KAISER FOUNDATION HEALTH PLAN, INC. AND SUBSIDIARIES AND KAISER FOUNDATION HOSPITALS AND SUBSIDIARIES

Combined Financial Statements

December 31, 2017 and 2016

(With Independent Auditors' Report Thereon)

KAISER FOUNDATION HEALTH PLAN, INC. AND SUBSIDIARIES AND KAISER FOUNDATION HOSPITALS AND SUBSIDIARIES

Table of Contents

KPMG LLP
Suite 1400
55 Second Street
San Francisco, CA 94105

Independent Auditors' Report

The Boards of Directors
Kaiser Foundation Health Plan, Inc.
and Kaiser Foundation Hospitals:

We have audited the accompanying combined financial statements of Kaiser Foundation Health Plan, Inc. and Subsidiaries (Health Plans) and Kaiser Foundation Hospitals and Subsidiaries (Hospitals), which comprise the combined balance sheets as of December 31, 2017 and 2016, and the related combined statements of operations and changes in net worth, and cash flows for the years then ended, and the related notes to the combined financial statements.

Management's Responsibility for the Combined Financial Statements

Management is responsible for the preparation and fair presentation of these combined financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of combined financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these combined financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the combined financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the combined financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the combined financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the combined financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the combined financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the combined financial statements referred to above present fairly, in all material respects, the combined financial position of Health Plans and Hospitals as of December 31, 2017 and 2016, and the results of their operations and their cash flows for the years then ended in accordance with U.S. generally accepted accounting principles.

KPMG LLP

San Francisco, California
February 14, 2018

KAISER FOUNDATION HEALTH PLAN, INC. AND SUBSIDIARIES AND KAISER FOUNDATION HOSPITALS AND SUBSIDIARIES

Combined Balance Sheets

December 31, 2017 and 2016

(In millions)

Assets	2017	2016
Current assets:		
Cash and cash equivalents	$ 552	$ 434
Current investments	6,742	8,677
Securities lending collateral	1,249	631
Broker receivables	388	767
Due from associated medical groups	11	12
Accounts receivable – net	2,013	2,030
Inventories and other current assets	1,543	1,357
Total current assets	12,498	13,908
Noncurrent investments	33,819	25,756
Land, buildings, equipment, and software – net	25,907	24,342
Goodwill	297	—
Other acquired intangible assets – net	293	—
Other long-term assets	569	607
Total assets	$ 73,383	$ 64,613
Liabilities and Net Worth		
Current liabilities:		
Accounts payable and accrued expenses	$ 4,085	$ 3,852
Medical claims payable	2,303	1,862
Due to associated medical groups	1,212	862
Payroll and related charges	2,134	1,828
Securities lending payable	1,249	631
Broker payables	520	849
Long-term debt subject to short-term remarketing arrangements – net	492	785
Other current debt	769	1,904
Other current liabilities	2,791	2,102
Total current liabilities	15,555	14,675
Long-term debt	8,891	4,754
Physicians' retirement plan liability	7,966	6,566
Pension and other retirement liabilities	9,378	9,148
Other long-term liabilities	2,640	2,380
Total liabilities	44,430	37,523
Net worth	28,953	27,090
Total liabilities and net worth	$ 73,383	$ 64,613

See accompanying notes to combined financial statements.

KAISER FOUNDATION HEALTH PLAN, INC. AND SUBSIDIARIES AND KAISER FOUNDATION HOSPITALS AND SUBSIDIARIES

Combined Statements of Operations and Changes in Net Worth

Years ended December 31, 2017 and 2016

(In millions)

	2017	2016
Revenues:		
Members' dues	$ 49,204	$ 43,315
Medicare	16,920	15,414
Copays, deductibles, fees, and other	6,617	5,822
Total operating revenues	72,741	64,551
Expenses:		
Medical services	35,588	30,486
Hospital services	18,447	16,664
Outpatient pharmacy and optical services	8,301	7,370
Other benefit costs	4,696	4,099
Total medical and hospital services	67,032	58,619
Health Plan administration	3,557	4,008
Total operating expenses	70,589	62,627
Operating income	2,152	1,924
Other income and expense:		
Investment income – net	1,932	1,379
Interest expense	(286)	(183)
Total other income and expense	1,646	1,196
Net income	3,798	3,120
Change in pension and other retirement liability charges	(3,567)	(1,215)
Change in net unrealized gains on investments	1,628	299
Change in restricted donations	30	(1)
Change in noncontrolling interest	(26)	(10)
Change in net worth	1,863	2,193
Net worth at beginning of year	27,090	24,897
Net worth at end of year	$ 28,953	$ 27,090

See accompanying notes to combined financial statements.

KAISER FOUNDATION HEALTH PLAN, INC. AND SUBSIDIARIES AND KAISER FOUNDATION HOSPITALS AND SUBSIDIARIES

Combined Statements of Cash Flows

Years ended December 31, 2017 and 2016

(In millions)

	2017	2016
Cash flows from operating activities:		
Net income	$ 3,798	$ 3,120
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and software amortization	2,490	2,299
Other amortization	(30)	(76)
Gain recognized on investments – net	(1,037)	(752)
Loss on land, buildings, equipment, and software – net	80	31
Changes in assets and liabilities:		
Accounts receivable – net	233	(64)
Due from associated medical groups	1	(7)
Other assets	(78)	83
Accounts payable and accrued expenses	99	814
Medical claims payable	164	112
Due to associated medical groups	257	(9)
Payroll and related charges	231	134
Pension and other retirement liabilities	(2,529)	(2,233)
Other liabilities	581	(10)
Net cash provided by operating activities	4,260	3,442
Cash flows from investing activities:		
Additions to land, buildings, equipment, and software	(3,272)	(2,786)
Proceeds from sales of land, buildings, and equipment	4	5
Proceeds from investments	34,894	37,699
Investment purchases	(37,246)	(38,278)
Decrease (increase) in securities lending collateral	(618)	437
Broker receivables / payables	44	(262)
Issuance of notes receivable	(150)	(170)
Prepayment and repayment of notes receivable	180	107
Physicians' retirement plan liability	497	491
Cash paid for acquisition, net of cash assumed	(1,714)	—
Other investing	(67)	24
Net cash used in investing activities	(7,448)	(2,733)
Cash flows from financing activities:		
Issuance of debt	6,397	3,261
Prepayment and repayment of debt	(3,682)	(3,298)
Increase (decrease) in securities lending payable	618	(437)
Change in restricted donations	(1)	(1)
Change in noncontrolling interest	(26)	(10)
Net cash provided by (used in) financing activities	3,306	(485)
Net change in cash and cash equivalents	118	224
Cash and cash equivalents at beginning of year	434	210
Cash and cash equivalents at end of year	$ 552	$ 434
Supplemental cash flows disclosure:		
Cash paid for interest – net of capitalized amounts	$ 275	$ 214
Noncash changes in accounts payable related to purchases of fixed assets	$ —	$ 61

See accompanying notes to combined financial statements.

(1) Description of Business

The accompanying combined financial statements include Kaiser Foundation Health Plan, Inc. and Subsidiaries (Health Plans) and Kaiser Foundation Hospitals and Subsidiaries (Hospitals) (collectively referred to herein as Health Plans and Hospitals). Health Plans and Hospitals are primarily not-for-profit corporations whose capital is available for charitable, educational, research, and related purposes. Health Plans are primarily health maintenance organizations and are generally exempt from federal and state income taxes. Membership at December 31, 2017 and 2016 was 11.8 million and 10.7 million, respectively. At December 31, 2017 and 2016, the percentage of enrolled membership in California was approximately 73% and 77%, respectively. The principal operating subsidiary of Kaiser Foundation Hospitals is Kaiser Hospital Asset Management, Inc. The principal operating subsidiaries of Kaiser Foundation Health Plan, Inc. (Health Plan, Inc.) are:

Kaiser Foundation Health Plan of Colorado

Kaiser Foundation Health Plan of Georgia, Inc.

Kaiser Foundation Health Plan of the Mid-Atlantic States, Inc.

Kaiser Foundation Health Plan of the Northwest

Kaiser Foundation Health Plan of Washington

Kaiser Health Plan Asset Management, Inc.

Independent Medical Groups (Medical Groups) cooperate with Health Plans and Hospitals in conducting the Kaiser Permanente Medical Care Program. Health Plans contracts with Hospitals and the Medical Groups to provide or arrange hospital and medical services for members. Hospitals also contracts with the Medical Groups for certain professional services. Contract payments to the Medical Groups represent a substantial portion of the expenses for medical services reported in these combined financial statements. Payments from Health Plans and Hospitals constitute substantially all of the revenues for the Medical Groups. Because the Medical Groups are independent and not controlled by Health Plans and Hospitals, their financial statements are not combined or consolidated with Health Plans and Hospitals.

At both December 31, 2017 and 2016, the percentage of Health Plans and Hospitals' total labor force covered under collective bargaining agreements was approximately 71%. At December 31, 2017, approximately 29% of the workforce was covered under collective bargaining agreements that were scheduled to expire within one year. At December 31, 2017, none of the workforce was working under an expired agreement, and approximately 1% of the workforce was in a new bargaining unit that was negotiating an agreement.

Health Plans and Hospitals strives to improve the health and welfare of the communities it serves through its Community Benefit investment programs. Community Benefit expenditures provide funding for programs that serve communities through research, community-based health partnerships, the provision of charity care to low-income patients, direct health coverage for low-income families, and collaboration with community clinics, health departments, and public hospitals.

Cost-based methods are used to account for losses incurred under the care and coverage lines of business qualifying for treatment as Community Benefit. Patients assigned to these lines of business must first prove eligibility based upon family income relative to the Federal Poverty Guidelines. Most costs determined to be Community Benefit are allocated across the lines of business following pre-determined allocation rules applied within the organization's cost accounting systems. Certain Community Benefit costs are determined using the out-of-pocket costs directly billed to patients or a cost-to-charge ratio applied to uncompensated charges associated with care provided to these patients.

For the year ended December 31, 2017, Community Benefit expenditures (at cost, net of approximately $3.2 billion of related revenues) were $2.8 billion, representing 3.9% of operating revenue. In comparison, for the year ended December 31, 2016, Community Benefit expenditures (at cost, net of $3.0 billion of related revenues) were $2.5 billion, representing 3.9% of operating revenue.

(2) Summary of Significant Accounting Policies

(a) Basis of Presentation

The financial statements of Health Plans and Hospitals are presented on a combined basis due to the operational interdependence of these organizations and because their governing boards and management are substantially the same. These combined financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). All material intercompany balances and transactions have been eliminated. Management has evaluated subsequent events through February 14, 2018, which is the date that these combined financial statements were issued.

(b) Cash and Cash Equivalents

Cash and cash equivalents include interest-bearing deposits purchased with an original or remaining maturity of three months or less. Cash and investments that are restricted per contractual or regulatory requirements are classified as noncurrent investments and excluded from cash and cash equivalents.

(c) Investments

Investments include equity, U.S. Treasury, government agencies, money market funds, and other marketable debt securities and are reported at fair value. Investments are categorized as current assets if they are intended to be available to satisfy current liabilities. Alternative investments are reported under the equity method. Certain investments are illiquid and are valued based on the most current information available. Other-than-temporary impairment and recognized gains and losses, which are recorded on the specific identification basis, and interest, dividend income, and income from equity method alternative investments are included in investment income – net. Health Plans and Hospitals has designated a portion of its investments for the physicians' retirement plan liability related to defined retirement benefits provided for physicians associated with certain Medical Groups. These investments are unrestricted assets of Health Plans and Hospitals. A portion of investment income that represents the expected return on the investments designated for the physicians' retirement plan has been recorded as a reduction in the provision for physicians' retirement plan benefits and is excluded from investment income – net, as described in the *Physicians' Retirement Plan* note.

Investments are regularly reviewed for impairment and a charge is recognized when the fair value is below cost basis and is judged to be other-than-temporary. In its review of assets for impairment that is deemed other-than-temporary, management generally follows these guidelines:

- Substantially all investments are managed by outside investment managers who do not need Health Plans and Hospitals' management preapproval for sales; therefore, substantially all declines in value below cost are recognized as impairment that is other-than-temporary.
- For other securities, losses are recognized for known matters, such as bankruptcies, regardless of ownership period, and investments that have been continuously below book value for an extended period of time are evaluated for impairment that is other-than-temporary.

All other unrealized losses and all unrealized gains on investments are included as other changes in net worth.

Interest income is calculated under the effective interest method and included in investment income – net. Dividends are included in investment income – net on the ex-dividend date, which immediately follows the record date.

Health Plans and Hospitals' investment transactions are recorded on a trade date basis.

(d) Securities Lending Collateral and Payable

Health Plans and Hospitals enters into securities lending agreements whereby certain securities from its portfolios are loaned to other institutions. Securities lent under such agreements remain in the portfolios of Health Plans and Hospitals. Health Plans and Hospitals receives a fee from the borrower under these agreements, which is recognized ratably over the period that the securities are lent. Collateral, primarily cash, is required at a rate of 102% of the fair value of securities lent and is carried as securities lending collateral. The obligation of Health Plans and Hospitals to return the cash collateral is carried as securities lending payable. The fair value of securities lending collateral is determined using level 1 or 2 inputs as appropriate, as defined in the *Fair Value Estimates* note. The fair value of the loaned securities is monitored on a daily basis, with additional collateral obtained or refunded as the fair value of the loaned securities fluctuates.

(e) Broker Receivables and Payables

Broker receivables and payables represent current amounts for unsettled securities sales or purchases.

(f) Accounts Receivables – Net

Accounts receivable – net are comprised of members' dues, Medicare receivables, patient receivables, and other receivables. Health Plans and Hospitals provides an allowance for potential uncollectible accounts receivable. The allowances for bad debt are estimated based on the aging of accounts receivable, historical collection experience, and other economic factors.

(g) Inventory

Inventories, consisting primarily of pharmaceuticals and supplies, are carried at the lower of cost (generally first-in, first-out, or average price) or net realizable value.

(h) Land, Buildings, Equipment, and Software

Land, buildings, equipment, and software are stated at cost less accumulated depreciation and amortization. Interest is capitalized on facilities construction and internally developed software work in progress and is added to the cost of the underlying asset. Software, which includes internal and external costs incurred in developing or obtaining computer software for internal use, is capitalized. Qualifying costs incurred during the application development stage are capitalized. Depreciation and amortization begin when the project is substantially complete and ready for its intended use. Software is amortized on a straight-line basis over the estimated useful lives, generally ranging from 3 to 7 years. Buildings and equipment are depreciated on a straight-line basis over the estimated useful lives of the various classes of assets, generally ranging from 3 to 40 years.

Management evaluates alternatives for delivering services that may affect the current and future utilization of existing and planned assets and could result in an adjustment to the carrying values or remaining lives of such land, buildings, equipment, and software in the future. Management evaluates and records impairment losses or adjusts remaining lives, where applicable, based on expected utilization, projected cash flows, and recoverable values.

Maintenance and repairs are expensed as incurred. Major improvements that increase the estimated useful life of an asset are capitalized. Upon the sale or retirement of assets, recorded cost and related accumulated depreciation are removed from the accounts, and any gain or loss on disposal is reflected in operations.

Management estimates the fair value of asset retirement obligations that are conditional on a future event if the amount can be reasonably estimated. Estimates are developed through the identification of applicable legal requirements, identification of specific conditions requiring incremental cost at time of asset disposal, estimation of costs to remediate conditions, and estimation of remaining useful lives or date of asset disposal.

(i) Goodwill and Other Acquired Intangible Assets

Goodwill and other acquired intangible assets arise from acquisition related activity. Goodwill represents the excess of the purchase price over the fair value of net assets acquired when accounted for using the acquisition method of accounting. Goodwill is required to be tested for impairment at least annually, or sooner, whenever events or circumstances indicate that the asset may be impaired.

Other acquired intangible assets are recognized at fair value on the date of purchase and are amortized on a straight-line basis or accelerated basis over periods from 2 to 16 years. These intangible assets are subject to impairment tests whenever events or circumstances indicate that these assets may be impaired.

(j) Medical Claims Payable

The cost of health care services is recognized in the period in which services are incurred. Medical claims payable consists of unpaid health care expenses to third party providers, which include an estimate of the cost of services provided to Health Plans' members by the third party providers that have been incurred but not reported. The estimate for incurred but not reported claims is based on actuarial projections of costs using historical paid claims and other relevant data. Estimates are monitored and reviewed and, as claim payments are received, adjudicated, and paid, estimates are revised and are reflected in current operations. Such estimates are subject to actual utilization of medical services, changes in membership and product mix, claim submission and processing patterns, medical inflation, and other relevant factors. Given the inherent variability of such estimates, the actual liability could differ significantly from the amounts provided. While the ultimate amount of paid claims is dependent on future developments, management is of the opinion that the reserves for claims are adequate to cover such claims.

Health Plans and Hospitals records anticipated reinsurance recoveries for high cost claims eligible for reimbursement under the Patient Protection and Affordable Care Act (PPACA) as described in *The PPACA Health Insurance Providers Fee, Reinsurance, Risk Adjustment, and Risk Corridors Programs* note.

(k) Due to Associated Medical Groups

Due to associated medical groups consists primarily of unpaid medical expenses owed to the Medical Groups for medical services provided to members under medical services agreements with Health Plans. The cost of medical services is recognized by Health Plans in the period in which services are provided and is reflected as a component of medical and hospital services expenses.

(l) Self-Insured Risks

Costs associated with self-insured risks, primarily for professional, general, and workers' compensation liabilities, are charged to operations based upon actual and estimated claims. The portion estimated to be paid during the next year is included in current liabilities. The estimate for incurred but not reported self-insured claims is based on actuarial projections of costs using historical claims and other relevant data. Estimates are monitored and reviewed and, as settlements are made or estimates are revised, adjustments are reflected in current operations. Given the inherent variability of such estimates, the actual liability could differ significantly from the amounts provided. While the ultimate payments for self-insured claims are dependent on future developments, management is of the opinion that the reserve for self-insured risks is adequate. Insurance coverage, in excess of the per occurrence self-insured retention, has been secured with insurers or reinsurers for specified amounts for professional, general, and workers' compensation liabilities. The limit and scope of the self-insured layer and the amounts of excess insurance purchased are reviewed each year, subject to management's analysis of actuarial loss projections and the price and availability of acceptable commercial insurance.

(m) Premium Deficiency Reserves

Premium deficiency reserves and the related expense are recognized when it is probable that expected future health care and maintenance costs under a group of existing contracts will exceed anticipated future premiums and reinsurance recoveries over the contract period. If applicable, premium deficiency reserves extending beyond one year are shown as a long-term liability. Expected investment income and interest expense are included in the calculation of premium deficiency reserves, as appropriate. The level at which contracts are grouped for evaluation purposes is generally by geographic region. The methods for making such estimates and for establishing the resulting reserves are reviewed and estimates are periodically updated, and any resulting adjustments are reflected in current operations. At December 31, 2017 and 2016, premium deficiency reserves were $0 million and $16 million, respectively. Given the inherent variability of such estimates, the actual liability could differ significantly from the calculated amount.

(n) Derivative Financial Instruments

Derivative financial instruments are utilized primarily to manage the interest costs and the risk associated with changing interest rates. Health Plans and Hospitals enters into interest rate swaps with investment or commercial banks with significant experience with such instruments. In addition, certain investments include derivative products. The changes in the fair value of these derivative instruments are included in investment income – net and settlement costs are recorded as interest expense or investment income – net.

Derivative financial instruments are also utilized to manage the risk of holding equity investments, primarily to hedge downside volatility risk. Heath Plans and Hospitals enters into derivatives such as put-spread collars with similar investment or commercial banks noted above. The changes in fair value for these derivatives are included in investment income – net.

Derivative financial instruments are utilized by Health Plans and Hospitals' investment portfolio managers. These instruments include futures, forwards, options, and swaps. The changes in fair value for these derivative financial instruments are included in investment income – net.

(o) Revenue Recognition

Members' dues revenue includes premiums from employer groups and individuals. Members' dues revenue is recognized over the period in which the members are entitled to health care services.

Health Plans estimates accrued retrospective premium adjustments for certain group health insurance contracts based on claims experience and the provisions of the contract. Health Plans records accrued retrospective premiums as an adjustment to members' dues. For the years ended December 31, 2017 and 2016, the amount of premiums written by Health Plans subject to the retrospective rating feature were $1,293 million and $932 million, respectively. During the years ended December 31, 2017 and 2016, revenue derived under these contracts was 2.6% and 2.1%, respectively, of total members' dues. During the years ended December 31, 2017 and 2016, retrospective dues reductions derived under these contracts were $56 million and $21 million, respectively.

Health Plans participates in certain contracts with commercial large groups that include provision for risk adjustment of dues premiums, based on comparative data provided by Health Plans as well as other health plan vendors participating in these same arrangements. Settlements are typically calculated and paid according to the contract provisions and final settlements are made after the contract terms expire. For the years ended December 31, 2017 and 2016, dues subject to these risk adjustment arrangements comprise 8.2% and 8.8%, respectively, of total members' dues. For the years ended December 31, 2017 and 2016, $166 million and $42 million, respectively, have been recorded as reductions to revenue for these risk adjustment arrangements.

The majority of Health Plans and Hospitals' Medicare revenue is received from the Medicare Advantage Program (Part C). Revenues for Part C include capitated payments, which vary based on health status, demographic status, and other factors. Medicare revenues also include accruals for estimates resulting from changes in health risk factor scores. Such accruals are recognized when the amounts become determinable and collection is reasonably assured. Part C revenue is finalized after all data is submitted to Medicare and the final settlement is made after the end of the year.

In addition, Medicare benefits include a voluntary prescription drug benefit (Part D). Revenues for Part D include capitated payments made from Medicare adjusted for health risk factor scores. Revenues also include amounts to reflect a portion of the health care costs for low-income Medicare beneficiaries and a risk-sharing arrangement to limit the exposure to unexpected expenses. Related accruals are recognized monthly based on cumulative experience and membership data. Part D revenue is finalized after all data is submitted to Medicare and the final settlement is made after the end of the year.

Medicare Part C and D revenue is subject to governmental audits and potential payment adjustments. The Centers for Medicare & Medicaid Services (CMS) performs coding audits to validate the supporting documentation maintained by Health Plans and its care providers.

Certain Medicare revenues are paid under cost reimbursement plans based on pre-established rates, and the final settlement is made after the end of the year. Estimates of final settlements of the cost reports are recorded by Health Plans in current operations.

Estimates of retrospective adjustments resulting from coding audits, cost reports, and other contractual adjustments are recorded in the time period in which members are entitled to health care services. Actual retrospective adjustments may differ from initial estimates.

Premiums collected in advance are deferred and recorded as dues collected in advance or Medicare payments received in advance. Revenue is adjusted to reflect estimates of collectability, including retrospective membership adjustment trends and economic conditions. Revenue and related receivables are exclusive of charity care. A portion of revenues derived under contracts with the United States Office of Personnel Management is subject to audit and potential retrospective adjustments.

Patient services revenue is included in copays, deductibles, fees, and other revenue in the statement of operations and is recognized as services are rendered. Bad debt expense related to patient services revenue is calculated based on historical bad debt experience and recorded as an offset to patient services revenue (net of contractual allowances, charity care, and discounts).

Health Plans provides coverage to certain Medicaid members through contracts with third parties. Third party Medicaid revenue is included in copays, deductibles, fees, and other revenue in the statement of operations. For the years ended December 31, 2017 and 2016, revenues related to these arrangements were $1.5 billion and $1.4 billion, respectively.

(p) Pension and Other Postretirement Benefits

Health Plans and Hospitals' defined benefit pension and other postretirement benefit plans are actuarially evaluated and involve various assumptions. Critical assumptions include the discount rate and the expected rate of return on plan assets, and the rate of increase for health care costs (for postretirement benefit plans other than pension), which are important elements of expense and/or liability measurement. Other assumptions involve demographic factors such as retirement age, mortality, turnover, and the rate of compensation increases. Health Plans and Hospitals evaluates assumptions annually, or when significant plan amendments occur, and modifies them as appropriate. Pension and other postretirement costs are allocated over the service period of the employees in the plans.

Health Plans and Hospitals uses a discount rate to determine the present value of the future benefit obligations. The discount rate is established based on rates available for high-quality fixed-income debt securities at the measurement date whose maturity dates match the expected cash flows of the retirement plans.

Differences between actual and expected plan experience and changes in actuarial assumptions, in excess of a 10% corridor around the larger of plan assets or plan liabilities, are recognized into benefits expense over the expected average future service of active participants. Prior service costs and credits arise from plan amendments and are amortized into postretirement benefits expense over the expected average future service to full eligibility of active participants.

Effective January 1, 2017, Health Plans and Hospitals changed the method used to determine the service and interest cost pertaining to pension and other postretirement benefits expense. Historically, a weighted average discount rate was used in the calculation of service and interest costs. The new method utilizes a "spot rate approach" and provides a more precise measurement of service and interest costs by applying the spot rate along an interest rate yield curve for each expected future cash flow of a retirement plan. This change is considered a change in accounting estimate that is inseparable from a change in accounting principle and accordingly will be accounted for prospectively. The spot rate approach resulted in a reduction in pension and other postretirement benefits expense of approximately $310 million during 2017.

(q) Donations and Grants Made or Received

Donations and grants made are recognized at fair value in the period in which a commitment is made, provided the payment of the donation or grant is probable and the amount is determinable. Donations or grants received, including research grants, are recognized at fair value in the period the donation or grant was committed unconditionally by the grantor or in the period the donation or grant requirements are met, if later.

(r) Income Taxes

Health Plans and Hospitals are not-for-profit corporations exempt from income taxes under Internal Revenue Code Section 501(a) as organizations described in section 501(c)(3) and the laws of the states in which they operate. Accordingly, Health Plans and Hospitals are generally not subject to federal or state income taxes. Health Plans and Hospitals are subject to income taxes on unrelated business income. A limited number of Health Plans and Hospitals' subsidiaries are for profit entities and are subject to income taxes. For the years ended December 31, 2017 and 2016, no significant income tax provision has been recorded.

(s) Use of Estimates

The preparation of these combined financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts. Allowance for uncollectible accounts receivable; estimated fair value of investments; fair value of assets acquired and liabilities assumed via acquisition; recoverability of goodwill and other acquired intangible assets – net; Medicare revenue accruals; Medicare reserves; incurred but not reported medical claims payable; physicians' retirement plan liabilities; pension and other retirement liabilities; premium deficiency reserves; self-insured professional liabilities; self-insured general and workers' compensation liabilities; land, buildings, equipment, and software impairment and useful lives; investment impairment; and certain amounts accrued related to the PPACA Risk Adjustment Program represent significant estimates. Actual results could differ materially from those estimates. As occurs from time to time, negotiations with labor partners may result in changes to compensation and benefits. These changes are reflected in the financial statements as appropriate when agreements are finalized.

(t) The PPACA Health Insurance Providers Fee, Reinsurance, Risk Adjustment, and Risk Corridors Programs

The PPACA requires Health Plans to pay a Health Insurance Providers (HIP) fee that is assessed based on Health Plans' prior year net premiums as a percentage of total premiums for all U.S. health plans. The Internal Revenue Service (IRS) assessed a HIP fee of $498 million for 2016, and the amount was paid and expensed in 2016. The HIP fee was suspended for the 2017 calendar year but is expected to recommence in 2018.

The PPACA also includes three programs designed to mitigate health plan risk. Two were temporary and one is permanent.

The PPACA Risk Adjustment Program is permanent, and provides for retrospective adjustment of revenue for non-grandfathered individual and small group market plans, whether inside or outside PPACA exchanges. The PPACA Risk Adjustment Program is designed such that payments to plans with higher relative risk are funded by transfers from plans with lower relative risk. For the years ended December 31, 2017 and 2016, Health Plans recorded $830 million and $845 million, respectively, in net revenue reductions related to the PPACA Risk Adjustment Program.

The Reinsurance Program was temporary and related to 2014 to 2016. This program provided for partial reimbursement of certain high cost claims for non-grandfathered individual members. As described in the *Summary of Significant Accounting Policies – Medical Claims Payable* note, certain

amounts have been recorded in 2017 and 2016 as expected claims reimbursements under this program. For the years ended December 31, 2017 and 2016, Health Plans recorded $19 million and $146 million, respectively, for estimated recoveries from the Reinsurance Program. For the years ended December 31, 2017 and 2016, Health Plans recorded $0 million and $218 million, respectively, of Reinsurance fees.

The Risk Corridors Program was temporary and related to 2014 to 2016. This program provided for gains and losses on the individual and small group market plans. For the years ended December 31, 2017 and 2016, Health Plans recorded $1 million and $7 million, respectively, in net revenue increases related to the Risk Corridors Program.

At December 31, the net receivables (payables) for PPACA Risk Adjustment settlements, Reinsurance recoveries, and Risk Corridors settlements were as follows (in millions):

	2017	2016
Risk Adjustment settlements	$ (851)	$ (654)
Reinsurance recoveries	26	150
Risk Corridors settlements	1	1
Total	$ (824)	$ (503)

(u) Recently Issued Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09 *Revenue from Contracts with Customers (Topic 606)*. The ASU replaces most existing revenue recognition guidance in U.S. GAAP. Topic 606 was adopted January 1, 2018. The standard permits the use of either the retrospective or cumulative effect transition method. Management selected the cumulative effect transition method.

Management will include new disclosures in 2018 in accordance with Topic 606. The adoption of Topic 606 did not have a significant impact on the results of operations.

In July 2015, the FASB issued ASU No. 2015-11 *Inventory – Simplifying the Measurement of Inventory (Topic 330)*. The amendments in this update change the measurement principle for inventory from the lower of cost or market to lower of cost and net realizable value. The new standard was adopted by Health Plans and Hospitals in 2017. The standard requires the application of the prospective transition method. The adoption of this standard did not have a significant effect on the combined financial statements and related disclosures.

In January 2016, the FASB issued ASU No. 2016-01 *Financial Instruments – Overall (Subtopic 825-10)*. The standard requires entities to measure equity investments that are not accounted for under the equity method or do not result in consolidation to be recorded at fair value and recognize any changes in fair value to net income. Investments that qualify for a practicability exception would not require a change in accounting. The disclosure of fair value of investments held at amortized cost will no longer be required. The new standard is effective for Health Plans and Hospitals on January 1,

2019. Early application is permitted but not earlier than January 1, 2018. The standard requires the use of the cumulative effect transition method, except for equity securities without readily determinable fair values, for which the standard requires the application of the prospective transition method. The impact of adoption will result in the change in fair value of available for sale equity securities being reflected in net income and a reduction in the fair value disclosures for certain securities carried at amortized cost.

In February 2016, the FASB issued ASU No. 2016-02 *Leases (Topic 842)*. The standard introduces new requirements to increase transparency and comparability among organizations for leasing transactions for both lessees and lessors. ASU No. 2016-02 requires a lessee to record a right-of-use asset and a lease liability for all leases with terms longer than 12 months. These leases will be classified as either operating or finance, with classification affecting the pattern of expense recognition. The new standard is effective for Health Plans and Hospitals on January 1, 2019. Early application is permitted. The standard requires the application of the modified retrospective transition method. Additional disclosures will be added as required by the standard.

Management is in the process of evaluating necessary changes to information technology systems, accounting policies, and processes to support the adoption of the standard. Management expects to record significant amounts for right-of-use assets and lease liabilities on its combined balance sheets from a lessee perspective. Health Plans and Hospitals does not have significant lessor activity.

In August 2016, the FASB issued ASU No. 2016-14 *Not-for-Profit Entities (Topic 958)*. The amendments in this update make certain improvements that address many, but not all, of the identified issues about the current financial reporting for not-for-profits. The new standard is effective for Health Plans and Hospitals for the annual period beginning on January 1, 2018. The standard requires the use of the retrospective transition method. The impact of adoption will result in enhanced disclosures about the classification of expenses and management of liquid resources.

In January 2017, the FASB issued ASU No. 2017-04 *Intangibles – Goodwill and Other (Topic 350)*, *Simplifying the Test for Goodwill Impairment*. The amendments in this update eliminate Step 2 from the goodwill impairment test in an effort to simplify the subsequent measurement of goodwill. The new standard is effective for Health Plans and Hospitals on January 1, 2022. Early application is permitted. Management is evaluating the effect that ASU No. 2017-04 will have on its combined financial statements and related disclosures. Management has not determined the effect of the standard on its ongoing financial reporting.

In March 2017, the FASB issued ASU No. 2017-07 *Compensation – Retirement Benefits (Topic 715), Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost*. The amendments in this update require that an employer disaggregate the service cost component from the other components of net benefit cost and provide explicit guidance on how to present the service cost component and the other components of net benefit cost in the income statement. The new standard is required to be adopted by January 1, 2019 but early application is permitted. Health Plans and Hospitals has elected to early adopt the standard effective January 1, 2018. The standard requires the use of the retrospective transition method. The impact of adoption results in the non-service cost components of pension and postretirement benefit costs, previously classified as an operating expense, being reported as other income and expense.

(3) Acquisition of Group Health Cooperative and Maui Health System Agreement

Acquisition of Group Health Cooperative

On February 1, 2017, KFHPW Holdings (Holdings), a subsidiary of Health Plan, Inc., acquired and became the sole corporate member of Group Health Cooperative (GHC), a Washington nonprofit corporation (the "Acquisition"). After closing of the Acquisition, GHC remained the sole shareholder of Group Health Options, Inc. (GHO), a Washington for-profit corporation. Following the Acquisition, GHC was renamed "Kaiser Foundation Health Plan of Washington", and GHO was renamed "Kaiser Foundation Health Plan of Washington Options, Inc." (Kaiser Foundation Health Plan of Washington and its subsidiaries are collectively referred to herein as Washington Health Plans).

Washington Health Plans offers comprehensive, coordinated health care to an enrolled membership primarily for a fixed fee through its owned and leased facilities, employed providers, and contracted providers. In addition, Washington Health Plans provides certain health care services on a fee for service basis to both members and nonmembers. Through this Acquisition, Health Plans expects to better meet the needs of individuals as well as large commercial and national accounts with employees who live and work in the State of Washington.

Following execution of a definitive Acquisition Agreement on December 2, 2015, $2 billion was transferred from Hospitals to Holdings and restricted for purposes of completing this Acquisition and related transactions. At December 31, 2016, this restricted asset was included in current investments in the combined financial statements. At closing, Holdings transferred approximately $1.8 billion in cash, of which $75 million was deposited into escrow for possible future indemnity claims. In addition to and separate from this transaction consideration, the Acquisition Agreement requires $1 billion to be spent over the 10 year period following closing (subject to standard capital and budget approval processes) for capital improvements and key investments in infrastructure and other improvements at Washington Health Plans, and also states that $800 million in community benefit contributions is expected to be made over the same period. During the year ended December 31, 2017, $215 million in capital and other investments were made. At December 31, 2017, $785 million of remaining capital and other investment commitments are required to be made relating to the Acquisition.

Prior to the Acquisition, Group Health Permanente, P.C. (GHP), which is an independent medical group, provided physician and certain other medical services exclusively to Washington Health Plans' members. GHP continues to be an independent medical group, not controlled by Health Plans or Hospitals or any of its subsidiaries; therefore, their financial statements are not combined or consolidated by Health Plans or Hospitals. As part of the successful completion of the Acquisition, Holdings and GHP entered into agreements to continue that arrangement following closing of the Acquisition, including payments to GHP of up to $200 million, recognized primarily as operating expenses and intangible assets. Payments of $140 million have been made to GHP. Additional payments may be made based on achieved milestones. Following the Acquisition, GHP was renamed "Washington Permanente Medical Group, P.C.".

The following table summarizes the fair value measurement of the assets acquired and liabilities assumed at the date of the acquisition (in millions):

Current investments	$	274
Accounts receivable		199
Other current assets		179
Noncurrent investments		777
Land, buildings, equipment, and software		794
Goodwill		297
Other acquired intangible assets		251
Other long-term assets		26
Medical claims payable		(277)
Other current liabilities		(451)
Pension and other retirement liabilities		(110)
Other long-term liabilities		(159)
Total purchase price	$	1,800

Goodwill represents the excess of the purchase price over the fair value of net tangible and intangible assets acquired and primarily relates to expected contributions of Washington Health Plans to the overall corporate strategy.

For the year ended December 31, 2017, acquisition related costs of $14 million were recognized in operating expenses.

The results of operation of Washington Health Plans since the acquisition date of February 1, 2017, are included in Health Plans and Hospitals combined financial statements and include $3.7 billion of operating revenue and $42 million of net loss.

The following table summarizes Health Plans and Hospitals' unaudited pro forma results of operations as if the Acquisition had occurred on January 1, 2016 (in millions):

	Years ended December 31,	
	2017	**2016**
Operating revenues	$ 73,089	$ 68,349
Net income	$ 3,895	$ 3,091

The pro forma disclosures in the table above include adjustments primarily for amortization of other acquired intangible assets, depreciation of the adjusted fair value of buildings and equipment, and other nonrecurring costs related to the acquisition to reflect results that are more representative of the combined results of the transactions, as if the Acquisition had occurred on January 1, 2016. This pro forma information is presented for illustrative purposes only and may not be indicative of the results of operation that would have actually occurred.

Maui Health System Agreement

In January 2016, Maui Health System, A Kaiser Foundation Hospitals LLC (MHSKFH), a subsidiary of Hospitals, entered into a contract with State of Hawaii entities to manage, operate, and provide health care services at hospitals of the Maui Region of Hawaii Health Systems Corporation under the terms of a 30 year transfer agreement. The transfer was completed on July 1, 2017 and accounted for using the acquisition method of accounting, which did not have a significant impact to the combined financial statements. The agreement includes an option for MHSKFH to extend for a potential of two more 10 year terms. Certain existing facilities are leased from the State of Hawaii entities with financial responsibility of any additional investments to the facilities to be shared between MHSKFH and the State of Hawaii entities during the first 10 years, and MHSKFH will be eligible to receive annual operating support from the State of Hawaii.

(4) Fair Value Estimates

The carrying amounts reported in the combined balance sheets for cash and cash equivalents, securities lending collateral, broker receivables, accounts receivable – net, accounts payable and accrued expenses, medical claims payable, due to associated medical groups, payroll and related charges, securities lending payable, and broker payables approximate fair value.

Investments, other than alternative investments, as discussed in the *Investments* note, are reported at fair value. The fair values of investments are based on quoted market prices, if available, or estimated using quoted market prices for similar investments. If listed prices or quotes are not available, fair value is based upon other observable inputs or models that primarily use market-based or independently sourced market parameters as inputs. In addition to market information, models also incorporate transaction details such as maturity. Fair value adjustments, including credit, liquidity, and other factors, are included, as appropriate, to arrive at a fair value measurement. Certain investments are illiquid and are valued based on the most current information available, which may be less current than the date of these combined financial statements.

The carrying value of alternative investments, which include absolute return, risk parity, and private equity, is reported under the equity method, which management believes to approximate fair value. The fair values of alternative investments have been estimated by management based on all available data, including information provided by fund managers or the general partners. The underlying securities within absolute return investments are typically valued using quoted prices for identical or similar instruments within active and inactive markets. The underlying holdings within private equity investments are valued based on recent transactions, operating results, and industry and other general market conditions.

Health Plans and Hospitals utilizes a three-level valuation hierarchy for fair value measurements. An instrument's categorization within the hierarchy is based upon the lowest level of input that is significant to the fair value measurement. For instruments classified in level 1 of the hierarchy, valuation inputs are quoted prices for identical instruments in active markets at the measurement date. For instruments classified in level 2 of the hierarchy, valuation inputs are directly observable but do not qualify as level 1 inputs. Examples of level 2 inputs include: quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in inactive markets; other observable inputs such as interest rates

and yield curves observable at commonly quoted intervals, volatilities, prepayment speeds, loss severities, credit risks, and default rates; and market-correlated inputs that are derived principally from or corroborated by observable market data. For instruments classified in level 3 of the hierarchy, valuation inputs are unobservable inputs for the instrument. Level 3 inputs incorporate assumptions about the factors that market participants would use in pricing the instrument.

The fair value of long-term debt is based on level 2 inputs for debt with similar risk, terms, and remaining maturities. At December 31, 2017 and 2016, the carrying amount of long-term debt totaled $9.4 billion and $5.6 billion, respectively. At December 31, 2017 and 2016, the estimated fair value of long-term debt was approximately $9.9 billion and $5.7 billion, respectively.

At December 31, 2017 and 2016, Health Plans and Hospitals held derivative financial instruments including interest rate swaps, as well as futures, swaps, and forwards held within investment portfolios. The estimated fair values of derivative instruments were determined using level 2 inputs, including available market information and valuation methodologies, primarily discounted cash flows. Additional description and the fair value of derivative instruments are contained in the *Derivative Instruments* note.

(5) Investments

Management's methods for estimating fair value of financial instruments are discussed in the *Fair Value Estimates* note.

At December 31, 2017, the estimated fair value of current investments by level was as follows (in millions):

	Quoted prices in active markets for identical assets level 1	Significant other observable inputs level 2	Significant unobservable inputs level 3	Total
U.S. equity securities	$ 22	$ —	$ —	$ 22
Debt securities issued by the U.S. government	—	1,691	—	1,691
Debt securities issued by U.S. government agencies and corporations	—	30	—	30
Debt securities issued by U.S. states and political subdivisions of states	—	79	—	79
Foreign government debt securities	—	83	—	83
U.S. corporate debt securities	—	2,336	—	2,336
Foreign corporate debt securities	—	909	—	909
U.S. agency mortgage-backed securities	—	492	—	492
Non-U.S. agency mortgage-backed securities	—	210	—	210
Other asset-backed securities	—	648	—	648
Short-term investment funds	—	242	—	242
Total	$ 22	$ 6,720	$ —	$ 6,742

At December 31, 2017, the estimated fair value of noncurrent investments by level was as follows (in millions):

	Quoted prices in active markets for identical assets level 1	Significant other observable inputs level 2	Significant unobservable inputs level 3	Total
U.S. equity securities	$ 6,155	$ 1,312	$ —	$ 7,467
Foreign equity securities	2,603	2,198	—	4,801
Global equity funds	—	541	—	541
Debt securities issued by the U.S. government	—	1,747	—	1,747
Debt securities issued by U.S. government agencies and corporations	—	65	—	65
Debt securities issued by U.S. states and political subdivisions of states	—	214	—	214
Foreign government debt securities	—	1,735	—	1,735
U.S. corporate debt securities	—	4,934	—	4,934
Foreign corporate debt securities	—	1,830	—	1,830
U.S. agency mortgage-backed securities	—	698	—	698
Non-U.S. agency mortgage-backed securities	—	270	2	272
Other asset-backed securities	—	312	—	312
Short-term investment funds	—	710	—	710
Other	132	633	1	766
	$ 8,890	$ 17,199	$ 3	26,092
Alternative investments:				
Absolute return				2,164
Private equity				4,806
Risk parity				757
Total				$ 33,819

At December 31, 2016, the estimated fair value of current investments by level was as follows (in millions):

	Quoted prices in active markets for identical assets level 1	Significant other observable inputs level 2	Significant unobservable inputs level 3	Total
U.S. equity securities	$ 24	$ —	$ —	$ 24
Debt securities issued by the U.S. government	—	3,200	—	3,200
Debt securities issued by U.S. government agencies and corporations	—	58	—	58
Debt securities issued by U.S. states and political subdivisions of states	—	61	—	61
Foreign government debt securities	—	90	—	90
U.S. corporate debt securities	—	2,267	—	2,267
Foreign corporate debt securities	—	1,009	—	1,009
U.S. agency mortgage-backed securities	—	735	—	735
Non-U.S. agency mortgage-backed securities	—	216	—	216
Other asset-backed securities	—	723	—	723
Short-term investment funds	—	294	—	294
Total	$ 24	$ 8,653	$ —	$ 8,677

At December 31, 2016, the estimated fair value of noncurrent investments by level was as follows (in millions):

	Quoted prices in active markets for identical assets level 1	Significant other observable inputs level 2	Significant unobservable inputs level 3	Total
U.S. equity securities	$ 3,744	$ 164	$ —	$ 3,908
Foreign equity securities	2,690	1,455	—	4,145
Global equity funds	—	451	—	451
Debt securities issued by the U.S. government	—	1,238	—	1,238
Debt securities issued by U.S. government agencies and corporations	—	100	—	100
Debt securities issued by U.S. states and political subdivisions of states	—	182	—	182
Foreign government debt securities	—	1,157	—	1,157
U.S. corporate debt securities	—	3,566	—	3,566
Foreign corporate debt securities	—	1,387	—	1,387
U.S. agency mortgage-backed securities	—	614	—	614
Non-U.S. agency mortgage-backed securities	—	235	8	243
Other asset-backed securities	—	241	—	241
Short-term investment funds	—	1,021	—	1,021
Other	143	518	1	662
	$ 6,577	$ 12,329	$ 9	18,915
Alternative investments:				
Absolute return				2,076
Private equity				4,089
Risk parity				676
Total				$ 25,756

At December 31, 2017, debt and equity securities available-for-sale were as follows (in millions):

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
U.S. equity securities	$ 6,135	$ 1,354	$ —	$ 7,489
Foreign equity securities	3,571	1,230	—	4,801
Global equity funds	379	162	—	541
Debt securities issued by the U.S. government	3,413	25	—	3,438
Debt securities issued by U.S. government agencies and corporations	91	4	—	95
Debt securities issued by U.S. states and political subdivisions of states	253	40	—	293
Foreign government debt securities	1,690	128	—	1,818
U.S. corporate debt securities	6,958	312	—	7,270
Foreign corporate debt securities	2,606	133	—	2,739
U.S. agency mortgage-backed securities	1,180	10	—	1,190
Non-U.S. agency mortgage-backed securities	472	10	—	482
Other asset-backed securities	947	13	—	960
Short-term investment funds	952	—	—	952
Other	729	37	—	766
Total	$ 29,376	$ 3,458	$ —	$ 32,834

At December 31, 2016, debt and equity securities available-for-sale were as follows (in millions):

	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
U.S. equity securities	$ 3,267	$ 665	$ —	$ 3,932
Foreign equity securities	3,562	583	—	4,145
Global equity funds	359	92	—	451
Debt securities issued by the U.S. government	4,427	11	—	4,438
Debt securities issued by U.S. government agencies and corporations	152	6	—	158
Debt securities issued by U.S. states and political subdivisions of states	215	28	—	243
Foreign government debt securities	1,190	57	—	1,247
U.S. corporate debt securities	5,571	262	—	5,833
Foreign corporate debt securities	2,316	80	—	2,396
U.S. agency mortgage-backed securities	1,338	11	—	1,349
Non-U.S. agency mortgage-backed securities	451	8	—	459
Other asset-backed securities	949	15	—	964
Short-term investment funds	1,315	—	—	1,315
Other	650	12	—	662
Total	$ 25,762	$ 1,830	$ —	$ 27,592

At December 31, available-for-sale debt securities by contractual maturity and mortgage-backed and other asset-backed debt securities were as follows (in millions):

	2017		2016	
	Amortized cost	Fair value	Amortized cost	Fair value
Due in one year or less	$ 2,197	$ 2,208	$ 2,356	$ 2,362
Due after one year through five years	5,776	5,870	7,604	7,702
Due after five years through ten years	4,342	4,483	2,563	2,671
Due after ten years	4,377	4,810	3,313	3,557
U.S. agency mortgage-backed securities	1,180	1,190	1,338	1,349
Non-U.S. agency mortgage-backed securities	472	482	451	459
Other asset-backed securities	947	960	949	964
Total	$ 19,291	$ 20,003	$ 18,574	$ 19,064

For the year ended December 31, 2017, the reconciliation of investments with fair value measurements using significant unobservable inputs (level 3) was as follows (in millions):

	Equity securities	Debt securities	Total
Beginning balance	$ —	$ 9	$ 9
Transfers into level 3	5	—	5
Total net losses:			
Realized	—	—	—
Unrealized	(1)	(1)	(2)
Purchases	—	—	—
Sales	(4)	—	(4)
Settlements	—	(5)	(5)
Ending balance	$ —	$ 3	$ 3
Total realized and unrealized year-to-date net gains (losses) related to assets held at December 31, 2017	$ —	$ —	$ —

For the year ended December 31, 2016, the reconciliation of investments with fair value measurements using significant unobservable inputs (level 3) was as follows (in millions):

	Debt securities
Beginning balance	$ 12
Transfers out of level 3	—
Total net losses:	
Realized	1
Unrealized	—
Purchases	1
Sales	(1)
Settlements	(4)
Ending balance	$ 9
Total realized and unrealized year-to-date net gains (losses) related to assets held at December 31, 2016	$ —

Transfers between fair value input levels, if any, are recorded at the end of the reporting period. Transfers between fair value input levels occur when valuation inputs used to record or disclose assets or liabilities change from one level of the valuation hierarchy to another. During the years ended December 31, 2017 and 2016, there were no transfers between assets with inputs with quoted prices in active markets for identical assets (level 1) and assets with inputs with significant other observable inputs (level 2).

Investments include specific funds held in trust accounts related to collateral requirements for certain reinsurance agreements. At December 31, 2017 and 2016, the values of these funds were $34 million and $44 million, respectively.

Absolute return investments use advanced investment strategies, including derivatives, to generate positive long-term risk adjusted returns. Private equity investments consist of funds that make direct investments in private companies. Risk parity funds use risk as the primary factor to allocate investments among asset classes. Management meets with alternative investment fund managers periodically to assess portfolio performance and reporting and exercises oversight over fund managers. At December 31, 2017, Hospitals had original commitments related to alternative investments of $9.1 billion, of which $5.6 billion was invested, leaving $3.5 billion of remaining commitments. At December 31, 2016, Hospitals had original commitments related to alternative investments of $7.9 billion, of which $4.7 billion was invested, leaving $3.2 billion of remaining commitments.

For the years ended December 31, investment income – net was comprised of the following (in millions):

	2017	2016
Other-than-temporary impairment	$ (387)	$ (622)
Recognized gains	1,161	1,349
Recognized losses	(148)	(344)
Income from equity method alternative investments	852	532
Interest, dividends, and other income – net	964	876
Derivative income (loss)	(42)	15
Total investment income – net	2,400	1,806
Less investment income included in operating income	(468)	(427)
Investment income – net	$ 1,932	$ 1,379

For the years ended December 31, 2017 and 2016, Health Plans and Hospitals recorded impairment of certain investments in accordance with the policy described in the *Summary of Significant Accounting Policies – Investments* note. During the years ended December 31, 2017 and 2016, there was $5 million and $2 million, respectively, of impairment of alternative investments.

Absolute return, risk parity, and private equity investments include redemption restrictions. Absolute return and risk parity investments require 10 to 90 day written notice of intent to withdraw and are often subject to the approval and capital requirements of the fund manager. At December 31, 2017, absolute return and risk parity investments of $717 million are subject to lock-up periods of up to three years. Private equity agreements do not include provisions for redemption. Distributions will be received as the underlying investments of the funds are liquidated, which is expected over the next 11 years.

The majority of debt and equity securities can be redeemed within 10 days. Debt and equity investment funds of $1.7 billion are redeemable between 10 and 30 days. Equity investment funds of $356 million have a redemption period of between 30 days and one year. No debt or equity investments require a redemption period of greater than one year.

(6) Derivative Instruments

(a) Interest Rate Swaps

At both December 31, 2017 and 2016, Health Plans and Hospitals had 11 agreements to manage interest rate fluctuations (Interest Rate Swaps) with a total notional amount of $1.2 billion. At December 31, 2017 and 2016, the fair values of these agreements were $(229) million and $(251) million, respectively, and were recorded in other long-term liabilities. For the years ended December 31, 2017 and 2016, Health Plans and Hospitals recorded $28 million and $33 million, respectively, in interest expense relating to the Interest Rate Swaps. For the years ended December 31, 2017 and 2016, net changes in fair values totaled $22 million and $23 million, respectively, and were recorded in investment income – net.

These derivatives contain reciprocal provisions whereby if Health Plans and Hospitals' or the counterparties' credit rating was to decline to certain levels, provisions would be triggered requiring Health Plans and Hospitals or the counterparties to provide certain collateral. At December 31, 2017 and 2016, no collateral was required to be posted by either Health Plans and Hospitals or the counterparties.

(b) Derivatives Held in Investment Portfolios

At December 31, 2017 and 2016, Health Plans and Hospitals' portfolio managers held $1 million and $46 million, respectively, of futures, forwards, options, and swaps to attempt to protect investments against volatility. For the years ended December 31, 2017 and 2016, net changes in fair values totaled $(72) million and $59 million, respectively, and were recorded in investment income – net. For the years ended December 31, 2017 and 2016, gains (losses) resulting from derivative settlements totaled $8 million and $(67) million, respectively, and were recorded in investment income – net.

(c) Information on Derivative Gain (Loss) and Fair Value

Management's methods for estimating fair value of financial instruments are discussed in the *Fair Value Estimates* note.

Information on Derivative Gain (Loss) Mark-to-Market Valuation Recognized in Income

(In millions)

Derivatives not designated as hedging instruments	Statement of operations category	Gain (loss) recognized in income on derivatives for the years ended December 31, 2017	2016
Interest rate swaps – related to debt	Investment income – net	$ 22	$ 23
Interest rate swaps – other	Investment income – net	(22)	31
Futures and forwards	Investment income – net	(49)	29
Options, rights, and warrants	Investment income – net	(1)	(1)
		$ (50)	$ 82

Information on Derivative Settlement Costs Recognized in Income

(In millions)

Derivatives not designated as hedging instruments	Statement of operations category	Gain (loss) recognized in income on derivatives for the years ended December 31, 2017	2016
Interest rate swaps – related to debt	Interest expense	$ (28)	$ (33)
Interest rate swaps – other	Investment income – net	11	(4)
Futures and forwards	Investment income – net	(10)	(83)
Options, rights, and warrants	Investment income – net	7	20
		$ (20)	$ (100)

Information on Fair Value of Derivative Instruments – Assets

(In millions)

Derivatives not designated as hedging instruments	Balance sheet category	Fair value at December 31, 2017	Fair value at December 31, 2016
Interest rate swaps – other	Noncurrent investments	$ 36	$ 47
Futures and forwards	Noncurrent investments	51	64
Options, rights, and warrants	Noncurrent investments	13	7
		$ 100	$ 118

Information on Fair Value of Derivative Instruments – Liabilities

(In millions)

Derivatives not designated as hedging instruments	Balance sheet category	Fair value at December 31, 2017	Fair value at December 31, 2016
Interest rate swaps – related to debt	Other long-term liabilities	$ 229	$ 251
Interest rate swaps – other	Other long-term liabilities	36	25
Futures and forwards	Other long-term liabilities	52	38
Options, rights, and warrants	Other long-term liabilities	11	9
		$ 328	$ 323

(7) Accounts Receivable – Net

At December 31, accounts receivable – net were as follows (in millions):

	2017	2016
Members' dues	$ 889	$ 799
Patient services	600	387
Medicare	196	315
Reinsurance recoveries	26	150
Risk Adjustment receivables	9	15
Other	547	564
	2,267	2,230
Allowances for bad debt	(254)	(200)
Total	$ 2,013	$ 2,030

(8) Inventories and Other Current Assets

At December 31, inventories and other current assets were as follows (in millions):

	2017	2016
Inventories – net	$ 840	$ 832
Prepaid expenses	577	455
Other	126	70
Total	$ 1,543	$ 1,357

(9) Land, Buildings, Equipment, and Software – Net

At December 31, land, buildings, equipment, and software – net were as follows (in millions):

	2017	2016
Land	$ 2,070	$ 1,884
Buildings and improvements	34,835	32,627
Furniture, equipment, and software	12,324	11,654
Construction and software development in progress	1,716	1,379
	50,945	47,544
Accumulated depreciation and amortization	(25,038)	(23,202)
Total	$ 25,907	$ 24,342

Health Plans and Hospitals capitalizes interest costs on borrowings incurred during the construction, upgrade, or development of qualifying assets. Capitalized interest is added to the cost of the underlying assets and is depreciated or amortized over the useful lives of the assets. During the years ended December 31, 2017 and 2016, Health Plans and Hospitals capitalized $22 million and $26 million, respectively, of interest in connection with various capital projects.

Asset retirement obligations relate primarily to the following: leased building restoration, building demolition, building materials containing asbestos, leaded wall shielding, storage tanks (above ground and below ground), chillers or cooling tower chemicals, mercury in large fixed-components, polychlorinated biphenyl window caulk, and hard drives requiring data wiping prior to disposal. At December 31, 2017 and 2016, the liability for asset retirement obligations was $121 million and $103 million, respectively. At December 31, 2017 and 2016, the unamortized asset related to these retirement obligations was $42 million and $19 million, respectively.

(10) Goodwill and Other Acquired Intangible Assets – Net

The carrying amount of goodwill for the years ended December 31, 2017 and 2016, were as follows (in millions):

Goodwill at December 31, 2016	$	-
Goodwill acquired during 2017		297
Goodwill at December 31, 2017	$	297

The increase in goodwill in 2017 was due to the acquisition of GHC as disclosed in the Acquisition of Group Health Cooperative footnote disclosure. There was no goodwill impairment loss in 2017.

At December 31, 2017, other acquired intangible assets – net were as follows (in millions):

	Weighted average amortization period	Gross carrying amount	Accumulated amortization	Net carrying amount
Intangible assets				
Amortizing intangible assets:				
GHC acquired intangible assets:				
Member relationships	9 years	$ 133	$ (25)	$ 108
Intellectual property	15 years	39	(2)	37
Other	11 years	79	(9)	70
Total GHC acquired intangible assets	11 years	251	(36)	215
Other acquired intangible assets:				
Intellectual property	15 years	39	(2)	37
Other	13 years	44	(3)	41
Total other acquired intangible assets	14 years	83	(5)	78
Total intangible assets	11 years	$ 334	$ (41)	$ 293

Intangible assets subject to amortization are amortized on a straight-line or accelerated basis over their useful lives. For the year ended December 31, 2017, aggregate amortization expense related to amortizing intangible assets was $41 million.

The estimated aggregate amortization expense for the next five years at December 31 is as follows (in millions):

2018	$	51
2019		39
2020		34
2021		28
2022		23

(11) Medical Claims Payable

For the years ended December 31, activity in the liability for medical claims payable was as follows (in millions):

	2017	2016
Balances at January 1	$ 1,862	$ 1,750
Acquired business at February 1, 2017	277	—
Incurred related to:		
Current year	11,816	9,117
Prior years	(95)	(144)
Total incurred	11,721	8,973
Paid related to:		
Current year	9,740	7,415
Prior years	1,817	1,446
Total paid	11,557	8,861
Balances at December 31	$ 2,303	$ 1,862

Amounts incurred related to prior years vary from previously estimated liabilities as the claims are ultimately adjudicated and paid. Liabilities are reviewed and revised as information regarding actual claims payments becomes known. Negative amounts reported for incurred related to prior years result from claims being adjudicated and paid for amounts less than originally estimated.

(12) Other Liabilities

At December 31, other current liabilities were as follows (in millions):

	2017	2016
Self-insured risks	$ 378	$ 388
Dues collected in advance	768	682
Physicians' retirement plan liability	199	185
Other	1,446	847
Total	$ 2,791	$ 2,102

At December 31, other long-term liabilities were as follows (in millions):

	2017	2016
Self-insured risks	$ 1,632	$ 1,518
Derivatives liability	328	323
Due to associated medical groups	199	202
Other	481	337
Total	$ 2,640	$ 2,380

(13) Debt

At December 31, debt was as follows (in millions):

	2017	2016
Tax-exempt revenue bonds and taxable bonds and notes:		
0.68% to 2.00% variable rate due through 2052	$ 3,660	$ 5,107
3.15% to 5.00% fixed rate due through 2051	6,473	2,329
Others at various rates due through 2027	19	7
Total	$ 10,152	$ 7,443
Other current debt:		
Commercial paper	$ 750	$ 1,886
Current portion of long-term debt	19	18
Long-term debt subject to short-term remarketing arrangements – net	492	785
Long-term debt classified as a long-term liability	8,891	4,754
Total	$ 10,152	$ 7,443

In May 2017, Hospitals issued $2.1 billion of taxable bonds and $2.1 billion of tax-exempt revenue bonds. Total proceeds from issuance, which includes $200 million of bond premium, were $4.4 billion. Additionally, in May 2017, $1.4 billion of bond proceeds were used to refinance taxable commercial paper.

At December 31, 2017 and 2016, repurchase of variable rate bonds totaling $2.9 billion and $3.2 billion, respectively, may be required at earlier than stated maturity. These bonds may be remarketed rather than repurchased. Health Plans and Hospitals has provided self liquidity for the variable rate demand bonds with put options. Additionally, at both December 31, 2017 and 2016, management had the ability to finance the acquisition of up to $2.4 billion of any unremarketed bonds that are put, using available credit facilities. At December 31, 2017 and 2016, $492 million and $785 million, respectively, of these variable rate demand bonds were classified in current liabilities, net of available long-term credit facilities of $2.4 billion.

At December 31, 2017 and 2016, $215 million and $31 million, respectively, of the above tax-exempt fixed-rate revenue bonds and taxable fixed-rate bonds represented a net unamortized premium balance. At December 31, 2017 and 2016, $(42) million and $(23) million, respectively, of unamortized debt issuance cost was presented within long-term debt.

Scheduled principal payments for each of the next five years and thereafter considering obligations subject to short-term remarketing as due according to their long-term amortization schedule, except as described below, were as follows (in millions):

2018	$	769
2019		256
2020		19
2021		18
2022		798
Thereafter		8,119
Total	$	9,979

Credit Facility

Hospitals' credit facility of $2.4 billion terminates in September 2022. Various interest rate options are available under this facility. Any revolving borrowings mature on the termination date. Hospitals pays facility fees, which range from 0.05% to 0.15% per annum, depending upon Hospitals' long-term senior unsecured debt rating. At December 31, 2017, the facility fee was at an annual rate of 0.06%. At December 31, 2017 and 2016, no amounts were outstanding under this credit facility.

Hospitals' revolving credit facility contains a financial covenant. Under the terms of this facility, Hospitals is required to maintain a ratio of total debt to capital, as defined.

Taxable Commercial Paper Program

Hospitals maintains a commercial paper program providing for the issuance of up to $2.4 billion in aggregate maturity value of short-term indebtedness. The commercial paper is issued in denominations of

$100,000 and will bear such interest rates, if interest-bearing, or will be sold at such discount from their face amounts, as agreed upon by Hospitals and the dealer acting in connection with the commercial paper program. The commercial paper may be issued with varying maturities up to a maximum of 270 days from the date of issuance. At December 31, 2017 and 2016, commercial paper of $750 million and $1.9 billion, respectively, was outstanding under this program and is included within other current debt.

(14) Pension Plans

(a) Defined Benefit Plans

Health Plans and Hospitals has defined benefit pension plans (Plans) covering substantially all their employees. Benefits are based on age at retirement, years of credited service, and average compensation for a specified period prior to retirement. Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future.

For financial reporting purposes, the projected unit credit method is used. At December 31, 2017 and 2016, substantially all pension fund assets were held in a group trust. At both December 31, 2017 and 2016, trust assets were invested primarily in fixed-income and equity securities, with approximately 21% of trust assets, net of liabilities, invested in alternative investments.

At December 31, the funded status of the Plans was as follows (in millions):

	2017	2016
Change in projected benefit obligation (PBO):		
Benefit obligation at beginning of year	$ 18,578	$ 16,536
Pension benefit obligation acquired through acquisition	844	—
Service cost	1,167	1,079
Interest cost	724	772
Net actuarial loss	3,782	1,058
Benefits paid	(1,463)	(867)
Benefit obligation at end of year	$ 23,632	$ 18,578
Accumulated benefit obligation at end of year	$ 17,925	$ 14,316
Change in Health Plans' and Hospitals' share of trust assets:		
Fair value of plan assets at beginning of year	$ 11,771	$ 10,149
Fair value of plan assets acquired through acquisition	770	—
Actual return on plan assets	2,214	758
Contributions	2,401	1,731
Benefits paid	(1,463)	(867)
Fair value of plan assets at end of year	$ 15,693	$ 11,771
Funded status	$ (7,939)	$ (6,807)
Amounts recognized in the balance sheet consist of:		
Noncurrent assets	$ —	$ —
Current liabilities	—	—
Pension and other retirement liabilities	(7,939)	(6,807)
	$ (7,939)	$ (6,807)
Amounts recognized in net worth:		
Net actuarial loss	$ 7,882	$ 5,602
Prior service cost	87	99
	$ 7,969	$ 5,701

The measurement date used to determine pension valuations was December 31.

For the years ended December 31, pension expense was as follows (in millions):

	2017	2016
Service cost	$ 1,167	$ 1,079
Interest cost	724	772
Expected return on plan assets	(989)	(810)
Amortization of net actuarial loss	277	209
Amortization of prior service cost	12	14
Net pension expense	1,191	1,264
Other changes in plan assets and PBO recognized in net worth:		
Net actuarial loss	2,557	1,110
Prior service cost	—	—
Amortization of net actuarial loss	(277)	(209)
Amortization of prior service cost	(12)	(14)
Total recognized in net worth	2,268	887
Total recognized in net periodic benefit cost and net worth	$ 3,459	$ 2,151

During 2018, $600 million and $10 million in estimated net actuarial loss and prior service cost, respectively, will be amortized from net worth into net pension expense.

Actuarial assumptions used were as follows:

	2017	2016
Discount rates at January 1 for calculating pension expense	4.15% - 4.45%	4.70%
Discount rates for calculating December 31 PBO	3.60% - 3.80%	4.45%
Discount rates for calculating February 1 PBO	4.15% - 4.35%	N/A
Salary scale for calculating pension expense	3.00% - 4.50%	4.20%
Salary scale for calculating December 31 PBO	3.50% - 4.50%	4.20%
Salary scale for calculating February 1 PBO	3.50% - 4.50%	N/A
Expected long-term rates of return on plan assets for calculating pension expense	5.25% - 7.00%	7.25%

During 2018, management expects to contribute approximately $1.6 billion to the Plan.

The following benefit payments, which reflect expected future service, are expected to be paid (in millions):

2018	$	865
2019		948
2020		1,048
2021		1,134
2022		1,213
2023–2027		7,260

Explanation of Investment Strategies and Policies

A total return investment approach is employed for the Plans whereby the Plans invest in a mix of equity, fixed-income, and alternative asset classes to maximize the long-term return of plan assets for a prudent level of risk. The intent of this strategy is to minimize plan expenses by outperforming plan liabilities over the long run. Risk tolerance is established through consideration of plan liabilities, plan funded status, and corporate financial condition. The investment portfolio will consist over time of a varying but diversified blend of equity, fixed-income, and alternative investments. Diversification includes such factors as geographic location, equity capitalization size and style, placement in the capital structure, and security type. Investment risk is measured and monitored on an ongoing basis through annual liability measurements, periodic asset/liability studies, and quarterly investment portfolio reviews. The Plans' investment policy has restrictions relating to credit quality, industry/sector concentration, duration, concentration of ownership, and use of derivatives.

Capital Market Assumption Methodology

To determine the long-term rate of return assumption for plan assets, management incorporates historical relationships among the various asset classes and subclasses to be accessed over the investment horizon. Management's intent is to maximize portfolio efficiency. This will be accomplished by seeking the highest returns prudently available among the available asset classes. Overall portfolio volatility is managed through diversification among asset classes. Current market factors such as inflation and interest rates are evaluated before long-term capital market assumptions are determined. From time to time, management reviews its long-term investment strategy and reconciles that strategy with the long-term liabilities of the Plans. This asset-liability study produces a range of expected returns over medium and long-term time periods. Those intermediate and long-term investment projections form the basis for the expected long-term rate of return on assets.

At December 31, 2017, the estimated fair value of total pension trust assets – net by level was as follows (in millions):

	Quoted prices in active markets for identical assets level 1	Significant other observable inputs level 2	Total
Assets:			
Cash and cash equivalents	$ 686	$ 1,083	$ 1,769
Broker receivables	—	331	331
Securities lending collateral	—	1,181	1,181
U.S. equity securities	6,371	494	6,865
Foreign equity securities	6,144	2,657	8,801
Global equity funds	—	276	276
Debt securities issued by the U.S. government	—	1,463	1,463
Debt securities issued by U.S. government agencies and corporations	—	53	53
Debt securities issued by U.S. states and political subdivisions of states	—	214	214
Foreign government debt securities	—	614	614
U.S. corporate debt securities	—	4,675	4,675
Non-U.S. corporate debt securities	—	1,295	1,295
U.S. agency mortgage-backed securities	—	82	82
Non-U.S. agency mortgage-backed securities	—	47	47
Other	1	720	721
Total assets	13,202	15,185	28,387
Liabilities:			
Broker payables	—	609	609
Securities lending payable	—	1,181	1,181
Other liabilities	12	296	308
Total liabilities	12	2,086	2,098
Fair value of pension trust assets – net	$ 13,190	$ 13,099	26,289
Investments measured at net asset value (NAV):			
Alternative investments:			
Absolute return			1,770
Private equity			4,150
Risk parity			1,090
Total pension trust assets – net			$ 33,299

At December 31, 2017, Health Plans and Hospitals' share of pension trust assets was 47.1%, or $15.7 billion. The remaining share of pension trust assets is for Medical Groups and a related party associated with Medical Groups.

At December 31, 2016, the estimated fair value of total pension trust assets – net by level was as follows (in millions):

	Quoted prices in active markets for identical assets level 1	Significant other observable inputs level 2	Total
Assets:			
Cash and cash equivalents	$ 117	$ 1,018	$ 1,135
Broker receivables	—	355	355
Securities lending collateral	—	979	979
U.S. equity securities	5,212	510	5,722
Foreign equity securities	4,679	1,834	6,513
Global equity funds	—	253	253
Debt securities issued by the U.S. government	—	1,036	1,036
Debt securities issued by U.S. government agencies and corporations	—	56	56
Debt securities issued by U.S. states and political subdivisions of states	—	201	201
Foreign government debt securities	—	492	492
U.S. corporate debt securities	—	4,256	4,256
Non-U.S. corporate debt securities	—	1,037	1,037
U.S. agency mortgage-backed securities	—	189	189
Non-U.S. agency mortgage-backed securities	—	44	44
Other	—	666	666
Total assets	10,008	12,926	22,934
Liabilities:			
Broker payables	—	508	508
Securities lending payable	—	979	979
Other liabilities	19	631	650
Total liabilities	19	2,118	2,137
Fair value of pension trust assets – net	$ 9,989	$ 10,808	20,797
Investments measured at NAV:			
Alternative investments:			
Absolute return			1,670
Private equity			3,241
Risk parity			752
Total pension trust assets – net			$ 26,460

At December 31, 2016, Health Plans and Hospitals' share of pension trust assets was 44.5%, or $11.8 billion. The remaining share of pension trust assets is for Medical Groups and a related party associated with Medical Groups.

During the years ended December 31, 2017 and 2016, there were no significant transfers of assets with inputs with quoted prices in active markets for identical assets (level 1) and assets with inputs with significant other observable inputs (level 2).

The target asset allocation and expected long-term rate of return on assets (ELTRA) for calculating pension expense were as follows:

	2017 and 2016 target range	2016 ELTRA	2017 ELTRA
Cash and cash equivalents	0% - 3%	3.00%	3.00%
Equity securities	43% - 55%	8.65%	8.65%
Debt securities	28% - 45%	5.50%	5.00%
Alternative investments	10% - 25%	7.60%	7.25%
Total	100%	7.25%	7.00%

Alternative investments, which include absolute return, risk parity, and private equity, held in the pension trust are reported at NAV as a practical expedient for fair value. Absolute return investments use advanced investment strategies, including derivatives, to generate positive long-term risk adjusted returns. Private equity investments consist of funds that make direct investments in private companies. Risk parity funds use risk as the primary factor to allocate investments among asset classes. At December 31, 2017, the trust had original commitments related to alternative investments of $8.0 billion, of which $4.5 billion was invested, leaving $3.5 billion of remaining commitments. At December 31, 2016, the trust had original commitments related to alternative investments of $6.7 billion, of which $3.4 billion was invested, leaving $3.3 billion of remaining commitments.

Absolute return, risk parity, and private equity investments include redemption restrictions. Absolute return and risk parity investments require 10 to 90 day written notice of intent to withdraw and are often subject to the approval and capital requirements of the fund manager. At December 31, 2017, absolute return and risk parity investments of $647 million are subject to lock-up periods of up to 3 years. Private equity agreements do not include provisions for redemption. Distributions will be received as the underlying investments of the funds are liquidated, which is expected over the next 11 years.

The majority of debt and equity securities can be redeemed within 10 days. At December 31, 2017, debt and equity investment funds of $2.5 billion are redeemable between 10 and 30 days. Debt and equity investment funds of $240 million have a redemption period of up to 120 days. No debt or equity investments require a redemption period of greater than 120 days.

(b) Defined Contribution Plans

Health Plans and Hospitals has defined contribution plans for eligible employees. Employer contributions and costs are typically based on a percentage of covered employees' eligible compensation. During 2017 and 2016, there were no required employee contributions. For the years ended December 31, 2017 and 2016, plan expense, primarily employer contributions, was $330 million and $257 million, respectively.

(c) Multi-Employer Plans

Health Plans and Hospitals participates in a number of multi-employer defined benefit pension plans under the terms of collective bargaining agreements that cover some union-represented employees. Some risks of participating in these multi-employer plans that differ from single-employer plans include:

- Assets contributed to the multi-employer plan by one employer may be used to provide benefits to employees of other participating employers.
- If a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers.
- Employers that choose to stop participating in a multi-employer plan may be required to pay the plan an amount based on the underfunded status of the plan, referred to as a withdrawal liability.

Health Plans and Hospitals' participation in these plans for the year ended December 31, 2017 is outlined in the table below. The "EIN/PN" column provides the Employee Identification Number (EIN) and the three-digit plan number (PN), if applicable. Unless otherwise noted, the most recent Pension Protection Act (PPA) zone status available in 2017 and 2016 is for the plan's year-end in 2016 and 2015, respectively. The zone status is based on information that Health Plans and Hospitals obtained from publicly available information provided by the United States Department of Labor. Among other factors, plans in the red zone are generally less than 65% funded, plans in the yellow zone are between 65% and 80% funded, and plans in the green zone are at least 80% funded. The "FIP/RP Status Pending/Implemented" column indicates plans for which a financial improvement plan (FIP) or a rehabilitation plan (RP) is either pending or has been implemented. The "Health Plans and Hospitals' Contributions to Plan Exceeded More Than 5% of Total Contributions" columns represent those plans where Health Plans and Hospitals was listed in the plans' Forms 5500 as providing more than 5% of the total contributions for the plan years listed. The last column lists the expiration dates of the collective bargaining agreements to which the plans are subject. There have been no significant changes that affect the comparability of 2017 and 2016 employer expense.

Pension fund	EIN-PN	Pension Protection Act zone status 2017	Pension Protection Act zone status 2016	FIP/RP status pending / implemented	(in millions) Health Plans and Hospitals' contributions December 31, 2017	(in millions) Health Plans and Hospitals' contributions December 31, 2016	Surcharge imposed	Health Plans and Hospitals' contributions to plan exceeded more than 5% of total Contributions [1] 2016	Health Plans and Hospitals' contributions to plan exceeded more than 5% of total Contributions [1] 2015	Expiration date of collective bargaining agreement
IUOE Stationary Engineers Local 39 Pension Fund	946118939 -001	Green	Green	N/A	$ 11	$ 11	No	Yes	Yes	9/18/2018
Southern California United Food and Commercial Workers Unions and Drug Employers Pension Fund	516029925 -001	Red	Red	Implemented	6	5	No	Yes	Yes	2/1/2020
Oregon Retail Employees Pension Trust[2]	936074377 -001	Red	Red	Implemented	3	4	No	Yes	Yes	9/30/2018 - 10/31/2018
Solano - Napa County Electrical Workers Pensions Trust (IBEW Local 180)[3]	946220673 -001	Green	Green	N/A	—	—	No	Yes	No	5/31/2019
Other[4]	Various	Red	Red	Implemented	9	7	Yes/No	No	No	4/30/2018 - 10/31/2020
Other	Various	Green	Green		15	14		No	No	5/31/2018 - 12/31/2020
Other	Various	Yellow	Yellow		4	4		No	No	6/30/2019 - 6/30/2020
Total expense					$ 48	$ 45				

(1) Forms 5500 information was available for all plan years ended in 2016. The majority of plans have a plan year end of December 31.

(2) Includes UFCW Local 555 Pharmacy Techs and Radiologists expiring September 30, 2018 and October 31, 2018, respectively.

(3) 2017 was the first year that KP reached the 5% contribution threshold for this union. Total pension contributions for the year were $81K.

(4) Surcharge imposed on the Sound Retirement Trust comprised of UFCW Local 21 Pro-Tech and Optical and Pharmacy. The other red plan included in this grouping does not have a surcharge imposed.

(15) Postretirement Benefits Other than Pensions

(a) Defined Benefit Plan

Certain employees may become eligible for postretirement health care and life insurance benefits while working for Health Plans and Hospitals. Benefits available to retirees, through both affiliated and unaffiliated provider networks, vary by employee group. Postretirement health care benefits available to retirees include subsidized Medicare premiums, medical and prescription drug benefits, dental benefits, vision benefits, and contributions to health care savings accounts.

At December 31, the accrued liability for postretirement benefits was as follows (in millions):

	2017	2016
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 5,436	$ 5,503
Benefit obligation acquired through acquisition	40	156
Service cost	156	156
Interest cost	206	235
Plan amendments	(36)	7
Benefits paid or provided	(151)	(133)
Net actuarial gain (loss)	275	(332)
Benefit obligation at end of year	$ 5,926	$ 5,592
Change in plan assets:		
Fair value of plan assets at beginning of year	3,095	1,365
Actual return on plan assets	388	130
Contributions	1,151	1,733
Benefits paid or provided	(151)	(133)
Fair value of plan assets at end of year	$ 4,483	$ 3,095
Funded status	$ (1,443)	$ (2,497)
Amounts recognized in the balance sheet consist of:		
Noncurrent assets	$ —	$ —
Current liabilities	(4)	—
Pension and other retirement liabilities	(1,439)	(2,341)
	$ (1,443)	$ (2,341)
Amounts recognized in net worth:		
Net actuarial loss	$ 2,184	$ 2,201
Prior service credit	(1,889)	(2,286)
	$ 295	$ (85)

The measurement date used to determine postretirement benefits valuations was December 31.

For the years ended December 31, postretirement benefits expense was as follows (in millions):

	2017	2016
Service cost	$ 156	$ 156
Interest cost	206	235
Expected return on plan assets	(189)	(100)
Amortization of net actuarial loss	93	108
Amortization of prior service credit	(433)	(431)
Postretirement benefits expense	(167)	(32)
Other changes in plan assets and benefit obligations recognized in net worth:		
Net actuarial loss (gain)	76	(362)
Prior service cost (credit)	(36)	7
Amortization of net actuarial loss	(93)	(108)
Amortization of prior service credit	433	431
Total recognized in net worth	380	(32)
Total recognized in net periodic benefit cost and net worth	$ 213	$ (64)

During 2018, $107 million and $(434) million in estimated net actuarial loss and prior service credit, respectively, will be amortized from net worth into postretirement benefits expense.

During 2017, the employer contributions and benefits paid or provided were $1,151 million and $151 million, respectively. During 2016, the employer contributions and benefits paid or provided were $1,733 million and $133 million, respectively. During 2017 and 2016, there were no participant contributions from active employees.

Actuarial assumptions used were as follows:

	2017	2016
Discount rates used for calculating postretirement benefits expense from January 1 to December 31	3.70% - 4.45%	4.75%
Discount rates for calculating December 31 accumulated postretirement benefit obligation	3.35% - 3.80%	4.45%
Discount rate for calculating February 1 accumulated postretirement benefit obligation	3.70%	N/A
Expected long-term rate of return on plan assets for calculating benefits expense	6.00%	7.00%

The following were the assumed health care cost trend rates used to determine the December 31, 2017 and 2016 benefit obligation and postretirement benefits expense for the years ended December 31, 2017 and 2016:

	Basic medical pre-65/post-65	Prescription drug pre-65/post-65	Medicare Part D	Dental	Medicare Part A&B	Medicare Part C	Supplemental medical pre-65/post-65
Initial trend rate – 2016	5.50% / 5.25%	7.00% / 7.00%	4.00%	4.50%	5.25%	3.25%	5.50% / 5.25%
Initial trend rate – 2017	5.25% / 5.25%	6.50% / 6.50%	4.00%	4.50%	5.25%	4.25%	5.25% / 5.25%
Ultimate trend rate	4.50% / 4.50%	4.50% / 4.50%	4.50%	4.50%	4.50%	4.50%	4.50% / 4.50%
First year at ultimate trend rate	2026 / 2022	2025 / 2025	2026	2015	2022	2018	2026 / 2022

A 1% increase in the health care medical trend rate would increase the benefit obligation by $624 million and the service cost plus interest by $33 million. A decrease of 1% in the health care medical trend rate would decrease the benefit obligation by $582 million and the service cost plus interest by $34 million.

The following benefit payments, which reflect expected future service, are expected to be paid or provided (in millions):

2018	$	158
2019		171
2020		186
2021		203
2022		222
2023-2027		1,397

Explanation of Investment Strategies and Policies

A total return investment approach is employed for the retirement benefit trust whereby the assets are invested in various asset classes to maximize the long-term return of plan assets for a prudent level of risk. The intent of this strategy is to minimize plan expenses by outperforming plan liabilities over the long run. Risk tolerance is established through consideration of plan liabilities, plan funded status, and corporate financial condition. The investment portfolio will consist over time of a varying but diversified blend of equity, fixed-income, and alternative investments. Diversification includes such factors as geographic location, equity capitalization size and style, placement in the capital structure, and security type. Investment risk is measured and monitored on an ongoing basis through annual liability measurements, periodic asset/liability studies, and quarterly investment portfolio reviews. The retirement benefit trust investment policy has restrictions relating to credit quality, industry/sector concentration, duration, concentration of ownership, and use of derivatives.

Capital Market Assumption Methodology

To determine the long-term rate of return assumption for plan assets, management incorporates historical relationships among the various asset classes and subclasses to be accessed over the investment horizon. Management's intent is to maximize portfolio efficiency. This will be accomplished by seeking the highest returns prudently available among the available asset classes. Overall portfolio volatility is managed through diversification among asset classes. Current market factors such as inflation and interest rates are evaluated before long-term capital market assumptions are determined. From time to time, management reviews its long-term investment strategy and reconciles that strategy with the long-term liabilities of the Plan. This asset-liability study produces a range of expected returns over medium and long-term time periods. Those intermediate and long-term investment projections form the basis for the expected long-term rate of return on assets.

At December 31, 2017, the estimated fair value of retirement benefit trust assets by level was as follows (in millions):

	Quoted prices in active markets for identical assets level 1	Significant other observable inputs level 2	Total
Assets:			
Cash and cash equivalents	$ —	$ 263	$ 263
Broker receivables	—	1	1
U.S. equity securities	1,523	—	1,523
Foreign equity securities	605	—	605
Other	—	5	5
Total assets	2,128	269	2,397
Liabilities:			
Broker payables	—	—	—
Total liabilities	—	—	—
Total fair value of retirement benefit trust assets	$ 2,128	$ 269	2,397
Investments measured at NAV:			
Alternative investments:			
Absolute return			401
Risk parity			1,685
Total retirement benefit trust assets			$ 4,483

At December 31, 2016, the estimated fair value of retirement benefit trust assets by level was as follows (in millions):

	Quoted prices in active markets for identical assets level 1	Significant other observable inputs level 2	Total
Assets:			
Cash and cash equivalents	$ —	$ 201	$ 201
Other	—	2	2
Total fair value of retirement benefit trust assets	$ —	$ 203	203
Investments measured at NAV:			
Alternative investments:			
Absolute return			1,155
Risk parity			1,737
Total retirement benefit trust assets			$ 3,095

The target asset allocation and expected long-term rate of return on assets (ELTRA) for calculating postretirement benefits expense were as follows:

	2017 and 2016 target range	2017 ELTRA	2016 ELTRA
Alternative investments	100%	6.00%	7.00%
Total	100%	6.00%	7.00%

Absolute return and risk parity investments include redemption restrictions. Absolute return and risk parity investments require 10 to 90 day written notice of intent to withdraw and are often subject to the approval and capital requirements of the fund manager. At December 31, 2017, absolute return and risk parity investments of $239 million are subject to lock-up periods of up to three years.

(b) Multi-Employer Plans

Health Plans and Hospitals participates in multi-employer union-administered retiree medical health and welfare plans that provide benefits to some union employees. Benefits for retirees under these plans are negotiated as part of the collective bargaining process. For the years ended December 31, 2017 and 2016, Health Plans and Hospitals' employer expense for both current and retiree benefits was $83 million and $81 million, respectively.

(16) Physicians' Retirement Plan

Kaiser Foundation Health Plan, Inc. provides defined retirement benefits for physicians associated with certain Medical Groups. Benefits are determined based on the length of service and level of compensation of each participant. The plan is unfunded and is not subject to the Employee Retirement Income Security Act.

At December 31, the accrued liability for physicians' retirement plan was as follows (in millions):

	2017	2016
Change in projected benefit obligation:		
Physicians' retirement plan liability at January 1	$ 6,751	$ 5,901
Service cost	342	317
Interest cost	266	283
Net actuarial loss	982	414
Benefits paid	(176)	(164)
Physicians' retirement plan liability at December 31	$ 8,165	$ 6,751
Accumulated benefit obligation at end of year	$ 6,325	$ 5,306
Change in plan assets:		
Fair value of plan assets at the beginning of year	$ —	$ —
Company contributions	176	164
Benefits paid	(176)	(164)
Fair value of plan assets at end of year	$ —	$ —
Funded status	$ (8,165)	$ (6,751)
Amounts recognized in the balance sheet consist of:		
Noncurrent assets	$ —	$ —
Current liabilities	(199)	(185)
Physicians' retirement plan liability	(7,966)	(6,566)
	$ (8,165)	$ (6,751)
Amounts recognized in net worth:		
Net actuarial loss	$ 2,650	$ 1,733

The measurement date used to determine physicians' retirement valuation was December 31.

A portion of the investments of Health Plans has been designated by management for the liabilities of the physicians' retirement plan. These investments are not held in trust or otherwise legally segregated and are not restricted even though it has been intended that these assets be used to pay the obligations of the physicians' retirement plan.

For purposes of the physicians' retirement plan expense, the expected return on assets is the portion of investment income that represents the expected return on the investments designated for the physicians' retirement plan. This amount is recorded as a reduction in the expense for the physicians' retirement plan and is excluded from investment income – net, as described below and in the *Summary of Significant Accounting Policies – Investments* note.

For the years ended December 31, physicians' retirement plan provision was as follows (in millions):

	2017	2016
Service cost	$ 342	$ 317
Interest cost	266	283
Amortization of net actuarial loss	65	54
Total benefit expense	673	654
Expected return on assets – investment income included in operating expenses	(468)	(427)
Net benefit expense	205	227
Other changes in projected benefit obligations recognized in net worth:		
Net actuarial loss	982	414
Amortization of net actuarial loss	(65)	(54)
Total recognized in net worth	917	360
Total recognized in net periodic benefit cost and net worth	$ 1,122	$ 587

During 2018, $110 million in estimated net actuarial loss will be amortized from net worth into net benefit expense.

Actuarial assumptions used were as follows:

	2017	2016
Discount rate at January 1 for calculating benefit expense	4.55%	4.80%
Discount rate for calculating December 31 PBO	3.85%	4.55%
Salary scale for calculating pension expense	4.40%	4.40%
Salary scale for calculating December 31 PBO	4.40%	4.40%
Expected long-term rate of return on designated investments for calculating benefit expense	7.00%	7.25%

The following benefit payments, which reflect expected future service, are expected to be paid (in millions):

2018	$	199
2019		218
2020		239
2021		263
2022		286
2023–2027		1,744

(17) Commitments and Contingencies

(a) Lease and Purchase Commitments

Health Plans and Hospitals leases primarily office space, medical facilities, and equipment under various leases that expire through 2048. Certain leases contain rent escalation clauses and renewal options for additional periods.

At December 31, 2017, minimum commitments under noncancelable leases extending beyond one year were as follows (in millions):

2018	$	329
2019		320
2020		284
2021		231
2022		186
Thereafter		599
Total	$	1,949

Minimum payments above have not been reduced by minimum sublease rentals of $2 million due in the future under noncancelable subleases.

For the years ended December 31, 2017 and 2016, total lease expense for all leases was $490 million and $464 million, respectively.

At December 31, 2017, minimum purchase commitments extending beyond one year were as follows (in millions):

2018	$	324
2019		220
2020		96
2021		38
2022		33
Thereafter		8
Total	$	719

During 2017 and 2016, Health Plans and Hospitals' total purchases under contracts with minimum purchase commitments were $576 million and $552 million, respectively.

(b) Renewable Energy Contracts

Hospitals has entered into 20 year renewable energy contracts to reduce the financial risk of unexpected increases in utility prices and help achieve its renewable energy goals. Under the renewable energy contracts, Hospitals will net settle with the counterparty based on 100% of the output of two renewable energy sites and also realize renewable energy credits from the production of energy from wind and solar sites. The wind site started its production in December 2015 and the solar site began its production in May 2016. To the extent that the price of electrical energy varies from the fixed amounts in the contracts, Hospitals will pay more or less than the current value of electrical energy over the term of the contracts. Management cannot reasonably estimate the future financial impact of these contracts as they are subject to market fluctuations in energy prices and to the actual production volume of the sites. In addition, Health Plans and Hospitals has entered into multiple on-site renewable energy contracts ranging between 10 and 20 years that are recorded as either contingent operating leases or purchase agreements.

(c) Surety Instruments and Standby Letters of Credit

In the normal course of business, Health Plans and Hospitals contracts to perform certain financial obligations that require a guarantee from a third party. This guarantee creates a contingent liability to the entity that provides that guarantee. At December 31, 2017 and 2016, Health Plans and Hospitals had entered into surety instruments and standby letters of credit that totaled $128 million and $87 million, respectively.

Health Plan, Inc. and Hospitals also guarantee payment of workers' compensation liabilities of certain Medical Groups under self-insurance programs. The majority of such liabilities are recorded as other long-term liabilities of Health Plan, Inc., as payment is provided for under the applicable medical service agreements. In addition to amounts accrued, at December 31, 2017 and 2016, pursuant to such guarantees, Health Plan, Inc. and Hospitals are contingently liable for approximately $140 million and $180 million, respectively, of certain Medical Groups' self-insured workers' compensation liabilities.

(d) Regulatory

Health Plans is required to periodically file financial statements with regulatory agencies in accordance with statutory accounting and reporting practices. Health Plans must comply with the various states' minimum regulatory net worth requirements generally under the regulation of the California Department of Managed Health Care and various state departments of insurance. Such requirements are generally based on tangible net equity or risk-based capital, and for California are calculated on the basis of combined net worth of Health Plans and Hospitals. At December 31, 2017 and 2016, the regulatory net worth, so defined, exceeded the aggregate regulatory minimum requirements by approximately $26 billion and $25 billion, respectively.

Health Plans' regulated subsidiaries maintain investments in various states where they are licensed. At December 31, 2017 and 2016, $7 million and $6 million, respectively, in securities were held to satisfy various state regulatory requirements.

Health Plans and Hospitals is subject to numerous and complex laws and regulations of federal, state, and local governments, and accreditation requirements. Compliance with such laws, regulations, and accreditation requirements can be subject to retrospective review and interpretation, as well as regulatory actions. These laws and regulations include, but are not necessarily limited to, requirements of tax exemption, government reimbursement, government program participation, privacy and security, false claims, anti-kickback, accreditation, healthcare reform, controlled substances, facilities, and professional licensure. In recent years, government activity has increased with respect to compliance and enforcement actions.

In the ordinary course of business operations, Health Plans and Hospitals is subject to periodic reviews, investigations, and audits by various federal, state, and local regulatory agencies and accreditation agencies, including, without limitation, CMS, Department of Managed Health Care, Office of Personnel Management, Occupational Safety and Health Administration, Drug Enforcement Administration, State Boards of Pharmacy, Food and Drug Administration, IRS, National Committee for Quality Assurance, and state departments of insurance.

Health Plans and Hospitals' compliance with the wide variety of rules and regulations and accreditation requirements applicable to their business may result in certain remediation activities and regulatory fines and penalties, which could be substantial. Where appropriate, reserves have been established for such sanctions. While management believes these reserves are adequate, the outcome of legal and regulatory matters is inherently uncertain, and it is possible that one or more of the legal or regulatory matters currently pending or threatened could have a material adverse effect on the combined financial position or results of operations.

(e) Litigation

Health Plans and Hospitals is involved in lawsuits and various governmental investigations, audits, reviews, and administrative proceedings arising, for the most part, in the ordinary course of business operations. Lawsuits have been brought under a wide range of laws and include, but are not limited to, business disputes, employment and retaliation claims, claims alleging professional liability, improper disclosure of personal information, labor disputes, administrative regulations, the False Claims Act, information privacy and HIPAA laws, mental health parity laws, and consumer protection laws. In addition, Health Plans indemnifies the Medical Groups against various claims, including professional liability claims.

Health Plans and Hospitals records reserves for legal proceedings and regulatory matters where available information indicates that at the date of the combined financial statements a loss is probable and the amount can be reasonably estimated. While such reserves reflect management's best estimate of the probable loss for such matters, Health Plans and Hospitals' recorded amounts may differ materially from the actual amount of any such losses.

In September 2015, a lawsuit was filed seeking to have the State of California impose the gross premiums tax on Health Plan, Inc. In the opinion of management, strong defenses exist regarding this claim. However, an unfavorable outcome could have a material adverse effect. No reserves have been provided related to this lawsuit.

Pursuant to a civil subpoena, Health Plans and Hospitals has provided documents and information to the Department of Justice and Department of Health and Human Services – Office of Inspector General relating to Medicare Part C risk adjustment practices, policies, and programs. This matter could result in a False Claims Act litigation, in which an unfavorable outcome could have a material adverse effect. No significant reserves have been provided related to this matter.

In the opinion of management, based upon current facts and circumstances, the resolution of these matters is not expected to have a material adverse effect on the combined financial position or combined results of operations of Health Plans and Hospitals. The outcome of litigation and other legal and regulatory matters is inherently uncertain, however, and it is possible that one or more of the legal or regulatory matters currently pending or threatened could have a material adverse effect.