company, or John Hancock, John Hancock entered into a number of reinsurance arrangements, including with respect to personal accident insurance and the occupational accident component of workers' compensation insurance, a portion of which was originated through a pool managed by Unicovert Managers, Inc. Under these arrangements, John Hancock assumed risks as a reinsurer and transferred certain of such risks to other companies. Similar reinsurance arrangements were entered into by John Hancock following WHN s acquisition of the GBO of John Hancock. These various arrangements have become the subject of disputes, including a number of legal proceedings to which John Hancock is a party. We were in arbitration with John Hancock regarding these arrangements. The arbitration panel s Phase I ruling addressed liability. In April 2007, the arbitration panel issued a Phase II ruling stating the amount we owe to John Hancock for losses and expenses John Hancock paid through June 30, 2006. The panel further outlined a process for determining our liability for losses and expenses paid after June 30, 2006, which liability has not yet been determined. We filed a Petition to Confirm, which was granted by the Court. John Hancock has filed a notice of appeal with the Seventh Circuit Court of Appeals. We believe that the liability that may result from this matter is unlikely to have a material adverse effect on our consolidated financial condition or results of operations.

In various California state courts, we are defending a number of individual lawsuits, including one filed by the Los Angeles City Attorney, and four purported class actions alleging the wrongful rescission of individual insurance policies. The suits name WellPoint as well as Blue Cross of California, or BCC, and BC Life & Health

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Insurance Company, or BCL&H (which name changed to Anthem Blue Cross Life and Health Insurance Company in July 2007), both WellPoint subsidiaries. The lawsuits generally allege breach of contract, bad faith and unfair business practices in a purported practice of rescinding new individual members following the submission of large claims. The parties have agreed to mediate most of these lawsuits and the mediation has resulted in the resolution of some of these lawsuits. In addition, the California Department of Managed Health Care and California Department of Insurance are conducting investigations of the allegations. In February 2007, the California Department of Managed Health Care issued its final report in which it indicated its intention to impose a monetary penalty against BCC of \$1.0. In June 2007, the California Department of Insurance issued its final report in which it issued a number of citations alleging violations of fair-claims handling laws.

In various California state courts, several hospitals have filed suits against BCC and WHN for payment of claims denied where the member's insurance policy was rescinded. In addition, a purported class action has been filed against BCC, BCL&H and WHN in a California state court on behalf of hospitals. This suit also seeks to recover for payment of claims denied where the member was rescinded.

On July 11, 2008, preliminary approval of a class settlement was granted by the court in the purported class actions filed in California state court against BCC, BCL&H and WHN on behalf of California hospitals. Final approval of the settlement with the hospital plaintiffs is scheduled for hearing in September 2008. In addition, on July 17, 2008 we announced a tentative settlement with the California Department of Managed Health Care regarding the Department's investigation of rescission practices. Pursuant to the settlement, BCC will offer prospective coverage, without medical underwriting, to approximately 1,770 rescinded members. BCC also agreed to a procedure whereby these individuals could, under certain circumstances, be reimbursed for past medical expenses. BCC also agreed to pay a \$10.0 fine. Neither of these settlements, individually or collectively, is expected to have a material adverse effect on our consolidated financial condition or results of operations.

Other Contingencies

From time to time, we and certain of our subsidiaries are parties to various legal proceedings, many of which involve claims for coverage encountered in the ordinary course of business. We, like HMOs and health insurers generally, exclude certain health care services from coverage under our HMO, PPO and other plans. We are, in the ordinary course of business, subject to the claims of our enrollees arising out of decisions to restrict or deny reimbursement for uncovered services. The loss of even one such claim, if it results in a significant punitive damage award, could have a material adverse effect on us. In addition, the risk of potential liability under punitive damage theories may increase significantly the difficulty of obtaining reasonable settlements of coverage claims.

In addition to the lawsuits described above, we are also involved in other pending and threatened litigation of the character incidental to our business transacted, arising out of our operations and our 2001 demutualization, and are from time to time involved as a party in various governmental investigations, audits, reviews and administrative proceedings. These investigations, audits and reviews include routine and special investigations by state insurance departments, state attorneys general and the U.S. Attorney General. Such investigations could result in the imposition of civil or criminal fines, penalties and other sanctions. We believe that any liability that may result from any one of these actions, or in the aggregate, is unlikely to have a material adverse effect on our consolidated financial position or results of operations.

Contractual Obligations and Commitments

We have entered into certain agreements with International Business Machines Corporation, or IBM, to provide information technology infrastructure services. These services were previously performed in-house. Our remaining commitment under these contracts at June 30, 2008 is approximately \$746.8 over a five year period. We have the ability to terminate these agreements upon the occurrence of certain events, subject to certain early termination fees.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

References to the terms we, our, us or the Company used throughout this Management's Discussion and Analysis of Financial Condition and Results of Operations, or MD&A, refer to WellPoint, Inc. (name changed from Anthem, Inc. effective November 30, 2004), an Indiana corporation, and unless the context otherwise requires, its direct and indirect subsidiaries.

Certain prior year amounts have been reclassified to conform to the current year presentation.

The structure of our MD&A is as follows:

- I. Executive Summary

- II. Overview

- III. Significant Transactions

- IV. Membership June 30, 2008 Compared to June 30, 2007

- V. Cost of Care

- VI. Results of Operations Three Months Ended June 30, 2008 Compared to the Three Months Ended June 30, 2007

- VII. Results of Operations Six Months Ended June 30, 2008 Compared to the Six Months Ended June 30, 2007

- VIII. Critical Accounting Policies and Estimates

- IX. Liquidity and Capital Resources

- X. Safe Harbor Statement Under the Private Securities Litigation Reform Act of 1995

I. Executive Summary

We are the largest health benefits company in terms of medical membership in the United States, serving 35.3 million members as of June 30, 2008. We are an independent licensee of the Blue Cross and Blue Shield Association, or BCBSA, an association of independent health benefit plans. We serve our members as the Blue Cross licensee in California and as the Blue Cross and Blue Shield, or BCBS, licensee for: Colorado, Connecticut, Georgia, Indiana, Kentucky, Maine, Missouri (excluding 30 counties in the Kansas City area), Nevada, New Hampshire, New York (as the Blue Cross Blue Shield licensee in 10 New York City metropolitan and surrounding counties, and as the Blue Cross or Blue Cross Blue Shield licensee in selected upstate counties only), Ohio, Virginia (excluding Northern Virginia suburbs of Washington, D.C.) and Wisconsin. We also serve customers throughout the country as UniCare. We are licensed to conduct insurance operations in all 50 states through our subsidiaries.

Operating revenue for the three months ended June 30, 2008 was \$15.5 billion, an increase of \$0.5 billion, or 3%, over the three months ended June 30, 2007. Operating revenue for the six months ended June 30, 2008 was \$30.8 billion, an increase of \$0.9 billion, or 3% over the six

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months ended June 30, 2007. These increases were primarily driven by premium rate increases for all medical lines of business, growth in our Medicare Advantage business and increased reimbursement in the FEP program. These increases were partially offset by the loss of the New York State prescription drug contract, fully-insured membership declines in National Accounts and Local Group businesses, including UniCare, the conversion of the Connecticut Medicaid program from fully-insured to self-funded and our exit from the Ohio Covered Families and Children Medicaid program, or Ohio CFC program, on April 1, 2008.

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Net income for the three months ended June 30, 2008 was \$750.5 million, a 10% decrease over the three months ended June 30, 2007. Our fully-diluted earnings per share, or EPS, was \$1.44 for the three months ended June 30, 2008, which included \$0.03 per share of net realized investment losses and was a 7% increase over the EPS of \$1.35 for the three months ended June 30, 2007. The decline in net income reflects higher medical costs, which are further described below. The increase in EPS was the result of having fewer shares outstanding during 2008. The shares outstanding declined primarily due to share buyback activity resulting from our share repurchase program. Net income for the six months ended June 30, 2008 was \$1.3 billion, a 17% decrease over the six months ended June 30, 2007. Our fully-diluted EPS was \$2.50 for the six months ended June 30, 2008, which included \$0.09 per share of net realized investment losses and was 4% less than the EPS of \$2.61 for the six months ended June 30, 2007. The decline in net income and EPS reflect higher medical costs, which are further described below, with the decline in EPS being partially offset by the impact of our share repurchase program.

Operating cash flow for the six months ended June 30, 2008 was \$1.1 billion, or 0.9 times net income. Operating cash flow for the six months ended June 30, 2007 was \$2.7 billion, or 1.7 times net income. The decrease in operating cash flow from 2007 was driven primarily by the timing of payments from the Centers for Medicare and Medicaid Services, or CMS, the timing of collecting our self-funded receivables, increases in other accounts receivables due to a delay in reimbursements from other BCBSA plans, lower net income in 2008 compared to 2007 and lower tax deductions related to reduced stock option exercises. During 2007, the operating cash flow included the receipt of additional CMS payments related to the third quarter of 2007. This similar payment in 2008 was received in July 2008. The 2007 operating cash flow would have been approximately 1.3 times net income if these additional payments were excluded. The increase in receivables was due to membership growth, certain contractual modifications and other actions we have taken in response to our system migrations. We expect this increase in receivables to decline in the latter half of 2008 as we continue to collect our receivables. The reduction in net income reflects higher medical costs, which are further described below.

II. Overview

Beginning January 1, 2008, we implemented a new organizational structure designed to support our strategic plan, which reflects how our chief operating decision maker evaluates the performance of our business. As a result of this new organizational structure, we manage our operations through three reportable segments: Commercial; Consumer; and Other. For additional information, see Note 12 to our unaudited consolidated financial statements as of and for the three and six months ended June 30, 2008 included in this Quarterly Report on Form 10-Q.

Our Commercial and Consumer segments both offer a diversified mix of managed care products, including preferred provider organizations, or PPOs; health maintenance organizations, or HMOs; traditional indemnity benefits and point-of-service plans, or POS plans; a variety of hybrid benefit plans, including consumer-driven health plans, or CDHPs, hospital only and limited benefit products.

Our Commercial segment includes Local Group, National Accounts, UniCare and certain other business operations (dental, vision, life and disability and workers' compensation). Business units in the Commercial segment provide a broad array of managed care services to self-funded customers, including claims processing, underwriting, stop loss insurance, actuarial services, provider network access, medical cost management and other administrative services.

Our Consumer segment includes Senior, State-Sponsored and Individual business. Senior business includes services such as Medicare Part D, Medicare Advantage, and Medicare Supplement, while State-Sponsored includes our Medicaid business.

Our Other segment includes our Comprehensive Health Solutions Business unit that brings together our resources focused on optimizing the quality of health care and cost of care management. The Comprehensive Health Solutions Business unit includes provider relations, care and disease management, behavioral health,

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employee assistance programs and our pharmacy benefit management, or PBM, business, which includes NextRx, and our specialty pharmacy, PrecisionRx Specialty Solutions. Our Other segment also includes results from our Federal Government Solutions, or FGS, business. Our FGS business includes the FEP and National Government Services, Inc., or NGS, which acts as a Medicare contractor in several regions across the nation. The Other segment also includes other businesses that do not meet the quantitative thresholds for an operating segment as defined in Statement of Financial Accounting Standards (FAS) No. 131, *Disclosures about Segments of an Enterprise and Related Information*, as well as intersegment sales and expense eliminations and corporate expenses not allocated to the other reportable segments.

Our operating revenue consists of premiums, administrative fees and other revenue. Premium revenue comes from fully-insured contracts where we indemnify our policyholders against costs for covered health and life benefits. Administrative fees come from contracts where our customers are self-insured, or where the fee is based on either processing of transactions or a percent of network discount savings realized. Additionally, we earn administrative fee revenues from our Medicare processing business and from other health-related businesses, including disease management programs. Other revenue is principally generated from member co-payments and deductibles associated with the mail-order sale of drugs by our pharmacy benefit management companies.

Our benefit expense primarily includes costs of care for health services consumed by our members, such as outpatient care, inpatient hospital care, professional services (primarily physician care) and pharmacy benefit costs. All four components are affected both by unit costs and utilization rates. Unit costs include the cost of outpatient medical procedures per visit, inpatient hospital care per admission, physician fees per office visit and prescription drug prices. Utilization rates represent the volume of consumption of health services and typically vary with the age and health status of our members and their social and lifestyle choices, along with clinical protocols and medical practice patterns in each of our markets. A portion of benefit expense recognized in each reporting period consists of actuarial estimates of claims incurred but not yet paid by us. Any changes in these estimates are recorded in the period the need for such an adjustment arises. While we offer a diversified mix of managed care products, including PPO, HMO, POS and CDHP products, our aggregate cost of care can fluctuate based on a change in the overall mix of these products. Over the last few years, CDHP products have become more popular. CDHP products tend to have a lower benefit expense due to the benefit design of these products. It is possible the continued growth of CDHP products could influence our aggregate cost of care trends in future periods.

Our selling expense consists of external broker commission expenses and generally varies with premium volume. Our general and administrative expense consists of fixed and variable costs. Examples of fixed costs are depreciation, amortization and certain facilities expenses. Other costs are variable or discretionary in nature. Certain variable costs, such as premium taxes, vary directly with premium volume. Other variable costs, such as salaries and benefits, do not vary directly with changes in premium, but are more aligned with changes in membership. The acquisition or loss of a significant block of business would likely impact staffing levels, and thus associate compensation expense. Examples of discretionary costs include professional and consulting expenses and advertising. Other factors can impact our administrative cost structure, including systems efficiencies, inflation and changes in productivity.

Our cost of drugs consists of the amounts we pay to pharmaceutical companies for the drugs we sell via mail order through our PBM and specialty pharmacy companies. This amount excludes the cost of drugs related to affiliated health customers recorded in benefit expense. Our cost of drugs can be influenced by the volume of prescriptions at our PBM, as well as cost changes, driven by prices set by pharmaceutical companies and the mix of drugs sold.

Our results of operations depend in large part on our ability to accurately predict and effectively manage health care costs through effective contracting with providers of care to our members and our medical management programs. Several economic factors related to health care costs, such as regulatory mandates of

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coverage and direct-to-consumer advertising by providers and pharmaceutical companies, have a direct impact on the volume of care consumed by our members. The potential effect of escalating health care costs as well as any changes in our ability to negotiate competitive rates with our providers may impose further risks on our ability to profitably underwrite our business, and may have a material impact on our results of operations.

During early 2008, we experienced higher than expected medical costs in several business lines, including less favorable than expected prior year reserve development. We also experienced lower than expected fully-insured enrollment, primarily due to declines in our National and Local Group membership, including UniCare, and Individual membership. Additionally, our results of operations were impacted by the changing economic environment. The impact of these factors on the results of operations is discussed throughout this MD&A. Certain of these impacts on medical costs may continue for the remainder of 2008. We continue to evaluate the long-term impact of these factors on our medical cost trend and overall results of operations.

This MD&A should be read in conjunction with our audited consolidated financial statements as of and for the year ended December 31, 2007 and the MD&A included in our 2007 Annual Report on Form 10-K as filed with the U.S. Securities and Exchange Commission, or SEC, and in conjunction with our unaudited consolidated financial statements and accompanying notes as of and for the three and six months ended June 30, 2008 included in this Quarterly Report on Form 10-Q. Results of operations, cost of care trends, investment yields and other measures for the three and six month periods ended June 30, 2008 are not necessarily indicative of the results and trends that may be expected for the full year ending December 31, 2008.

III.