Report of Management on Blue Cross and Blue Shield of Massachusetts, Inc.'s Internal Control Over Financial Reporting

April 2, 2007

We, as members of management of Blue Cross and Blue Shield of Massachusetts, Inc., (the Company) are responsible for establishing and maintaining effective internal control over financial reporting. Internal control is designed to provide reasonable assurance to the Company's management and Board of Directors regarding the preparation of reliable published financial statements in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance. Internal control over financial reporting includes self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

Because of inherent limitations in any internal control, no matter how well-designed, misstatements due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed the Company's internal control as of December 31, 2006 based on criteria for effective internal control over financial reporting described in "Internal Control–Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, we assert that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on the COSO criteria.

Ernst & Young LLP audited the Company's financial statements and has issued an attestation report on management's assessment of the Company's internal control over financial reporting. The attestation is included in our annual report.

Blue Cross and Blue Shield of Massachusetts, Inc.

by ______________________

Cleve Killingsworth, Jr., President and Chief Executive Officer

by Allen Maltz

Allen Maltz, Executive Vice President and Chief Financial Officer

by Brett Painchaud

Brett Painchaud, Vice President and Controller

by William T. Cushing Jr.

William T. Cushing, Jr., Senior Vice President and Chief Audit Executive

Auditors Opinion on Management's Assessment and the Effectiveness of Internal Control over Financial Reporting

Board of Directors
Blue Cross and Blue Shield of Massachusetts, Inc.

We have audited management's assessment, included in the accompanying Report of Management's Internal Control Over Financial Reporting, that Blue Cross and Blue Shield of Massachusetts, Inc. (the Company) maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over statutory financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance. A company's internal control over statutory financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisitions, use, or disposition of the company's assets that could have a material effect on the statutory financial statements.

Because of its inherent limitations, internal control over statutory financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over statutory financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, the Company maintained, in all material respects, effective internal control over statutory financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States), the statutory-basis balance sheet of Blue Cross and Blue Shield of Massachusetts, Inc. at December 31, 2006 and 2005, and the related statutory-basis statements of income, changes in surplus and cash flow for the years then ended and our report dated April 20, 2007 expressed an unqualified opinion thereon.

Ernst + Young LLP

Boston, Massachusetts
April 20, 2007

Report of Management on Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.'s Internal Control Over Financial Reporting

April 2, 2007

We, as members of management of Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc., (the Company) are responsible for establishing and maintaining effective internal control over financial reporting. Internal control is designed to provide reasonable assurance to the Company's management and Board of Directors regarding the preparation of reliable published financial statements in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance. Internal control over financial reporting includes self-monitoring mechanisms, and actions are taken to correct deficiencies as they are identified.

Because of inherent limitations in any internal control, no matter how well-designed, misstatements due to error or fraud may occur and not be detected, including the possibility of the circumvention or overriding of controls. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, internal control effectiveness may vary over time.

Management assessed the Company's internal control as of December 31, 2006 based on criteria for effective internal control over financial reporting described in "Internal Control–Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, we assert that the Company maintained effective internal control over financial reporting as of December 31, 2006 based on the COSO criteria.

Ernst & Young LLP audited the Company's financial statements and has issued an attestation report on management's assessment of the Company's internal control over financial reporting. The attestation is included in our annual report.

Blue Cross and Blue Shield of Massachusetts, Inc.

by ______________________

Cleve Killingsworth, Jr., President and Chief Executive Officer

by Allen Maltz

Allen Maltz, Executive Vice President and Chief Financial Officer

by Brett Painchaud

Brett Painchaud, Vice President and Controller

by William T. Cushing Jr.

William T. Cushing, Jr., Senior Vice President and Chief Audit Executive

Auditors Opinion on Management's Assessment and the Effectiveness of Internal Control over Financial Reporting

Board of Directors
Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

We have audited management's assessment, included in the accompanying Report of Management's Internal Control Over Financial Reporting, that Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. (the Company) maintained effective internal control over financial reporting as of December 31, 2006 based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over statutory financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance. A company's internal control over statutory financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisitions, use, or disposition of the company's assets that could have a material effect on the statutory financial statements.

Because of its inherent limitations, internal control over statutory financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over statutory financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also in our opinion, the Company maintained, in all material respects, effective internal control over statutory financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States), the statutory-basis balance sheets of Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. at December 31, 2006 and 2005 and the related statutory-basis statements of income, changes in surplus and cash flow for the years then ended and our report dated April 20, 2007 expressed an unqualified opinion thereon.

Ernst + Young LLP

Boston, Massachusetts
April 20, 2007

2006 Report of the Human Resources Committee on Compensation

Competitive Compensation Assessment

For the last 12 years, BCBSMA has conducted regular annual reviews of competitive compensation levels for associates and leaders. Watson Wyatt & Company conducted the 2006 review of the compensation programs for the Human Resources Committee (HRC) of the Board of Directors which is responsible for ensuring that BCBSMA's compensation and benefits reflect best-practices. As part of their work, Watson and Wyatt evaluates and approves the compensation and benefits of the President and CEO as well as the members of the Executive Leadership Team.

Watson Wyatt is a global consulting firm focused on human capital and financial management, specializing in employee benefits, human capital strategies, technology solutions, and insurance and financial services. The HRC engaged Watson Wyatt directly, and it annually commissions a competitive assessment of Blue Cross Blue Shield of Massachusetts (BCBSMA) compensation programs. Watson Wyatt is an independent firm and is hired by the HRC for the single purpose of informing and assessing our compensation practices and programs. Watson Wyatt has no other engagement with BCBSMA.

The 2006 review was designed to determine whether current BCBSMA programs continue to be reasonable given BCBSMA's business direction and current market practice. To the greatest extent possible, the methodology for Wyatt's review has remained unchanged, focusing on similar data sources as in prior years. The review focused on:

- Current compensation philosophy which ensures that BCBSMA is fiscally responsible and reflects BCBSMA dual commitment to our members *and* to achieving the solid financial performance required to fulfill our obligations to our members and the providers who serve them,
- Base salary structure and administrative guidelines; and
- Incentive pay provided through the Associate Performance Plan, Leadership Performance Plan, and Long-Term Incentive Plan (short-term and long-term incentive programs).

Watson Wyatt concluded that the current philosophy and programs serve the organization well and are consistent with competitive market practices. BCBSMA programs are effectively designed to provide sufficient flexibility to respond to market trends over time. Continued consideration should be given to the short-term and long-term incentive performance measures to ensure that the programs continue to support BCBSMA's business needs and are aligned with current strategic objectives. The HRC will continue to evaluate programs on an ongoing basis relative to market trends and business needs.

Compensation Philosophy and Programs

BCBSMA's 2006 compensation philosophy, was most recently reviewed and approved by the HRC in November 2005. The review indicated that the philosophy continued to effectively support business needs and reflected leading market practice. The HRC appreciates the cost and cash flow components of all the compensation and benefits programs.

Key elements of the philosophy are:

- Provide competitive compensation opportunities (salary and incentives) sufficient to attract and retain high-quality associates and to motivate them to achieve superior performance in a not-for-profit organization.
- Place a significant portion of compensation at reasonable risk through incentive plans for associates in leadership positions.
- Provide *all* associates with the opportunity to supplement competitive base salaries.
- Support business plans and strategies with effective compensation arrangements.
- Ensure compensation results that are responsible and consistent with sound business practices found in other large, multi-product, billion-dollar organizations
- Ensure that no more than reasonable compensation is paid by linking incentive payments first to overall corporate performance and second to individual performance as assessed by each individual's leader; for the President, CEO and Executive Leadership Team, the HRC reviews each individual's respective performance assessment and total compensation.

How Current Programs Support the Philosophy

BCBSMA's current programs effectively support the compensation philosophy as follows:

BCBSMA PHILOSOPHY	PROGRAM
Provide competitive compensation opportunities sufficient to attract and retain high-quality associates.	The base pay program targets median compensation levels based on industry and/or local market practice.
Place a significant portion of compensation at reasonable risk through incentive plans for associates in leadership positions.	The Leadership Performance Plan provides leaders with an incentive opportunity targeted at 10% to 75% of base salary. In combination with the Long-Term Incentive Plan, with its incentive opportunity targeted at 10% to 100%, the programs encourage a balance between short-term business goals and long-term organization objectives
Provide all associates with the opportunity to supplement base salaries through an incentive plan. (Also supports motivation to achieve superior performance.)	The Associate Performance Plan provides all associates in non-leadership positions with an incentive opportunity targeted at 4% of base salary. BCBSMA also provides a wide range of additional recognition programs targeted at specific business groups and recognizing key accomplishments within those groups.
Support business plans and strategies with effective compensation arrangements.	The incentive plans provide a platform for communicating the Company's goals and rewarding their achievement. The plans are designed to focus associates on desired behaviors and link overall compensation with demonstrated results.
Ensure compensation results that are responsible and consistent with sound business practices.	BCBSMA uses flexible compensation policies and procedures that permit the organization to compete effectively for essential talent. The elements employed in the current compensation program are consistent with prevalent industry practice.

Base Salary Structure

BCBSMA targets base salary at median market levels, which is consistent with market practice. The base pay structure and administrative practices generally align well with other organizations.

Annual Incentive Plans

As part of fulfilling its compensation philosophy, BCBSMA provides annual incentive opportunities to all associates, through a combination of the Leadership Performance Plan and the Associate Performance Plan. Awards for 2006 were based on Statutory Net Income, Member Satisfaction, and Loyalty measures, as well as progress against our strategic plan, all key indicators of BCBSMA's success. BCBSMA extends annual incentives further down in the organization than many other firms do.

Long-Term Incentive Plan

In addition to the short-term incentive plans, the Long-Term Incentive Plan (for selected senior leaders) bases awards on company performance and provides a key element in the attraction and retention of talented executives. The performance measure for the 2005 through 2007 performance cycle is membership growth combined with a minimum level of statutory reserves and progress against the strategic plan.

By encouraging the delivery of cost-effective products that provide access to high-quality health care as a means to increase membership, the Long-Term Incentive Plan focuses senior leaders on the cost and quality of care.

Recognition Programs

In addition to annual and long-term incentives, BCBSMA sponsors a wide range of recognition programs that can effectively motivate and reward individual or team accomplishments and ideas. All associates are eligible for at least one form of recognition award, with the nature of awards varying based on individual department success criteria.

CEO and Senior Associate Compensation Competitive Assessment

The HRC, on behalf of BCBSMA, conducts regular annual reviews of senior associate competitive compensation levels. This year's analysis and report were prepared by Watson Wyatt & Company. To the greatest extent possible, the methodology for the review has remained unchanged year-to-year, focusing on similar data sources as in prior years, and presented in a similar format.

The comparator organizations used in the analysis continue to reflect a mix of large Blue Cross Blue Shield plans, managed care organizations, and broader industry life/health insurers. The Committee believes this mix of comparators (which includes a mix of stock versus non-stock organizations) continues to be appropriate given the nature of BCBSMA's competition for senior associate talent. BCBSMA's greatest competition for talent is found within other large health insurers and managed care companies.

Key findings of the 2005 analysis suggest that current senior associate compensation levels are generally consistent with median market practice, as summarized below.

COMPENSATION ELEMENT	FINDINGS
Base Salaries	Overall, base salaries are within a competitive range (+/-15%) of median industry market practice, including the CEO position.
Total Cash Compensation (TCC-base salary plus target annual bonus)	Target total cash compensation is competitive with median market practice for the CEO and EVPs.
Total Direct Compensation (TDC-base salary plus target bonus and target long-term incentives)	BCBSMA target total direct compensation levels (base salary plus annual bonus and long-term incentives) for the CEO and EVPs are within a competitive range of the market median. BCBSMA total direct pay levels are more conservative (lower) when compared to public peer organizations of similar size due to the prevalent use of equity compensation among those organizations.
Supplemental Retirement Program (SRP)	The SRP is limited to select participants voted on by the Board; it provides retirement benefits that are necessary to attract and retain talented individuals to lead the organization.

BLUE CROSS AND BLUE SHIELD OF MASSACHUSETTS, INC.

AUDITED STATUTORY-BASIS FINANCIAL STATEMENTS

Years Ended December 31, 2006 and 2005

Contents

Report of Independent Auditors

Board of Directors
Blue Cross and Blue Shield of Massachusetts, Inc.

We have audited the accompanying statutory-basis balance sheets of Blue Cross and Blue Shield of Massachusetts, Inc. (the Company) as of December 31, 2006 and 2005, and the related statutory-basis statements of income, changes in surplus, and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 3 to the financial statements, the Company presents its financial statements in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance, which practices differ from U.S. generally accepted accounting principles. The variances between such practices and U.S. generally accepted accounting principles and the effects on the accompanying financial statements are described in Note 3.

In our opinion, because of the effects of the matter described in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles the financial position of Blue Cross and Blue Shield of Massachusetts, Inc. at December 31, 2006 and 2005, or the results of its operations or its cash flows for the years then ended.

However, in our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Blue Cross and Blue Shield of Massachusetts, Inc. at December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over statutory financial reporting as of December 31, 2006, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated April 20, 2007 expressed an unqualified opinion thereon.

Ernst & Young LLP

Boston, Massachusetts

April 20, 2007

Blue Cross and Blue Shield of Massachusetts, Inc.

Statutory-basis Balance Sheets

(In thousands)

	December 31	
	2006	2005
Admitted assets		
Bonds	**$ 443,416**	$ 408,830
Preferred stock	**2,992**	2,465
Common stock	**153,631**	186,092
Properties occupied by the company	**129,882**	60,440
Cash, cash equivalents and short-term investments	**62,166**	22,850
Receivable for securities	**1,049**	71
Other invested assets	**385,314**	369,323
Total cash and invested assets	**1,178,450**	1,050,071
Accrued investment income	**3,831**	3,634
Premiums receivable	**18,472**	561
Receivable related to uninsured plans	**400,670**	350,122
Income tax recoverable	**48,402**	15,254
Net deferred tax asset	**10,735**	12,852
Data processing equipment	**3,740**	5,235
Receivable from affiliates	**70,858**	75,787
Health care receivables	**25,045**	10,543
Due from Federal Employees Program	**39,347**	44,144
Other assets	**42,424**	36,429
Total admitted assets	**$1,841,974**	$1,604,632
Liabilities and surplus		
Health care claim reserves	**$ 229,426**	$ 197,784
Accrued medical incentive pool and bonus payments	**15,159**	9,599
Aggregate policy reserves	**30,731**	31,187
Premiums received in advance	**43,279**	47,930
Federal income taxes payable	**13,283**	25,677
Accounts payable and accrued liabilities	**406,703**	402,074
Payable to affiliates	**10,419**	12,877
Payable for securities	**15,594**	3,363
Uninsured group advance deposits	**391,458**	358,692
Liability for post-retirement benefits	**57,734**	50,082
Total liabilities	**1,213,786**	1,139,265
Surplus	**628,188**	465,367
Total liabilities and surplus	**$1,841,974**	$1,604,632

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts, Inc.

Statutory-basis Statements of Income

(In thousands)

	Years Ended December 31	
	2006	2005
Premiums earned	**$2,097,457**	$1,976,829
Health care benefits	**1,787,509**	1,695,031
Claim adjustment expenses	**141,355**	115,503
General and administrative expenses	**110,424**	83,340
Total expenses	**2,039,288**	1,893,874
Underwriting gain	**58,169**	82,955
Net investment income	**39,881**	34,141
Net realized capital gains, less capital gains tax of $2,606 and $1,883 in 2006 and 2005, respectively	**10,424**	21,781
Total investment gains	**50,305**	55,922
Other expense	**2,374**	–
Net income before federal income tax expense	**106,100**	138,877
Federal income tax (benefit) expense	**(51,150)**	11,154
Net income	**$ 157,250**	$ 127,723

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts, Inc.

Statutory-basis Statements of Changes in Surplus

(In thousands)

	Years Ended December 31	
	2006	2005
Balance prior to net assets transferred to HMO Blue	**$ –**	$1,090,985
Net assets transferred to HMO Blue	**–**	(636,379)
Balance at January 1	**465,367**	454,606
Net assets transferred to HMO Blue on April 1	**–**	(60,000)
Net income	**157,250**	127,723
Change in net unrealized gains, net of taxes of $9,683	**17,984**	(9,524)
Change in nonadmitted assets	**(11,383)**	(47,700)
Change in net deferred income taxes	**690**	(5,433)
Pension liability adjustment, net of tax benefits of $735	**(1,365)**	(230)
Adjustment from the Master Reorganization Agreement	**–**	5,925
Other surplus adjustment	**(355)**	–
Balance at December 31	**$ 628,188**	$ 465,367

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts, Inc.

Statutory-basis Statements of Cash Flow

(In thousands)

	Years Ended December 31	
	2006	2005
Operating activities		
Premiums received	**$ 2,074,515**	$1,944,374
Health care benefits paid	**(1,768,768)**	(1,722,978)
General and claim adjustment expenses paid	**(283,100)**	(142,909)
Net investment income received	**40,798**	35,664
Federal income taxes recovered (paid)	**3,000**	(41,781)
Net cash provided by operating activities	**66,445**	72,370
Investing activities		
Sales, maturities and redemptions of investments	**547,567**	829,034
Cost of investments acquired	**(525,672)**	(888,262)
Acquisition of real estate	**(70,429)**	(28,739)
Other miscellaneous proceeds	**1,601**	1,003
Net cash used in investing activities	**(46,933)**	(86,964)
Financing or miscellaneous activities		
Net assets transferred to HMO Blue	**–**	(88,315)
Other sources (applications), net	**19,804**	(144,077)
Net cash provided by (used in) financing or miscellaneous activities	**19,804**	(232,392)
Net increase (decrease) in cash, cash equivalents and short-term investments	**39,316**	(246,986)
Cash, cash equivalents and short-term investments:		
Beginning of year	**22,850**	269,836
End of year	**$ 62,166**	$ 22,850

See accompanying notes.

(Dollars in thousands)

1. Master Reorganization

On January 1, 2005, pursuant to a Master Reorganization Agreement (“MRA”), Blue Cross and Blue Shield of Massachusetts, Inc. (“BCBSMA” or the “Company”) transferred its insured health maintenance organization line of business (with the exception of Blue Care 65, which was transferred on April 1, 2005) to Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. (“HMO Blue”), a separately incorporated, not-for-profit subsidiary of BCBSMA. Since January 1, 2005, HMO Blue has provided hospitalization, medical and other health benefits as a licensed health maintenance organization. Effective January 1, 2005, HMO Blue received a health maintenance organization (“HMO”) license from the Commonwealth of Massachusetts Division of Insurance (“DOI”). HMO Blue operates as a nonprofit, charitable organization and qualifies as a tax-exempt social welfare organization under Section 501(c)(4) of the Internal Revenue Code.

Significant components of the assets and liabilities transferred to HMO Blue on January 1, 2005 are as follows:

Cash and investments	$ 955,727
Real estate, less accumulated depreciation	27,291
Health care and other receivables	22,215
Premiums receivable	4,644
Data processing equipment	4,533
Other admitted assets	15,063
Total admitted assets	$1,029,473
Health care claim reserves	$ 204,813
Premiums received in advance	87,417
Accounts payable and accrued liabilities	57,867
Accrued medical incentive pool and bonus payments	29,210
Other liabilities	13,787
Total liabilities	$ 393,094

Under the MRA, both BCBSMA and HMO Blue (collectively referred to as the “Companies”) have an undivided interest in what had been BCBSMA’s property and equipment. The initial basis of the property and equipment was systematically allocated to each company at the date of the transaction. Ongoing depreciation expenses are charged to each company based on utilization.

Under the MRA, existing employees of the Companies (the “Associates”) are either concurrently employed by both BCBSMA and HMO Blue or solely employed by BCBSMA. Those individuals solely employed by BCBSMA include senior level management (“SLM”). The compensation, benefits and administrative expenses of the concurrently employed Associates are charged to BCBSMA and HMO Blue in accordance with their provision of services to each company. With respect to individuals solely employed by BCBSMA, the pro-rata portion of compensation, benefits, and administrative expenses attributable to services provided to HMO Blue is charged to HMO Blue on an arm’s length basis, including a mark-up. A common paymaster arrangement has been set up for payroll and payroll-related benefits. An agency arrangement has been set up for payment of claims and operating expenses and receipt of funds. The Companies’ pension and post-retirement benefits plans (“Benefit Plans”) continue to be sponsored by BCBSMA, and BCBSMA will continue to be financially responsible for the Benefit Plans. BCBSMA charges HMO Blue, as a participating employer of the Benefit Plans, a fee based on HMO Blue’s allocated share of the Benefit Plans’ expenses.

As a condition of granting an HMO license to HMO Blue, the DOI required the Companies to enter into an agreement with the DOI granting the DOI discretionary authority to require either company to issue a surplus note to the other company if either of the company’s health risk-based capital (“RBC”) is significantly higher than the other company’s RBC. Under the terms of its license with Blue Cross and Blue Shield Association, BCBSMA has also entered into a unilateral agreement with HMO Blue to guarantee all current and future financial obligations of HMO Blue.

2. Nature of Business

The Company is a nonprofit hospital and medical service corporation in the Commonwealth of Massachusetts, subject to regulation by the DOI. The Company is organized for the purpose of establishing, maintaining and operating a nonprofit hospital and medical service company to provide hospital and medical care and reimbursement for other health services to its members. Hospitalization, medical

2. Nature of Business (continued)

and other health benefits are provided to members through contracts with hospitals, participating physicians, skilled nursing facilities, nursing homes, and other health care organizations. The Company participates in a national arrangement to process claims for other Blue Cross and Blue Shield companies throughout the country. The Company offers a variety of group indemnity plans, preferred provider networks, nongroup plans, Medicare extension, dental and other supplementary programs for the benefit of its members.

3. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying financial statements have been prepared in accordance with the National Association of Insurance Commissioners ("NAIC") *Statements of Statutory Accounting Principles* ("SSAP"), and in conformity with accounting practices prescribed or permitted by the DOI, which practices differ from accounting principles generally accepted in the United States ("GAAP").

The more significant variances from GAAP are as follows:

Investments: Investments in bonds and preferred stocks are reported at amortized cost or fair value based on their NAIC rating; for GAAP, such fixed maturity investments would be designated at purchase as held-to-maturity, trading, or available-for-sale. Held-to-maturity fixed investments would be reported at amortized cost, and the remaining fixed maturity investments would be reported at fair value with unrealized holding gains and losses reported in a separate component of earnings for those designated as trading and as a separate component of other comprehensive income for those designated as available-for-sale.

All single-class and multi-class mortgage-backed/asset-backed securities are adjusted for the effects of changes in prepayment assumptions on the related accretion of discount or amortization of premium of such securities using the retrospective method. If it is determined that a decline in fair value is other-than-temporary, the cost basis of the security is written down to the undiscounted estimated future cash flows.

For GAAP purposes, all securities, purchased or retained, that represent beneficial interests in securitized assets, other than high credit quality securities, are adjusted using the prospective method when there is a change in estimated future cash flows. If it is determined that a decline in fair value is other-than-temporary, the cash basis of the security is written down to the discounted fair value. If high credit quality securities are adjusted, the retrospective method is used.

Fair value of certain investments in bonds and stocks is based on values specified by the NAIC rather than on actual or estimated market values.

Investments in real estate are reported net of related obligations rather than on a gross basis. Real estate owned and occupied by the Company is included in investments rather than reported as an operating asset under GAAP, and investment income and operating expenses include rent for the Company's occupancy of those properties.

Nonadmitted Assets: Certain assets designated as "nonadmitted," including deferred federal income taxes in excess of certain statutory limits, furniture, fixtures and equipment, leasehold improvements, nonoperating system software, prepaid expenses, certain premium receivable balances, and other assets not specifically identified as an admitted asset within the SSAP, are excluded from the accompanying balance sheets and are charged directly to surplus. Under GAAP, such assets are included in the balance sheets.

Deferred Income Taxes: Deferred tax assets are limited to (1) the amount of federal income taxes paid in prior years that can be recovered through loss carrybacks for existing temporary differences that reverse by the end of the subsequent calendar year, plus (2) the lesser of the remaining gross deferred tax assets expected to be realized within one year of the balance sheet date or 10% of surplus excluding any net deferred tax assets, Electronic Data Processing ("EDP") equipment and operating software, plus (3) the amount of remaining gross deferred tax assets that can be offset against existing gross deferred tax liabilities. The remaining deferred tax assets are nonadmitted. Under GAAP, a deferred tax asset is recorded for the amount of gross deferred tax assets expected to be realized in future years, and a valuation allowance is established for deferred tax assets not realizable.

Employee Benefits: For purposes of calculating the Company's pension and post-retirement benefit obligations, only vested participants and current retirees are included in the valuation. Under GAAP, active participants not currently eligible also would be included.

Statement of Cash Flow: Cash, cash equivalents, and short-term investments in the statements of cash flow represent cash balances and investments with initial maturities of one year or less. Under GAAP, the corresponding caption of cash and cash equivalents includes cash balances and investments with initial maturities of three months or less.

Consolidation: Wholly-controlled subsidiaries are not consolidated for individual entity statutory reporting. Under GAAP, financial statements of wholly-controlled subsidiaries are consolidated with the parent.

3. Summary of Significant Accounting Policies (continued)

A reconciliation of net income and surplus of the Company, as determined in accordance with statutory accounting practices, to amounts determined in accordance with GAAP are as follows:

	Year Ended December 31, 2006		Year Ended December 31, 2005	
	Net Income	Surplus	Net Income	Surplus
Statutory-basis amounts	**$ 157,250**	**$ 628,188**	$ 127,723	$ 465,367
Investments	**32,239**	**27,714**	25,301	10,246
Federal income taxes	**(1,314)**	**–**	(46,373)	–
Deferred income tax	**–**	**(39,948)**	–	(24,131)
Premium receivable allowance	**2,876**	**–**	(1,937)	–
Pension and post-retirement	**–**	**74,750**	–	88,964
Foundations	**13,533**	**100,689**	9,688	87,155
Other nonadmitted	**(288)**	**129,261**	(3,797)	95,463
GAAP-basis amounts	**204,296**	**920,654**	110,605	723,064
HMO Blue GAAP-basis amounts	**110,403**	**954,486**	160,636	847,909
GAAP-basis consolidated amounts	**$314,699**	**$1,875,140**	$271,241	$1,570,973

Other significant accounting practices are as follows:

Use of Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Investments

Bonds not backed by loans are stated at amortized cost, with amortization calculated based on the scientific method, using lower of yield to call or yield to maturity. Prepayment assumptions for mortgage-backed securities and structured securities were obtained from broker-dealer survey values. These assumptions are consistent with the current interest rate and economic environment. The retrospective adjustment method is used to value all mortgage-backed securities.

Common stocks are stated at fair value as determined by the NAIC Securities Valuation Office ("SVO"). Preferred stocks are stated at cost, amortized cost or fair value based on the underlying characteristics and NAIC designation. The Company has various ownership interests in limited liability partnerships and limited liability companies. The Company carries these investments based on its ownership interest in the underlying GAAP equity of the investee. These investments are included as other invested assets on the balance sheet.

Unrealized gains and losses on stocks and other invested assets are reflected directly in surplus unless there is deemed to be an other-than-temporary decline in value, in which case the loss is charged to income. Realized gains and losses on investments sold are determined using the specific identification method and are included in income. Amortization of bond premium and accretion of bond discount are recognized on a yield-basis method. Security transactions are accounted for on a trade-date basis, with any unsettled transactions recorded as due to or from investment broker and included as payable or receivable for securities in the Company's admitted assets and liabilities, respectively.

Investment income is recognized as income when earned. The Company periodically reviews the portfolio of securities to determine whether an other-than-temporary impairment has occurred. Any identified other-than-temporary impairment is recorded as part of net realized investment gains. The Company did not recognize any impairment write-down for its investments during the years ended December 31, 2006 and 2005.

Cash equivalents are short-term highly liquid investments with original maturities of three months or less and are principally stated at amortized cost. Short-term investments include investments with remaining maturities of one year or less at the time of acquisition and are principally stated at amortized cost.

Real Estate

Land is recorded at cost, and other real estate, which includes expenditures for significant improvements, is recorded at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful life of 50 years.

The Company and HMO Blue jointly own land and building with 343,800 square feet of office space in Quincy, Massachusetts. The renovation of this facility was completed for occupancy in September 2005.

In 2005, the Company and HMO Blue jointly entered into a Tri-Party agreement (as disclosed in Note 18) with a developer to construct a new office facility in Hingham,

3. Summary of Significant Accounting Policies (continued)

Massachusetts. As part of this agreement, in September 2006, the Company and HMO Blue took title to this property and related improvements. Improvements and construction continues, with occupancy anticipated to occur in 2007.

The components of the Company's real estate are summarized as follows:

	2006	2005
Land and Building	**$ 131,207**	$ 61,104
Less accumulated depreciation	**(1,325)**	(664)
Net real estate occupied by the Company	**$ 129,882**	$ 60,440

Under the statutory reporting guidelines, the Company is required to calculate imputed rental income for owner-occupied real estate. The method for calculating imputed rental income is based on estimated rental rates of like property in the same area times rentable square feet. These imputed amounts are reported as investment income and operating expense in the statement of income reflecting that the Company had paid rent of $3,964 and $1,130 for 2006 and 2005, respectively.

Furniture and Equipment

The admitted value of the Company's electronic data processing equipment and operating software is limited to three percent of adjusted surplus. The Company's admitted portion is reported at cost, less accumulated depreciation of $22,518 and $19,280 at December 31, 2006 and 2005, respectively. Electronic data processing equipment and operating and non-operating software are depreciated using the straight-line method over the lesser of its useful life or three years. Other furniture and equipment is depreciated using the straight-line method over its estimated useful life. Depreciation expense charged to income in 2006 and 2005 was $6,226 and $5,682, respectively.

Health Care Claim Reserves

The provision for health care claim reserves is actuarially determined based on historical claims payment experience and other statistics. This liability is subject to the impact of changes in claim severity and frequency, as well as numerous other factors. Management believes that the liability is adequate, but the ultimate net cost of settling this liability may vary from the estimated amount.

The methods used to develop the reserves for claims incurred but not yet reported are subject to continuing review and refinement, and any necessary adjustments are recorded in operations in the year in which they are determined to be necessary. An estimate of future claim payments is not recorded for ASC claims.

Accrued Medical Incentive Pool and Bonus Payments

Medical incentive pool and bonus accruals represent the liability for arrangements with health care providers and other risk sharing arrangements where the Company agrees to share savings with contracted providers.

Aggregate Policy Reserves

Aggregate policy reserves represent a reserve for unearned premium income and a reserve for rate credits and experience rating refunds.

Premium Deficiency

The Company evaluates its health care contracts to determine it if is probable that a loss will be incurred. A premium deficiency loss is recognized when it is probable that expected future paid claims, administrative expenses and reserves will exceed existing reserves plus anticipated future premiums on existing contracts. Anticipated investment income and overhead expenses are also considered in the calculation of premium deficiency losses. For all the periods presented no premiums deficiencies were recorded.

Premium

The Company receives premium revenue from insured business. Member premiums are billed in advance of their respective coverage periods. Premium receivable are recorded when due. Premium earned is recorded during the coverage period. Aggregate policy reserves are established to cover the unexpired portion of premiums written and are computed by pro-rata methods for direct business. Expenses incurred in connection with acquiring new insurance business, including acquisition costs such as sales commissions, are charged to administrative expenses as incurred. The premium paid by subscribers prior to the effective date is recorded in the balance sheet as premiums received in advance and subsequently credited to income as earned during the coverage period.

For uncollected premium, after the calculation of non-admitted amounts, an evaluation is made of the remaining admitted assets in accordance with SSAP No. 5 to determine if there is impairment. If it is probable that the balance is uncollectible, any uncollectible amount is written off and charged to income in the period the determination is made. As of December 31, 2006 and 2005, the Company reserved $1,692 and $1,397, respectively, for possible uncollectible amounts not written off.

Administrative Services Contract ("ASC") and Administrative Service Only ("ASO")

ASC and ASO are referred to as uninsured business under the applicable NAIC SSAP. ASC is a business where the Company pays benefits on the behalf of employers using the Company's check stock. ASO is a business where the Company pays benefits on the behalf of employers using the employer's check stock. The Company receives an administrative fee for providing these services. Premiums and claim expenses are not included in the Company's financial statements. The administrative fees earned are reported as a reduction to operating expenses in the Company's statements of income.

3. Summary of Significant Accounting Policies (continued)

Effective July 2006, the Company no longer processes ASO arrangements.

ASC and ASO accounts are billed monthly, in arrears, for actual medical claims plus administrative fees. The remaining balance of receivables from uninsured plans, after assessment for collectibility, are included in the Company's admitted assets and liabilities, respectively. The Company made adjustments of $(2,450) and $(2,800) in 2006 and 2005, respectively, to the initial provision of $10,500 recorded in 2004 to recognize certain estimated provider settlements related to prior disputed claim payments made on ASC and ASO accounts.

Health Care Receivables

The Company enters into contractual agreements with various health care providers to provide certain medical services to its members. Compensation arrangements vary by provider. Certain providers have entered into risk-sharing arrangements with the Company, whereby a settlement is calculated by comparing actual medical claims experience to a pre-approved and predetermined budgeted amount. These settlements are accrued on an estimated basis in the period the related services are rendered, and adjusted in future periods as final settlements are determined. Estimated settlements for these risk-sharing arrangements are reflected in health care receivables on the Company's balance sheets.

Other amounts included in health care receivables represent pharmaceutical rebates, claims overpayments, advances to the providers and capitation arrangement receivables. Pharmaceutical rebates are arrangements with pharmaceutical companies in which the Company receives rebates based upon drug utilization of its subscribers at participating pharmacies. Claim overpayments occur as a result of several events, including, but not limited to, claim payments paid in error to a provider. The Company also makes advances to providers, when those advances are supported by legally enforceable contracts and are generally entered into at the request of the providers.

Income Taxes

For federal income tax purposes, the Company is treated as a stock property and casualty insurance company subject to special provisions of the Internal Revenue Code applicable to Blue Cross and Blue Shield organizations. The Company is exempt from Massachusetts state income taxes.

Impairment of Long-Lived Assets

The Company continually evaluates the recoverability of long-lived assets by assessing whether the carrying amount of asset balances can be recovered as measured against the future undiscounted net cash flows expected to be generated by the assets. The future undiscounted net cash flows are based on historical trends, revenue forecasts and market trends projected over the remaining life of the long-lived assets.

If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. The Company recorded impairment of $13,563 and $441 in 2006 and 2005, respectively, related to internally developed software and furniture and fixtures.

Fair Value of Financial Instruments

The fair value of investment securities is estimated based on NAIC quoted prices for those or similar investment securities. The carrying amounts of cash, cash equivalents and short-term investment approximate fair value because of the short maturity of these instruments.

Reclassification

Certain amounts for the year ended December 31, 2005 have been reclassified to be consistent with the presentation of the amounts for the year ended December 31, 2006.

Medicare Part D Premium and Expenses

Beginning January 1, 2006, the Company entered into a Medicare Part D Inter-Plan Services Agreement to offer a Blue Cross and Blue Shield branded prescription drug plan ("PDP") under contract with the Centers for Medicare & Medicaid Services ("CMS"). The CMS premium, the member premium, and the low-income premium subsidy represent payments for the Company's insurance risk coverage under the Medicare Part D program and therefore are recorded as premium earned in the statement of income. Premium revenues is earned ratably over the period in which eligible individuals are entitled to receive prescription drug benefits.

Subsidies and reinsurance payments from CMS represent cost reimbursements under the Medicare Part D program. Amounts received for these subsidies are not reflected in premium earned, but rather are accounted for as deposits, with the related liability included in accounts payable and accrued liabilities in the balance sheet. Pharmacy benefit costs and administrative costs under the contract are expensed as incurred.

Reinsurance

In 2006, the Company entered into a Specific Excess of Loss Reinsurance agreement with ACE American Insurance Company ("Reinsurance Agreement"). The Reinsurance Agreement provides the Company with increased capacity to write larger risks and maintain its exposure to loss within its capital resources. The Reinsurance Agreement cannot be unilaterally cancelled except for nonpayment of premiums. The amounts ceded as a result of the Reinsurance Agreement were not significant in 2006.

4. Cash and Investments

The cost or amortized cost, gross unrealized gains (losses), and NAIC fair value of cash and investments are as follows:

	December 31, 2006			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	NAIC Fair Value
Cash, cash equivalents and short-term investments	$ 62,166	$ –	$ –	$ 62,166
Bonds:				
U.S. Government securities	154,626	325	(1,080)	153,871
Industrial and miscellaneous	93,642	1,098	(494)	94,246
Mortgage-backed securities	195,148	845	(948)	195,045
Total bonds	443,416	2,268	(2,522)	443,162
Common stocks	151,629	6,943	(4,941)	153,631
Preferred stocks	2,992	50	–	3,042
Other invested assets	308,038	78,095	(819)	385,314
Total cash and investments	$ 968,241	$ 87,356	$ (8,282)	$1,047,315

	December 31, 2005			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	NAIC Fair Value
Cash, cash equivalents and short-term investments	$ 22,850	$ –	$ –	$ 22,850
Bonds:				
U.S. Government securities	147,393	863	(697)	147,559
Industrial and miscellaneous	111,019	2,221	(770)	112,470
Mortgage-backed securities	150,418	638	(1,473)	149,583
Total bonds	408,830	3,722	(2,940)	409,612
Common stocks	180,907	10,258	(5,073)	186,092
Preferred stocks	2,465	50	–	2,515
Other invested assets	322,277	47,914	(868)	369,323
Total cash and investments	$ 937,329	$ 61,944	$ (8,881)	$990,392

Cash and investments include $133,001 and $119,609 at December 31, 2006 and 2005, respectively, of securities that are pledged as collateral for a Depository Agreement with the Blue Cross and Blue Shield Association to meet certain licensure standards.

Fair values of publicly traded bonds and unaffiliated stocks are generally based on independently quoted market prices, which may differ from NAIC fair values. The NAIC fair values of bonds were $443,162 and $409,612 at December 31, 2006 and 2005, respectively. The NAIC fair values of unaffiliated common stocks were $153,631 and $186,092 at December 31, 2006 and 2005, respectively. The NAIC fair value of unaffiliated preferred stocks was $3,042 and $2,515 at December 31, 2006 and 2005, respectively. The NAIC fair value of other invested assets was $385,314 and $369,323 at December 31, 2006 and 2005, respectively. Accrued investment income of $3,831 and $3,634 at December 31, 2006 and 2005, respectively, is defined as investment income earned as of the reporting date but not legally due to be paid to the Company until subsequent to the reporting date.

The following tables shows gross unrealized losses and fair values of fixed maturities, equities and other invested asset and length of time that individual securities have been in a continuous unrealized position.

	Less than 12 months		12 months or more		Total	
At December 31, 2006	NAIC Fair Value	Gross Unrealized Losses	NAIC Fair Value	Gross Unrealized Losses	NAIC Fair Value	Gross Unrealized Losses
Bonds	$157,817	$(1,043)	$129,806	$(1,479)	$287,623	$(2,522)
Common stocks	15,655	(647)	82,549	(4,294)	98,204	(4,941)
Other invested assets	6,151	(87)	14,128	(732)	20,279	(819)
Total	$179,623	$(1,777)	$226,483	$(6,505)	$406,106	$(8,282)

	Less than 12 months		12 months or more		Total	
At December 31, 2005	NAIC Fair Value	Gross Unrealized Losses	NAIC Fair Value	Gross Unrealized Losses	NAIC Fair Value	Gross Unrealized Losses
Bonds	$163,204	$(1,914)	$67,841	$(1,026)	$231,045	$(2,940)
Common stocks	101,708	(4,913)	2,362	(160)	104,070	(5,073)
Other invested assets	26,394	(868)	–	–	26,394	(868)
Total	$291,306	$(7,695)	$70,203	$(1,186)	$361,509	$(8,881)

4. Cash and Investments (continued)

Management regularly reviews the value of the Company's investments. If the value of any investment falls below its cost basis, the decline is analyzed to determine whether it is an other-than-temporary decline in value. To make this determination for each security, the following is considered:

- The length of time and the extent to which the fair value has been below cost;
- The financial condition and near-term prospects of the issuer of the security, including any specific events that may affect its operations or earnings potential;
- Volatility inherent in the asset class to which the investment belongs;
- Management's intent and ability to hold the security long enough for it to recover its value.

At December 31, 2006 and 2005, included in the Company's investments are unrealized losses deemed to be temporary. These investments reflect a range of industries, and the Company deems the current market volatility as temporary.

In 2006 and 2005, there was no write-down of debt or equity securities with a decline in market value that was determined by management to be other-than-temporary.

The amortized cost and NAIC fair value of bonds at December 31, 2006, by stated maturity, are shown below. Fixed maturities subject to early or unscheduled prepayments have been included based upon their stated maturity dates. Actual maturities may differ from stated maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	Cost or Amortized Cost	NAIC Fair Value
Within 1 year	$ 60,121	$ 59,933
After 1 year through 5 years	160,690	160,403
After 5 years through 10 years	63,250	63,045
After 10 years	159,355	159,781
Total bonds	$ 443,416	$ 443,162

Proceeds from the sale of investment securities were approximately $487,275 and $699,827 for the years ended December 31, 2006 and 2005, respectively. Gross realized investment gains and losses are as follows:

	2006	2005
Gross gains	$ 16,582	$ 26,910
Gross losses	(3,552)	(3,246)
Net realized investment gains	$ 13,030	$ 23,664

Included in other invested assets is a $10,000 surplus note purchased by the Company in November 2004. The note was issued by Neighborhood Health Plan, Inc. ("NHP"), and bears an initial interest rate of 5.3% per annum through September 30, 2008. Accrued interest payments on this note, subject to approval from the DOI, are due semi-annually in arrears on or before each April 1 and October 1, commencing on April 1, 2005, until payment in full of all amounts are received. Principal payments on this note, subject to approval from the DOI, are due and payable in semi-annual installments, commencing on April 1, 2014, with a final installment due and payable on October 1, 2018. There are no payments outstanding from NHP at December 31, 2006.

5. Health Care Claims Reserves

Activity in health care claims reserves is summarized in the reconciliation of the beginning and ending balances of claims payable and claims incurred but not yet reported as follows:

	2006	2005
Balance at January 1	$ 197,784	$ 419,072
Amount transferred to HMO Blue	–	204,813
Adjusted balance at January 1	197,784	214,259
Incurred related to:		
Current year	1,803,804	1,717,145
Prior years	(16,295)	(22,114)
Total incurred	1,787,509	1,695,031
Paid related to:		
Current year	1,590,587	1,532,985
Prior years	165,280	178,521
Total paid	1,755,867	1,711,506
Balance at December 31	$ 229,426	$ 197,784

The Company uses estimates for determining its claims incurred but not yet reported, which are based on historical claim payment patterns, healthcare trends and membership and includes a provision for adverse changes in claim frequency and severity. Amounts incurred related to prior years vary from previously estimated liabilities as the claims are ultimately settled. Liabilities at any year end are continually reviewed and re-estimated as information regarding actual claims payments become known. This information is compared to the originally established year end liability. Negative amounts reported for incurred related to prior years result from claims being settled for amounts less than originally estimated. The favorable development

5. Health Care Claims Reserves (continued)

in medical claims payable for the years ended December 31, 2006 and 2005 is primarily attributable to actual claim payment patterns and cost trends differing from those assumed at the time the liability was established.

Estimated subrogation credits of $2,589 and $2,038 for 2006 and 2005, respectively, were taken into account in determining health care claims reserves.

Management believes its methodologies for reserving for unpaid claims are appropriate and represent its best estimate at December 31, 2006 and 2005. Methodologies utilized for current year reserves for unpaid claims are consistent with prior years.

6. Pension and Other Post-Retirement Benefit Plans

All employees are eligible to participate in the Retirement Income Trust Plan ("RIT"), which grants benefits to retired employees at various levels based on age and years of service. The Company also participates in two noncontributory retirement plans for eligible employees, and sponsors a defined benefit plan covering medical, life and dental benefits. The Company uses a December 31 measurement date for the majority of its plans.

A summary of assets, obligations and assumptions of the RIT pension and other post-retirement benefit plans are as follows:

	Pension Benefits		Post-Retirement Benefits	
	2006	2005	2006	2005
Change in benefit obligation				
Benefit obligation at beginning of year	**$ 394,187**	$ 363,991	**$120,736**	$ 119,359
Service cost	**19,800**	13,488	**5,569**	5,058
Interest cost	**21,815**	20,281	**5,504**	6,628
Plan amendments	**(4,364)**	–	**–**	–
Actuarial loss (gain)	**3,686**	12,911	**(27,402)**	(3,656)
Benefits paid	**(21,414)**	(16,121)	**(7,288)**	(6,653)
Medicare Part D reimbursement	**–**	–	**335**	–
Administrative expenses paid	**(472)**	(363)	**–**	–
Benefit obligation at end of year	**$ 413,238**	$ 394,187	**$ 97,454**	$ 120,736

The plan amendments of $4,364 included in the change in benefit obligation represent the impact of the Pension Protection Act of 2006 related to rate adjustments applicable to lump sum payments to be made after December 31, 2011.

	Pension Benefits		Post-Retirement Benefits	
	2006	2005	2006	2005
Change in plan assets				
Fair value at beginning of year	**$ 420,795**	$ 389,402	**$ 9,152**	$ –
Actual return on plan assets	**53,023**	27,877	**1,140**	152
Employer contribution	**–**	20,000	**6,647**	15,653
Benefits paid	**(21,414)**	(16,121)	**(6,982)**	(6,653)
Medicare Part D reimbursement	**–**	–	**335**	–
401(h) benefit payments	**–**	–	**(306)**	–
Administrative fees paid	**(472)**	(363)	**–**	–
Fair value at end of year	**$ 451,932**	$ 420,795	**$ 9,986**	$ 9,152
Reconciliation of funded status				
Funded status	**$ 38,694**	$ 26,608	**$(87,469)**	$(111,585)
Unrecognized actuarial loss	**70,849**	92,206	**12,505**	41,401
Unrecognized transition obligation	**–**	–	**17,230**	20,102
Unrecognized prior service cost	**(1,792)**	2,945	**–**	–
Prepaid assets or (accrued liabilities)	**$ 107,751**	$121,759	**$(57,734)**	$(50,082)
Benefit obligation for nonvested employees	**$ 17,248**	$ 17,786	**N/A**	N/A
Components of net periodic benefit cost				
Service cost	**$ 19,800**	$ 13,488	**$ 5,569**	$ 5,058
Interest cost	**21,815**	20,281	**5,504**	6,628
Expected return on plan assets	**(32,701)**	(32,114)	**(732)**	–
Amortization of unrecognized transitional obligation	**–**	–	**2,872**	2,872
Recognized actuarial loss	**4,720**	4,289	**1,087**	2,791
Amortization of prior service cost	**373**	373	**–**	–
Total net periodic benefit cost	**$ 14,007**	$ 6,317	**$ 14,300**	$ 17,349

6. Pension and Other Post-Retirement Benefit Plans (continued)

A minimum pension liability is required when the actuarial present value of accumulated benefits exceeds plan assets and accrued pension liabilities. The minimum liability adjustment, less allowable intangible assets, net of tax benefit, is reported as a change in surplus. At December 31, 2006 and 2005, the additional minimum pension liability was $2,632 and $531, respectively.

The noncontributory nonqualified retirement plans include projected benefit obligations in excess of plan assets of $18,670 and $30,742, and accumulated benefit obligations in excess of plan assets of $17,244 and $29,899, at December 31, 2006 and 2005, respectively.

Weighted-average assumptions as of December 31, 2006 and 2005 are as follows:

	Pension Benefits		Post-Retirement Benefits	
	2006	2005	2006	2005
Discount rate	**5.90%**	5.75%	**5.75%**	5.75%
Expected return on plan assets	**8.00**	8.50	**8.00**	8.50
Rate of compensation increase	**4.50**	4.50	**N/A**	N/A

For measurement purposes, the rate of increase in the per capita cost of covered health care benefits was assumed to be in the range of 9.50% to 10.00% for 2006. The rate is assumed to decrease gradually to 5.00% over 10 years and remain at that level thereafter.

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one percentage-point change in assumed health care cost trend rates would have the following effects:

	1% point increase	1% point decrease
Increase (decrease) in total of service and interest cost components	$ 489	$ (462)
Increase (decrease) in post-retirement benefit obligation	$4,971	$(4,698)

The Company's pension benefit weighted-average asset allocations at December 31, 2006 and 2005, by asset category, are as follows:

	Pension Benefits		Post-Retirement Benefits	
	2006	2005	2006	2005
Asset category				
Equity securities	**59%**	58%	**59%**	58%
Debt securities	**21**	25	**21**	25
Real Estate	**6**	5	**6**	5
Other	**14**	12	**14**	12
Total	**100%**	100%	**100%**	100%

The Company's portfolio is managed within ERISA guidelines to ensure adequate funding of the pension obligation and to maximize the returns. The asset allocation has been structured to enable an 8.0% return target on the assets. The targets and ranges were established based on the results of an asset liability study which was done in 2003. The Company considered the historical returns and future expectations for returns for each asset class, as well as target allocation of the portfolio to develop the expected long-term rate of return on assets assumption. This resulted in the selection of the 8.0% long-term rate of return on assets assumption.

The Company has a nonpension post-retirement benefit plan. On December 31, 2006 and 2005, the Company's other benefits, included in its post-retirement plan, are medical, dental and life benefits for retired employees. The 401(h) account was instituted by BCBSMA in December 2003 and a contribution of $9,000 was made in December 2005. There were no contributions made in 2006.

At December 31, 2006, the Company's projected benefit payments are as follows:

	Pension Benefits	Post-Retirement Benefits	Medicare Subsidy
2007	$ 24,432	$ 7,737	$ 473
2008	26,329	8,065	521
2009	27,817	8,458	562
2010	29,287	8,805	608
2011	31,498	9,242	649
Next five years	179,737	50,166	3,865

In 2004, the Company adopted Financial Accounting Standards Board Staff Position 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003* ("FSP 106-2"). The Company and its actuarial advisors determined that benefits provided by the plan as of the date of the enactment were at least actuarially equivalent to Medicare Part D, and, accordingly, the Company is entitled to the federal subsidy. The

6. Pension and Other Post-Retirement Benefit Plans (continued)

Company determined that the aggregate effect on the service cost, interest cost, and amortization of the actuarial experience gains and losses due to FSP 106-2 is a reduction in annual net periodic post-retirement benefit cost of $1,775 and $887 in 2006 and 2005, respectively. The accumulated post-retirement benefit obligation decreased by $11,675 and $6,774 at December 31, 2006 and 2005, respectively, due to the effect of the Act. The calculation excludes nonvested employees costs per INT 04-17: *Impact of Medicare Modernization Act on Post-retirement Benefits*.

The Company also has a savings 401(k) plan for eligible employees. Under the employee savings plan, the Company contributes an amount equal to 65% of employee contributions, up to a maximum of 6% of each employee's compensation, subject to pretax Internal Revenue Code limits of $15,000 and $14,000 in 2006 and 2005, respectively. Contributions are maintained in investment funds established under the employee savings plan. Total Company contributions charged to income amounted to $6,271 and $6,718 in 2006 and 2005, respectively.

7. Income Taxes

The Company's tax rate is less than the regular tax rate of 35% for corporations due to utilization of the special deduction available to Blue Cross and Blue Shield Plans under Internal Revenue Code section 833. The special deduction subjects the Company to the Alternative Minimum Tax ("AMT") provisions. The AMT provisions tax income at a rate of 20% and limits utilization of net operating loss carryforwards to 90% of taxable income.

Under the asset and liability method, the Company's temporary differences represent the estimated future tax effects attributable to future taxable or deductible temporary differences between amounts recognized in the financial statements and income tax returns. These items primarily represent depreciation and amortization, post-retirement benefits, certain accrued liabilities, accrued pension costs and discounting of unpaid claims liabilities and expenses.

The components of the net deferred tax asset at December 31, 2006 and 2005 are as follows:

	2006	2005
Total of gross deferred tax assets	**$ 362,888**	$ 361,775
Total of deferred tax liabilities	**(30,433)**	(21,061)
Net deferred tax asset	**332,455**	340,714
Deferred tax asset non-admitted	**321,720**	327,862
Net admitted deferred tax asset	**$ 10,735**	$ 12,852
Decrease in non-admitted deferred tax asset	**$ (6,142)**	$ (28,499)

The provisions for federal income taxes on earnings for the year ended December 31, 2006 and 2005 are:

	2006	2005
Federal income tax (benefit) expense from operations	**$ (51,150)**	$ 11,154
Federal income tax on net capital gains	**2,606**	1,883
Federal income taxes (benefit) expense	**$ (48,544)**	$ 13,037

The tax effect of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are as follows:

	2006	2005
Deferred tax assets:		
Post-retirement benefits	**$ 20,970**	$ 27,438
Other-than-temporary impairment of securities	**7,492**	7,492
Fixed assets	**56,452**	22,042
Net operating losses and AMT credits	**261,404**	280,347
Accrued expenses	**16,570**	24,456
Total deferred tax assets	**362,888**	361,775
Non-admitted deferred tax assets	**(321,720)**	(327,862)
Admitted deferred tax assets	**41,168**	33,913
Deferred tax liabilities:		
Investment in LLC and LP	**(2,664)**	(2,975)
Unrealized gains on securities	**(27,769)**	(18,086)
Total deferred tax liabilities	**(30,433)**	(21,061)
Net admitted deferred tax asset	**$ 10,735**	$ 12,852

During 2005, the Internal Revenue Service initiated an examination of the tax years 2001 through 2004. In the Company's opinion, the Company has established an adequate provision for all amounts of federal income tax related to the years under examination and all subsequent tax years. During 2006, the Company accepted an IRS settlement offer regarding the tax basis of certain intangible assets of January 1, 1987. This settlement is reflected in the 2006 federal income tax benefit of the statements of income.

The Company's effective rate differs from the Company's applicable statutory rate of 35% due to the Section 833 deduction, changes in estimates of prior year tax liabilities, changes in deferred taxes related to the above-mentioned IRS settlement offer, and the impact of non-admitted assets.

The amount of federal income taxes incurred and available for recoupment in the event of future net losses is $9,882 and $11,393 from 2006 and 2005, respectively.

7. Income Taxes (continued)

The Company had $110,996 and $80,284 of regular tax operating loss carryforwards as of December 31, 2006 and December 31, 2005, respectively originating in 1992 through 1998 that will expire in years 2007 through 2018. The Company does not have any AMT operating loss carryforwards available to offset future income.

The Company had $222,555 and $252,248 of AMT credits as of December 31, 2006 and December 31, 2005, respectively. The AMT credits are available to offset future regular tax and will not expire.

8. Surplus

Chapter 160 of the Acts of 1988 requires that the Company maintain surplus of not less than 5% of all expenses and insured claims incurred in each year. At December 31, 2006 and 2005, the Company's surplus was in excess of the regulatory Chapter 160 requirements.

In addition, the NAIC has imposed regulatory RBC requirements on health insurance companies, including the Company. The RBC calculation serves as a benchmark for the regulation of health insurance companies' solvency by state insurance regulators. At December 31, 2006 and 2005, the Company's total adjusted capital is in excess of the regulatory RBC requirements.

9. Permitted Statutory Accounting Practices

State insurance laws and regulations prescribe accounting practices for determining statutory net income and surplus for insurance companies. In addition, state regulators may permit statutory accounting practices that differ from prescribed practices. The Company had no permitted practices that would have an effect on statutory surplus at December 31, 2006 and 2005.

10. Federal Employees Program

The Federal Employees Program ("FEP") is a national contract between Blue Cross and Blue Shield plans ("Participating Plans") and the U.S. Office of Personnel Management under which Participating Plans provide health coverage to U.S. Government employees.

The Company's share of revenue, expenses, assets, and liabilities under the FEP contract is reported in the Company's financial statements. Amounts receivable from FEP represent funds being held in a letter of credit account (the "FEP Account") maintained specifically for FEP benefits. As checks and electronic payments clear its bank accounts, the Company reimburses itself by drawing funds from the FEP Account.

11. Related Party Transactions

The Company entered into a bilateral intercompany agreement with HMO Blue as a result of the MRA to settle any claims, fees, administrative cost expense allocation and pass-through cash and expenses paid by one company on behalf of the other company. The Companies operate under common management control. At December 31, 2006 and 2005, the Company had a receivable from HMO Blue of $70,777 and $75,702, respectively.

Because of the significant related-party transactions with HMO Blue, the Company's financial condition and the results of operations may not necessarily be indicative of the financial condition or results of operations that would have occurred if the Company had been operated as an unaffiliated company.

The Company is the sole corporate member of two Foundations: The Health Care Assistance Foundation, Inc. ("HCAF") and the Blue Cross Blue Shield of Massachusetts Foundation ("BCBSF"). The Company provided the two Foundations with financial support of $8,274 and $8,799 in 2006 and 2005, respectively.

The mission of HCAF is to promote the care of the elderly, disabled and other persons who are experiencing financial hardship and to provide limited financial assistance for their care. Effective December 31, 2005, HCAF discontinued its prescription drug reimbursement and Medex Gold assistance programs.

The mission of BCBSF is to promote and support programs, research and policies that will help to expand access to high quality, affordable health care for Massachusetts residents. BCBSF is the sole corporate member of the Massachusetts Medicaid Policy Institute, Inc. ("MMPI"), which provides independent research and support on matters related to Medicaid in Massachusetts.

At December 31, 2006, the Company has payables to BCBSF and HCAF of $10,390 and $29, respectively, and a receivable from MMPI of $81. At December 31, 2005, the Company has payables to BCBSF and HCAF of $12,658 and $219, respectively, and a receivable from BCBSF of $85.

12. Medicare Part D Inter-Plan Services Agreement

In 2006, the Company entered into a Medicare Part D Inter-Plan Services Agreement with Anthem Blue Cross Blue Shield ("Anthem BCBS"), Blue Cross and Blue Shield of Rhode Island, and Blue Cross and Blue Shield of Vermont ("The Plans") to offer a Blue Cross and Blue Shield branded prescription drug plan ("PDP") The Plans have collectively entered into a contract with the CMS to offer a branded PDP based on the regulations contained with the Medicare Modernization Act of 2003. Anthem BCBS acts as a third party administrator to process premium and claims under PDP.

Name and Address of Third Party Administrator	FEIN Number	Exclusive Contract	Type of Business Written	Type of Authority Granted	Total Direct Premium Written
Wellpoint/Anthem Blue Cross Blue Shield 370 Basset Road, North Haven, CT. 06473	35-2145715	No	Medicare Part D	Administrative Services	$ 82,854

13. Retrospectively Rated Contracts and Contracts Subject to Redetermination

The Company estimates accrued retrospective premium adjustments for its retrospectively rated business through a mathematical approach consistent with the Company's underwriting rules and experience rating practices.

The amount of net premiums written by the Company for the years ended December 31, 2006 and 2005 that are subject to retrospective rating features was $98,088 and $14,100, that represented 4.7% and 0.7%, respectively, of the total net premiums written for the Company. No other premiums written by the Company are subject to retrospective rating features.

Profits and losses associated with the direct pay Blue Cross Blue Shield branded PDP are pooled and allocated amongst The Plans based upon membership in the applicable branded area and reported as other expense of $2,374.

14. Health Care Receivables

Amounts receivable for pharmaceutical rebates are estimated based on a per claim guarantee calculation. Rebate amounts are typically paid on a monthly basis as part of an overall settlement in accordance with the agreement.

The Company's pharmacy rebate receivable balances are as follows at the end of each quarter for 2006:

Quarter	Pharmacy Rebates as Reported on Financial Statements	Pharmacy Rebates as Billed or Otherwise Confirmed	Actual Rebates Collected within 90 days	Actual Rebates Collected within 91 to 180 days	Actual Rebates Collected in more than 180 days
12/31/2006	**$ 582**	**$ 582**	**$ –**	**$ –**	**$ –**
9/30/2006	–	–	–	–	–
6/30/2006	2,670	2,670	2,670	–	–
3/31/2006	3,187	3,187	785	2,402	–

To the extent that receivable and payable with the same provider are netted, the Company's risk sharing receivable balances are as follows at December 31:

Calendar year	Risk Sharing Receivable as Estimated in the Prior Year	Risk Sharing Receivable Adjusted in the Current Year	Risk Sharing Receivable Billed	Risk Sharing Receivable Not Billed	Risk Sharing Receivable Billed/ Received	Risk Sharing Receivable as Estimated in the Current Year
2006	**$ 1,512**	**$ 777**	**$ 1,803**	**$ –**	**$ 1,803**	**$ 486**
2005	4,583	(758)	2,313	–	2,313	1,512
2004	737	8,419	4,573	–	4,573	4,583

15. ASO and ASC Business

The Company provides certain claim administration services for its uninsured customers through ASO or ASC arrangements. The net gain or loss from income related to these contracts is as follows at December 31, 2006 and 2005:

	ASO Uninsured Plans	
	2006	2005
Net reimbursement for administrative expenses (including administrative fees) in excess of actual expenses	**$ 419**	$ 193
Net gain from operations	**$ 419**	$ 193
Total claim payment volume	**$ 5,379**	$ 12,192

	ASC Uninsured Plans	
	2006	2005
Gross reimbursement for medical cost incurred	**$ 5,053,775**	$ 4,399,246
Gross administrative fees accrued	**251,413**	238,341
Gross expenses incurred (claims and administrative)	**(5,308,974)**	(4,626,749)
Net (loss) gain from operations	**$ (3,786)**	$ 10,838

At December 31, 2006 and 2005, the Company admitted assets of $400,670 and $350,122, respectively in accounts receivable for uninsured plans and amounts due from agents. The Company routinely assesses the collectibility of their receivables.

At December 31, 2006 and 2005, the Company recorded gross ASO and ASC administrative fees accrued and not billed of $22,375 and $21,782, respectively.

16. Leases

The Company and HMO Blue jointly have a long-term operating lease agreement for approximately 500,000 square feet of office space for its corporate headquarters. The term of the lease is 15 years, commencing in May 2000, with an option to extend for one period of four years and eleven months.

The Company and HMO Blue jointly entered into several other long-term, non-cancelable operating lease agreements for office space and equipment that expire at various dates through 2010. For the years ended December 31, 2006 and 2005, the Company recorded rental expense of approximately $14,956 and $15,933, respectively.

16. Leases (continued)

At December 31, 2006, allocated minimum rental commitments on significant non-cancelable operating leases for the Company are as follows:

2007	$ 14,574
2008	11,369
2009	9,774
2010	10,061
2011	10,221
Thereafter	28,149

In addition, the Companies have an agreement with an outside vendor to provide certain information technology services for substantially all of the Companies' business operations. The Companies minimum commitments under this agreement are approximately $51,770 per year.

17. Revolving Line of Credit

The Company and HMO Blue jointly entered into two $100,000 revolving credit agreements. Borrowings under these lines of credit bear interest on a floating interest rate basis. The credit facilities are unsecured and mature in June 2007 and August 2007. There are no amounts outstanding under either credit facility at December 31, 2006.

The Company terminated a $30,000 revolving credit agreement in July 2006 which was set to expire in August, 2006.

18. Commitments and Contingencies

The Company is involved in pending and threatened litigation of the character incidental to its business or arising out of its insurance operations, and is, from time to time, involved as a party in various governmental and administrative proceedings. Management continues to monitor these matters, and believes the Company has accrued adequate reserves against potential liabilities.

In 2005, the Companies jointly entered into a Tri-Party agreement with Citizens Bank of Massachusetts ("Citizens") and Perry South Shore Developer, LLC (the "Developer") with respect to obligations of the Companies pursuant to a Purchase and Sale Agreement with the Developer for the construction and development of a building and related improvements. The Tri-Party agreement pledged assets of the Companies in the amount of $150,000 to Citizens for the Developers rights and interests under the Purchase and Sale agreement. In September 2006, with the Companies taking title to the property and related improvements, as disclosed in Note 3, the Tri-Party Agreement was terminated and the collateral released.

BLUE CROSS AND BLUE SHIELD OF MASSACHUSETTS HMO BLUE, INC.

AUDITED STATUTORY-BASIS FINANCIAL STATEMENTS

Years Ended December 31, 2006 and 2005

Contents

Report of Independent Auditors

Board of Directors
Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

We have audited the accompanying statutory-basis balance sheets of Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. (the Company) as of December 31, 2006 and 2005, and the related statutory-basis statements of income, changes in surplus, and cash flow for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 3 to the financial statements, the Company presents its financial statements in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance, which practices differ from U.S. generally accepted accounting principles. The variances between such practices and U.S. generally accepted accounting principles and the effects on the accompanying financial statements are described in Note 3.

In our opinion, because of the effects of the matter described in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with U.S. generally accepted accounting principles, the financial position of Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. at December 31, 2006 and 2005, or the results of its operations or its cash flows for the years then ended.

However, in our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. at December 31, 2006 and 2005, and the results of its operations and its cash flows for the years then ended in conformity with accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over statutory financial reporting as of December 31, 2006 based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated April 20, 2007 expressed an unqualified opinion thereon.

Ernst & Young LLP

Boston, Massachusetts
April 20, 2007

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

Statutory-basis Balance Sheets

(In thousands)

	December 31	
	2006	2005
Admitted assets		
Bonds	$ 505,549	$ 485,534
Preferred stock	2,845	578
Common stock	201,101	211,199
Properties occupied by the company	115,179	53,598
Cash, cash equivalents and short-term investments	62,689	47,677
Receivable for securities	10,503	83
Other invested assets	455,399	411,522
Total cash and invested assets	1,353,265	1,210,191
Accrued investment income	4,504	4,602
Premiums receivable	19,994	12,930
Data processing equipment	3,316	4,643
Health care and other receivables	16,459	20,977
Other assets	272	494
Total admitted assets	$ 1,397,810	$ 1,253,837
Liabilities and surplus		
Health care claim reserves	$ 270,936	$ 246,007
Accrued medical incentive pool and bonus payments	41,802	25,942
Aggregate policy reserves	17,972	15,687
Premiums received in advance	76,256	89,609
Accounts payable and accrued liabilities	34,856	34,142
Payable to affiliates	70,777	75,702
Payable for securities	45,549	2,967
Total liabilities	558,148	490,056
Surplus	839,662	763,781
Total liabilities and surplus	$ 1,397,810	$ 1,253,837

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

Statutory-basis Statements of Income

(In thousands)

	Year Ended December 31	
	2006	**2005**
Premiums earned	**$ 4,221,447**	$ 3,641,564
Health care benefits	**3,784,392**	3,214,718
Claims adjustment expenses	**218,612**	170,963
General and administrative expenses	**205,530**	194,338
Total expenses	**4,208,534**	3,580,019
Underwriting gain	**12,913**	61,545
Net investment income	**48,277**	35,047
Net realized investment gains	**9,082**	40,463
Net income	**$ 70,272**	$ 137,055

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

Statutory-basis Statements of Changes in Surplus

(In thousands)

	Year Ended December 31	
	2006	**2005**
Balance at January 1	**$ 763,781**	$ 636,379
Net assets transferred from BCBSMA on April 1, 2005	**–**	60,000
Net income	**70,272**	137,055
Change in net unrealized gains (losses)	**38,679**	(29,879)
Change in non-admitted assets	**(32,754)**	(39,774)
Other surplus adjustment	**(316)**	–
Balance at December 31	**$ 839,662**	$ 763,781

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

Statutory-basis Statements of Cash Flow

(In thousands)

	Year Ended December 31	
	2006	2005
Operating activities		
Premiums received	**$ 4,202,887**	$ 3,640,138
Health care benefits paid	**(3,745,941)**	(3,175,554)
General and claim adjustment expenses paid	**(409,878)**	(363,198)
Net investment income received	**50,009**	35,210
Net cash provided by operating activities	**97,077**	136,596
Investing activities		
Sales, maturities and redemptions of investments	**601,117**	639,608
Cost of investments acquired	**(610,184)**	(873,708)
Acquisition of real estate	**(62,447)**	(26,617)
Other miscellaneous proceeds	**32,161**	3,510
Net cash used in investing activities	**(39,353)**	(257,207)
Financing or miscellaneous activities		
Net assets transferred from BCBSMA	**–**	88,315
Other (applications) sources, net	**(42,712)**	79,973
Net cash (used in) provided by financing or miscellaneous activities	**(42,712)**	168,288
Net increase in cash, cash equivalents and short-term investments	**15,012**	47,677
Cash, cash equivalents and short-term investments:		
Beginning of year	**47,677**	–
End of year	**$ 62,689**	$ 47,677

See accompanying notes.

Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc.

Notes to Statutory-basis Financial Statements

December 31, 2006
(Dollars in thousands)

1. Master Reorganization

On January 1, 2005, pursuant to a Master Reorganization Agreement ("MRA"), Blue Cross and Blue Shield of Massachusetts, Inc. ("BCBSMA") transferred its insured health maintenance organization line of business (with the exception of Blue Care 65, which was transferred on April 1, 2005) to Blue Cross and Blue Shield of Massachusetts HMO Blue, Inc. ("HMO Blue" or the "Company"), a separately incorporated, non-profit subsidiary of BCBSMA. Since January 1, 2005, HMO Blue has provided hospitalization, medical and other health benefits as a licensed health maintenance organization as disclosed in Note 2. Effective January 1, 2005, HMO Blue received a health maintenance organization ("HMO") license from the Commonwealth of Massachusetts Division of Insurance ("DOI"). HMO Blue operates as a nonprofit, charitable organization and qualifies as a tax-exempt social welfare organization under Section 501(c)(4) of the Internal Revenue Code.

Significant components of the assets and liabilities transferred to HMO Blue are as follows:

	2005
Cash and investments	$ 955,727
Real estate, less accumulated depreciation	27,291
Health care and other receivables	22,215
Premiums receivable	4,644
Data processing equipment	4,533
Other admitted assets	15,063
Total admitted assets	$1,029,473
Health care claim reserves	$ 204,813
Premiums received in advance	87,417
Accounts payable and accrued liabilities	57,867
Accrued medical incentive pool and bonus payments	29,210
Other liabilities	13,787
Total liabilities	$ 393,094

Under the MRA, both BCBSMA and HMO Blue (collectively referred to as the "Companies") have an undivided interest in what had been BCBSMA's property and equipment. The initial basis of the property and equipment were systematically allocated to each company at the date of the transaction. Ongoing depreciation expenses are charged to each company based on utilization.

Under the MRA, existing employees of the Companies (the "Associates") are either concurrently employed by both BCBSMA and HMO Blue or solely employed by BCBSMA. Those individuals solely employed by BCBSMA include senior level management ("SLM"). The compensation, benefits and administrative expenses of the concurrently employed Associates are charged to BCBSMA and HMO Blue in accordance with their provision of services to each company. With respect to individuals solely employed by BCBSMA, the pro-rata portion of compensation, benefits, and administrative expenses attributable to services provided to HMO Blue is charged to HMO Blue on an arm's length basis, including a mark-up. A common paymaster arrangement has been set up for payroll and payroll related benefits. An agency arrangement has been set up for payment of claims and operating expenses and receipt of funds. The Companies' pension and post-retirement benefits plans ("Benefit Plans") continue to be sponsored by BCBSMA. BCBSMA charges HMO Blue, as a participating employer of the Benefit Plans, a fee based on HMO Blue's allocated share of the Benefit Plans' expenses.

As a condition of granting an HMO license to HMO Blue, the DOI required the Companies to enter into an agreement with the DOI granting the DOI discretionary authority to require either company to issue a surplus note to the other company if either of the company's health risk-based capital ("RBC") is significantly higher than the other company's RBC. Under the terms of its license with Blue Cross and Blue Shield Association, BCBSMA has also entered into a unilateral agreement with HMO Blue to guarantee all current and future financial obligations of HMO Blue.

2. Nature of Business

The Company is a Massachusetts corporation organized under Chapter 180 of the Massachusetts General Laws and holds a health maintenance organization license pursuant to Massachusetts General Laws Chapter 176G. The Company provides hospitalization, medical and other health benefits to members through contracts with hospitals, participating physicians, skilled nursing facilities, nursing homes, and other health care providers and organizations. The Company offers a variety of HMO and other supplementary programs for the benefit of its members.

3. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying financial statement has been prepared in accordance with the National Association of Insurance Commissioners ("NAIC") *Statements of Statutory Accounting Principles* ("SSAP"), and in conformity with accounting practices prescribed or permitted by the DOI, which practices differ from accounting principles generally accepted in the United States ("GAAP").

The more significant variances from GAAP are as follows:

Investments: Investments in bonds and preferred stocks are reported at amortized cost or fair value based on their NAIC rating; for GAAP, such fixed maturity investments would be designated at purchase as held-to-maturity, trading, or available-for-sale. Held-to-maturity fixed investments would be reported at amortized cost, and a remaining fixed maturity investments would be reported at fair value with unrealized holding gains and losses reported in a separate component of earnings for those designated as trading and as a separate component of other comprehensive income for those designated as available-for-sale.

All single-class and multi-class mortgage-backed/asset-backed securities are adjusted for the effects of changes in prepayment assumptions on the related accretion of discount or amortization of premium of such securities using the retrospective method. If it is determined that a decline in fair value is other-than-temporary, the cost basis of the security is written down to the undiscounted estimated future cash flows.

For GAAP purposes, all securities, purchased or retained, that represent beneficial interests in securitized assets, other than high credit quality securities, are adjusted using the prospective method when there is a change in estimated future cash flows. If it is determined that a decline in fair value is other-than-temporary, the cash basis of the security is written down to the discounted fair value. If high credit quality securities are adjusted, the retrospective method is used.

Fair value of certain investments in bonds and stocks are based on values specified by the NAIC rather than on actual or estimated market values, and therefore, are not stated in accordance with GAAP.

Investments in real estate are reported net of related obligations rather than on a gross basis. Real estate owned and occupied by the Company is included in investments rather than reported as an operating asset under GAAP, and investment income and operating expenses include rent for the Company's occupancy of those properties.

Nonadmitted Assets: Certain assets designated as "nonadmitted," including furniture, fixtures and equipment, leasehold improvements, nonoperating system software, prepaid expenses, certain premium receivable balances, and, other assets not specifically identified as an admitted asset within the SSAP, are excluded from the accompanying balance sheet and are charged directly to surplus. Under GAAP, such assets are included in the balance sheet.

Statement of Cash Flow: Cash, cash equivalents, and short-term investments in the statement of cash flow represent cash balances and investments with initial maturities of one year or less. Under GAAP, the corresponding caption of cash and cash equivalents includes cash balances and investments with initial maturities of three months or less.

A reconciliation of net income and surplus of the Company, as determined in accordance with statutory accounting practices to amounts determined in accordance with GAAP, is as follows:

	Year Ended December 31, 2006		Year Ended December 31, 2005	
	Net Income	Surplus	Net Income	Surplus
Statutory-basis amounts	**$ 70,272**	**$ 839,662**	$ 137,055	$ 763,781
Investments	**41,610**	**239**	24,043	1,134
Premium receivable allowance	**(428)**	**–**	–	–
Other non-admitted	**(1,051)**	**114,585**	(462)	82,994
GAAP-basis amounts	**$ 110,403**	**$ 954,486**	$ 160,636	$ 847,909

Other significant accounting practices are as follows:

Use of Estimates

The preparation of the financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statement and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates.

Investments

Bonds not backed by loans are stated at amortized cost, with amortization calculated based on the scientific method, using lower of yield to call or yield to maturity. Prepayment assumptions for mortgage-backed securities and structured securities were obtained from broker-dealer survey values. These assumptions are consistent with the current interest rate and economic environment. The retrospective adjustment method is used to value all mortgage-backed securities.

Common stocks are stated at fair values as determined by the NAIC Securities Valuation Office ("SVO"). Preferred stocks are stated at cost, amortized cost or fair value based on the underlying characteristics and NAIC designation. Other invested assets are stated at fair value of the underlying securities. The Company has various ownership interests in limited liability partnerships and limited liability companies. The Company carries these investments based on its ownership interest in the underlying GAAP equity of the investee. These investments are included as other invested assets on the balance sheet.

3. Summary of Significant Accounting Policies (continued)

Unrealized gains and losses on stocks and other invested assets are reflected directly in surplus unless there is deemed to be an other-than-temporary decline in value, in which case the loss is charged to income. Realized gains and losses on investments sold are determined using the specific identification method and are included in income. Amortization of bond premium and accretion of bond discount are recognized on a yield-basis method. Security transactions are accounted for on a trade-date basis, with any unsettled transactions recorded as due to or from investment broker and included as payable or receivable for securities in the Company's admitted assets and liabilities, respectively.

Investment income is recognized as income when earned. The Company periodically reviews the portfolio of securities to determine whether an other-than-temporary impairment has occurred. Any identified other-than-temporary impairment is recorded as part of net realized investment gains. HMO Blue did not recognize any impairment write-down for its investments during the years ended December 31, 2006 and 2005.

Cash equivalents are short-term highly liquid investments with original maturities of three months or less and are principally stated at amortized cost. Short-term investments include investments with remaining maturities of one year or less at the time of acquisition and are principally stated at amortized cost.

Real Estate

Land is recorded at cost, and other real estate, which includes expenditures for significant improvements, is recorded at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful life of 50 years.

The Company and BCBSMA jointly own land and building with 343,800 square feet of office space in Quincy, Massachusetts. The renovation of this facility was completed for occupancy in September, 2005.

In 2005, the Company and BCBSMA jointly entered into a Tri-Party agreement (as disclosed in Note 14) with a developer to construct a new office facility in Hingham, Massachusetts. As part of this agreement, in September 2006, the Company and BCBSMA took title to this property and related improvements to date. Improvements and construction continues, with occupancy anticipated to occur in 2007.

The components of the Company's real estate are summarized as follows:

	2006	2005
Land and building	**$ 116,354**	$ 54,186
Less accumulated depreciation	**(1,175)**	(588)
Net real estate occupied by the Company	**$ 115,179**	$ 53,598

Under statutory reporting guidelines, the Companies are required to calculate imputed rental income for owner-occupied real estate. The method for calculating imputed rental income is based on estimated rental rates of like property in the same area times rentable square feet. These imputed amounts are reported as investment income and operating expense in the statement of income reflecting that the Company had paid rent of $3,516 and $1,002 for 2006 and 2005, respectively.

Furniture and Equipment

The admitted value of the Company's electronic data processing equipment and operating software is limited to three percent of adjusted surplus. The Company's admitted portion is reported at cost, less accumulated depreciation of $19,968 at December 31, 2006 and $17,097 at December 31, 2005. Electronic data processing equipment and operating software are depreciated using the straight-line method over the lesser of its useful life or three years. Non-operating software is depreciated using the straight-line method over the lesser of its useful life or five years. Other furniture and equipment is depreciated using the straight-line method over its estimated useful life. Depreciation expense charged to income was $5,521 and $5,038 for 2006 and 2005, respectively.

Health Care Claim Reserves

The provision for health care claim reserves is actuarially determined based on historical claims payment experience and other statistics. This liability is subject to the impact of changes in claim severity and frequency, as well as numerous other factors. Management believes that the liability is adequate, but the ultimate net cost of settling this liability may vary from the estimated amount.

The methods used to develop the reserves for claims incurred but not yet reported are subject to continuing review and refinement, and any necessary adjustments are recorded in operations in the year in which they are determined to be necessary.

Accrued Medical Incentive Pool and Bonus Payments

Medical incentive pool and bonus accruals represent the liability for arrangements with health care providers and other risk sharing arrangements where the Company agrees to share savings with contracted providers.

Aggregate Policy Reserves

Aggregate policy reserves represent a reserve for unearned premium income and a reserve for rate credits and experience rating refunds.

Premium Deficiency

The Company evaluates its health care contracts to determine if it is probable that a loss will be incurred. A premium deficiency loss is recognized when it is probable that expected future paid claims, administrative expenses, and reserves will exceed existing reserves plus anticipated future premiums on existing contracts. Anticipated investment income and overhead expenses are also considered in the calculation of premium deficiency losses. For all periods presented, no premium deficiency losses were recorded.

3. Summary of Significant Accounting Policies (continued)

Premium

The Company receives premium revenue from insured business. Member premiums are billed in advance of their respective coverage periods. Premium receivable are recorded when due. Premium earned is recorded during the coverage period. Aggregate policy reserves are established to cover the unexpired portion of premiums written and are computed by pro-rata methods for direct business. Expenses incurred in connection with acquiring new insurance business, including acquisition costs such as sales commissions, are charged to administrative expenses as incurred. The premium paid by subscribers prior to the effective date is recorded in the balance sheet as premiums received in advance and subsequently credited to income as earned during the coverage period.

For uncollected premium, after the calculation of non-admitted amounts, an evaluation is made of the remaining admitted assets in accordance with SSAP No. 5 to determine if there is impairment. If it is probable that the balance is uncollectible, any uncollectible amount is written off and charged to income in the period the determination is made. As of December 31, 2006 and 2005 the Company reserved $3,268 and $2,004, respectively, for possible uncollectible amounts not written off.

Health Care Receivables

The Company enters into contractual agreements with various health care providers to provide certain medical services to its members. Compensation arrangements vary by provider. Certain providers have entered into risk-sharing arrangements with the Company, whereby a settlement is calculated by comparing actual medical claims experience to a pre-approved and predetermined budgeted amount. These settlements are accrued on an estimated basis in the period the related services are rendered, and adjusted in future periods as final settlements are determined. Estimated settlements for these risk-sharing arrangements are reflected in health care receivables on the Company's balance sheet.

Other amounts included in health care receivables represent pharmaceutical rebates, claims overpayments, advances to the providers and capitation arrangement receivables. Pharmaceutical rebates are arrangements with pharmaceutical companies in which the Company receives rebates based upon drug utilization of its subscribers at participating pharmacies. Claim overpayments occur as a result of several events, including, but not limited to, claim payments paid in error to a provider. The Company also makes advances to providers, when those advances are supported by legally enforceable contracts and are generally entered into at the request of the providers. Advances to the providers under a capitation arrangement are usually made in anticipation of the future services, and used in connection with some managed care contracts, when a physician or other medical provider is paid a flat amount.

Impairment of Long-lived Assets

The Company continually evaluates the recoverability of long-lived assets by assessing whether the carrying amount of asset balances can be recovered as measured against the future undiscounted net cash flows expected to be generated by the assets. The future undiscounted net cash flows are based on historical trends, revenue forecasts, and market trends projected over the remaining life of the long-lived assets.

If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. In 2006 and 2005, the Company recorded impairment charges of $12,027 and $392, respectively, related to internally developed software and furniture and fixtures.

Fair Value of Financial Instruments

The fair value of investment securities is estimated based on NAIC quoted prices for those or similar investment securities. The carrying amounts of cash, cash equivalents and short-term investments approximate fair value because of the short maturity of these instruments.

Reclassification

Certain amounts for the year ended December 31, 2005 have been reclassified to be consistent with the presentation of the amounts for the year ended December 31, 2006.

4. Cash and Investments

The cost or amortized cost, gross unrealized gains (losses), and NAIC fair value of cash and investments are as follows:

	December 31, 2006			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	NAIC Fair Value
Cash, cash equivalents and short-term investments	$ 62,689	$ –	$ –	$ 62,689
Bonds:				
U.S. Government securities	163,223	518	(1,308)	162,433
Industrial and miscellaneous	117,516	1,982	(610)	118,888
Mortgage-backed securities	224,810	857	(1,413)	224,254
Total bonds	505,549	3,357	(3,331)	505,575
Common stocks	200,590	5,648	(5,137)	201,101
Preferred stocks	2,845	–	–	2,845
Other invested assets	365,499	90,373	(473)	455,399
Total cash and investments	$ 1,137,172	$ 99,378	$ (8,941)	$ 1,227,609

4. Cash and Investments (continued)

	December 31, 2005			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	NAIC Fair Value
Cash, cash equivalents and short-term investments	$ 47,677	$ –	$ –	$ 47,677
Bonds:				
U.S. Government securities	146,466	898	(868)	146,496
Industrial and miscellaneous	146,730	3,368	(1,041)	149,057
Mortgage-backed securities	192,338	696	(2,167)	190,867
Total bonds	485,534	4,962	(4,076)	486,420
Common stocks	207,793	7,697	(4,291)	211,199
Preferred stocks	578	–	–	578
Other invested assets	362,436	49,621	(535)	411,522
Total cash and investments	$1,104,018	$ 62,280	$ (8,902)	$1,157,396

Included in Bonds is $1,000 in assets which the Company had on deposit with regulatory agencies at December 31, 2006 as required by M.G.L. c.176G section 26.

Fair value of publicly traded bonds and unaffiliated stocks are generally based on independently quoted market prices, which may differ from NAIC fair values. The NAIC fair value of bonds was $505,575 and $486,420 at December 31, 2006 and 2005, respectively. The NAIC fair value of unaffiliated common stocks was $201,101 and $211,199 at December 31, 2006 and 2005 respectively. The NAIC fair value of unaffiliated preferred stocks was $2,845 and $578 at December 31, 2006 and 2005, respectively. The NAIC fair value of other invested assets was $455,399 and $411,522 at December 31, 2006 and 2005, respectively. Accrued investment income of $4,504 and $4,602 at December 31, 2006 and 2005, respectively, is defined as investment income earned as of the reporting date but is not contractually due to be paid to the Company until subsequent to the reporting date.

The following tables shows gross unrealized losses and fair values of fixed maturities, equities and other invested asset and length of time that individual securities have been in a continuous unrealized position.

	Less than 12 months		12 months or more		Total	
At December 31, 2006	NAIC Fair Value	Gross Unrealized Losses	NAIC Fair Value	Gross Unrealized Losses	NAIC Fair Value	Gross Unrealized Losses
Bonds	**$180,529**	**$(1,164)**	**$137,221**	**$(2,167)**	**$317,750**	**$(3,331)**
Common stocks	**26,912**	**(1,209)**	**82,629**	**(3,928)**	**109,541**	**(5,137)**
Other invested assets	**11,405**	**(173)**	**8,444**	**(300)**	**19,849**	**(473)**
Total	**$218,846**	**$(2,546)**	**$228,294**	**$(6,395)**	**$447,140**	**$(8,941)**

	Less than 12 months		12 months or more		Total	
At December 31, 2005	NAIC Fair Value	Gross Unrealized Losses	NAIC Fair Value	Gross Unrealized Losses	NAIC Fair Value	Gross Unrealized Losses
Bonds	$215,641	$(3,096)	$81,435	$ (980)	$297,076	$(4,076)
Common stocks	103,305	(4,166)	1,037	(125)	104,342	(4,291)
Other invested assets	32,302	(535)	–	–	32,302	(535)
Total	$351,248	$(7,797)	$82,472	$ (1,105)	$433,720	$(8,902)

Management regularly reviews the value of the Company's investments. If the value of any investment falls below its cost basis, the decline is analyzed to determine whether it is an other-than-temporary decline in value. To make this determination for each security, the following is considered:

- The length of time and the extent to which the fair value has been below cost;
- The financial condition and near-term prospects of the issuer of the security, including any specific events that may affect its operations or earnings potential;
- Volatility inherent in the asset class to which the investment belongs;
- Management's intent and ability to hold the security long enough for it to recover its value.

At December 31, 2006 and 2005, included in the Company's investments are unrealized losses deemed to be temporary. These investments reflect a range of industries, and the Company deems the current market volatility as temporary.

In 2006 and 2005, there was no write-down of debt or equity securities with a decline in fair value that was determined by management to be other-than-temporary.

The amortized cost and NAIC fair value of debt securities at December 31, 2006, by stated maturity, are shown below. Fixed maturities subject to early or unscheduled prepayments have been included based upon their stated maturity dates. Actual maturities may differ from stated maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

4. Cash and Investments (continued)

	Cost or Amortized Cost	NAIC Fair Value
Within 1 year	$ 56,277	$ 56,145
After 1 year through 5 years	177,093	176,986
After 5 years through 10 years	77,837	77,569
After 10 years	194,342	194,875
Total bonds	$ 505,549	$ 505,575

Proceeds from the sale of investment securities were approximately $532,559 and $583,677 for the years ended December 31, 2006 and 2005, respectively. Gross realized investment gains and losses included in net investment income are as follows:

	2006	2005
Gross gains	$ 13,111	$ 42,172
Gross losses	(4,029)	(1,709)
Net realized investment gains	$ 9,082	$ 40,463

5. Health Care Claims Reserves

Activity in health care claims reserves is summarized in the reconciliation of the beginning and ending balances of claims payable and claims incurred but not yet reported as follows:

	2006	2005
Balance at January 1	$ 246,007	$ 204,813
Incurred related to:		
Current year	3,784,659	3,219,163
Prior years	(40,013)	(26,332)
Total incurred	3,744,646	3,192,831
Paid related to:		
Current year	3,523,793	2,987,928
Prior years	195,923	163,709
Total paid	3,719,716	3,151,637
Balance at December 31	$ 270,936	$ 246,007

The Company uses estimates for determining its claims incurred but not yet reported, which are based on historical claim payment patterns, healthcare trends and membership and includes a provision for adverse changes in claim frequency and severity. Amounts incurred related to prior years vary from previously estimated liabilities as the claims are ultimately settled. Liabilities at any year end are continually reviewed and re-estimated as information regarding actual claims payments become known. This information is compared to the originally established year end liability. Negative amounts reported for incurred related to prior years result from claims being settled for amounts less than originally estimated. The favorable development in medical claims payable for the years ended December 31, 2006 and 2005 is primarily attributable to actual claim payment patterns and cost trends differing from those assumed at the time the liability was established.

The Company also made adjustments of $(4,550) and $(5,200) in 2006 and 2005, respectively, to the initial provision of $19,500 recorded in 2004 to recognize certain estimated provider settlements related to prior disputed claim payments.

A reconciliation of incurred claims reported above to health care benefits in the Company's statements of income is as follows:

	December 31 2006	2005
Total incurred claims per above	$ 3,744,646	$ 3,192,831
Medical incentive pool and bonus payments incurred	39,746	21,887
Health care benefits	$ 3,784,392	$ 3,214,718

Estimated subrogation credits of $2,935 and $2,698 for 2006 and 2005, respectively, were taken into account in determining claims unpaid.

Management believes its methodologies for reserving for unpaid claims are appropriate and represent its best estimate at December 31, 2006 and 2005. Methodologies utilized for current year reserves for unpaid claims are consistent with prior years.

6. Pension and Other Post-Retirement Benefit Plans

The pension and other post-retirement benefit plans ("Plans") are sponsored by BCBSMA and the associated costs are shared by the Companies. All employees are eligible to participate in BCBSMA's Retirement Income Trust Plan ("RIT"), which grants benefits to retired employees at various levels based on age and years of service. BCBSMA also participates in two noncontributory retirement plans for eligible employees. BCBSMA uses a December 31 measurement date for the majority of its plans. Effective January 1, 2005, the Company is an active participating employer of the Plans. The pension and other post-retirement benefits costs allocated to the Company in 2006 and 2005 are $11,088 and $12,866 respectfully.

6. Pension and Other Post-Retirement Benefit Plans (continued)

BCBSMA also sponsors a defined benefit plan covering medical, life and dental benefits. The 401(h) account was instituted by BCBSMA in December 2003. There were no contributions made in 2006, and a contribution of $9,000 was made in December 2005. BCBSMA also has a savings 401(k) plan for eligible employees. Under the employee savings plan, BCBSMA contributes an amount equal to 65% of employee contributions, up to a maximum of 6% of each employee's compensation, subject to pretax Internal Revenue Service limits. The Company contributed $2,836 and $2,946 in 2006 and 2005, respectively, into the 401(k) plan.

7. Surplus

The NAIC has imposed regulatory RBC requirements on health insurance companies, including the Company. The RBC calculation serves as a benchmark for the regulation of health insurance companies' solvency by state insurance regulators. At December 31, 2006, the Company's total adjusted capital is in excess of the regulatory RBC requirements.

Chapter 141, which applies requirements of unfair insurance competition under Chapter 176D to HMOs and HMOs operated as a line of business, requires an HMO to have adjusted net worth of $1,500 when initially licensed. Thereafter, an HMO must maintain a minimum adjusted net worth in an amount determined by the DOI based initially on a sliding scale over a seven-year phase-in period effective, December 31, 2004. HMOs must maintain a minimum deposit of at least $1,000 with a trustee acceptable to the DOI. The Company met and exceeded all regulatory Chapter 141 requirements at December 31, 2006.

8. Permitted Statutory Accounting Practices

State insurance laws and regulations prescribe accounting practices for determining statutory net income and surplus for insurance companies. In addition, state regulators may permit statutory accounting practices that differ from prescribed practices. The Company had no permitted practices that would have an effect on statutory surplus at December 31, 2006 and 2005.

9. Related Party Transactions

The Company entered into a bilateral intercompany agreement with BCBSMA as a result of the MRA to settle any claims, fees, administrative cost expense allocation and pass-through cash and expenses paid by one company on behalf of the other company. The Companies operate under common management control. At December 31, 2006 and 2005, the Company had a payable to BCBSMA of $70,777 and $75,702 respectively.

Because of the significant related-party transactions with its parent, BCBSMA, the Company's financial condition and the results of operations may not necessarily be indicative of the financial condition or results of operations that would have occurred if the Company had been operated as an unaffiliated company.

The Company provided support of $3,514 and $6,734 in 2006 and 2005, respectively, to the Blue Cross and Blue Shield of Massachusetts Foundation, Inc. ("BCBSF"). The mission of BCBSF is to promote and support programs, research, and policies that will help expand access to high quality, affordable health care for Massachusetts residents.

10. Retrospectively Rated Contracts and Contracts Subject to Redetermination

As of January 1, 2006 the Company has a retrospectively rated contract with Centers for Medicare & Medicaid Services ("CMS") on its Medicare Part D business. The Company estimates accrued retrospective premium adjustments for this contract consistent with the methodology set by CMS.

The amount of net premium written for the year ended December 31, 2006 that is subject to retrospective rating features was $35,278 which represents 0.8% of total premiums. No other premiums written by the Company are subject to retrospective rating features.

11. Health Care Receivables

Amounts receivable for pharmaceutical rebates are estimated based on a per script calculation. Rebate amounts are typically paid on a quarterly basis 150 days after the end of each quarter. The Companies Pharmacy rebate receivable balances are as follows at the end of each quarter of 2006:

Quarter	Estimated Pharmacy Rebates as Reported on Financial Statements	Pharmacy Rebates as Billed or Otherwise Confirmed	Actual Rebates Received within 90 days	Actual Rebates Received within 91 to 180 days	Actual Rebates Received within more than 180 days
12/31/2006	**$ 921**	**$ 921**	**$ –**	**$ –**	**$ –**
9/30/2006	998	998	–	148	764
6/30/2006	807	807	–	–	–
3/31/2006	–	–	–	–	–

Calendar Year	Risk Sharing Receivable Estimated in the Prior Year	Risk Sharing Receivable Adjusted in the Current Year	Risk Sharing Receivable Billed	Risk Sharing Receivable Not Billed	Risk Sharing Receivable Billed/ Received	Risk Sharing Receivable as Estimated in the Current Year
2006	**$ 3,343**	**$ 3,096**	**$ 4,910**	**$ –**	**$ 4,910**	**$ 1,529**
2005	2,999	8,735	8,391	–	8,391	3,343

12. Leases

The Company and BCBSMA jointly have a long-term operating lease agreement for approximately 500,000 square feet of office space for its corporate headquarters. The term of the lease is 15 years, commencing in May 2000, with an option to extend for one period of four years and eleven months.

The Company and BCBSMA jointly entered into several other long-term, non-cancelable operating lease agreements for office space and equipment that expire at various dates through 2010. The Company recorded rental expense of approximately $14,329 and $15,053 for 2006 and 2005, respectively.

At December 31, 2006, allocated minimum rental commitments on significant non-cancelable operating leases for the Company are as follows:

2007	$ 13,964
2008	10,892
2009	9,364
2010	9,640
2011	9,793
Thereafter	26,970

In addition, the Companies have an agreement with an outside vendor to provide certain information technology services for substantially all of the Companies' business operations. The Companies' minimum commitments under this agreement are approximately $51,770 per year.

13. Revolving Line of Credit

The Company and BCBSMA jointly entered into two $100,000 revolving credit agreements. Borrowings under these lines of credit bear interest on a floating interest rate basis. The credit facilities are unsecured and mature in June 2007 and August 2007. There are no amounts outstanding under either credit facility at December 31, 2006.

14. Commitments and Contingencies

The Company is involved in pending and threatened litigation of the character incidental to its business or arising out of its insurance operations, and is, from time to time, involved as a party in various governmental and administrative proceedings. Management continues to monitor these matters, and believes the Company has accrued adequate reserves against potential liabilities.

The Companies jointly entered into a Tri-Party agreement with Citizens Bank of Massachusetts (Citizens) and Perry South Shore Developer, LLC (the Developer) with respect to obligations of the Companies pursuant to a Purchase and Sale Agreement with the Developer for the construction and development of a building and related improvements. The Tri-Party agreement pledged assets of the Companies in the amount of $150,000 to Citizens for the Developers rights and interests under the Purchase and Sale agreement. In September 2006, with the Companies taking title to the property and related improvements, as disclosed in Note 3, the Tri-Party Agreement was terminated and the collateral released.