



Sutter Health

Community Based, Not For Profit

Audited Financial Statements

December 31, 2004



Sutter Health and Affiliates

Combined Financial Statements

Years Ended December 31, 2004 and 2003

Contents

Audited Combined Financial Statements

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Report of Independent Auditors

The Board of Directors
Sutter Health and Affiliates

We have audited the accompanying combined balance sheets of Sutter Health and Affiliates as of December 31, 2004 and 2003, and the related combined statements of operations and changes in net assets, and cash flows for the years then ended. These financial statements are the responsibility of Sutter Health and Affiliates' management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of Sutter Health and Affiliates' internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Sutter Health and Affiliates' internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of Sutter Health and Affiliates at December 31, 2004 and 2003, and the combined results of their operations and changes in their net assets, and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.

Ernst & Young LLP

March 4, 2005

Sutter Health and Affiliates

Combined Balance Sheets

(In Millions)

| | December 31, | |
|--|---------------------|-----------------|
| | 2004 | 2003 |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 96 | \$ 71 |
| Short-term investments | 1,034 | 964 |
| Patient accounts receivable (less allowance for doubtful accounts of \$139 in 2004 and \$147 in 2003) | 747 | 764 |
| Other receivables | 88 | 81 |
| Inventories | 65 | 57 |
| Other current assets | 140 | 148 |
| Total current assets | <u>2,170</u> | <u>2,085</u> |
| Non-current investments | 1,011 | 821 |
| Property, plant and equipment, net | 2,362 | 1,977 |
| Other assets | 186 | 125 |
| | <u>\$ 5,729</u> | <u>\$ 5,008</u> |
| Liabilities and net assets | | |
| Current liabilities: | | |
| Current maturities of long-term obligations | \$ 24 | \$ 26 |
| Accounts payable and accrued expenses | 800 | 746 |
| Current portion of estimated third-party settlements | 2 | 15 |
| Total current liabilities | <u>826</u> | <u>787</u> |
| Non-current liabilities: | | |
| Long-term obligations, less current maturities | 1,450 | 1,333 |
| Other | 391 | 300 |
| Net assets: | | |
| Unrestricted | 2,795 | 2,332 |
| Temporarily restricted | 193 | 178 |
| Permanently restricted | 74 | 78 |
| | <u>3,062</u> | <u>2,588</u> |
| | <u>\$ 5,729</u> | <u>\$ 5,008</u> |

See accompanying notes.

Sutter Health and Affiliates

Combined Statements of Operations and Changes in Net Assets

(In Millions)

| | Years Ended December 31, | |
|---|---------------------------------|-------------|
| | 2004 | 2003 |
| Unrestricted net assets: | | |
| Unrestricted revenues, gains and other support: | | |
| Patient service revenues | \$ 4,962 | \$ 4,506 |
| Capitation revenues | 893 | 804 |
| Investment income | 108 | 76 |
| Other | 317 | 286 |
| Total revenues, gains and other support | 6,280 | 5,672 |
| Operating expenses: | | |
| Salaries and employee benefits | 2,658 | 2,366 |
| Purchased services | 1,208 | 1,071 |
| Supplies | 705 | 634 |
| Depreciation and amortization | 271 | 247 |
| Capitated purchased services | 265 | 253 |
| Provision for bad debts | 248 | 231 |
| Rentals and leases | 84 | 76 |
| Interest | 53 | 58 |
| Insurance | 34 | 34 |
| Other | 326 | 237 |
| Total operating expenses | 5,852 | 5,207 |
| Income | 428 | 465 |

Sutter Health and Affiliates

Combined Statements of Operations and Changes in Net Assets (Continued)

(In Millions)

| | Years Ended December 31, | |
|---|---------------------------------|-------------|
| | 2004 | 2003 |
| Unrestricted net assets (Continued): | | |
| Income (page 3) | \$ 428 | \$ 465 |
| Change in net unrealized gains and losses on investments | 6 | 101 |
| Net assets released from restrictions for equipment acquisition | 8 | 11 |
| Donated long-lived assets, including contributions in connection with business combinations | 18 | 3 |
| Change in additional minimum pension liability | – | 41 |
| Other, including impact of business combinations | 3 | 3 |
| Increase in unrestricted net assets | 463 | 624 |
| Temporarily restricted net assets: | | |
| Contributions | 54 | 46 |
| Investment income | 5 | 3 |
| Change in net unrealized gains and losses on investments | 1 | 13 |
| Net assets released from restriction | (49) | (67) |
| Other, including impact of business combinations | 4 | (1) |
| Increase (decrease) in temporarily restricted net assets | 15 | (6) |
| Permanently restricted net assets: | | |
| Contributions | 4 | 3 |
| Change in net unrealized gains and losses on investments | 2 | 3 |
| Net assets transferred to unrelated entity | (9) | – |
| Other, including impact of business combinations | (1) | 5 |
| (Decrease) increase in permanently restricted net assets | (4) | 11 |
| Increase in net assets | 474 | 629 |
| Net assets, beginning of year | 2,588 | 1,959 |
| Net assets, end of year | \$ 3,062 | \$ 2,588 |

See accompanying notes.

Sutter Health and Affiliates
 Combined Statements of Cash Flows

(In Millions)

| | Years Ended December 31, | |
|---|---------------------------------|--------------|
| | 2004 | 2003 |
| Operating activities | | |
| Change in net assets | \$ 474 | \$ 629 |
| Adjustments to reconcile change in net assets to net cash provided by operating activities: | | |
| Noncash impact of business combinations | – | (3) |
| Loss from extinguishment of debt | 9 | – |
| Depreciation and amortization | 271 | 247 |
| Change in net unrealized gains and losses on investments | (9) | (117) |
| Provision for bad debts | 248 | 231 |
| Increase in professional liability reserves | 18 | 18 |
| Decrease in equity in earnings on investments in health care-related businesses | (3) | (3) |
| Increase in other non-current liabilities | 73 | 6 |
| Restricted contributions and investment (loss) income | (22) | 4 |
| Loss on disposal of property, plant and equipment | 11 | 14 |
| Other | – | 1 |
| Net changes in operating assets and liabilities: | | |
| Patient accounts receivable and other receivables | (238) | (347) |
| Inventories and other assets | (44) | (124) |
| Accounts payable, accrued expenses and current portion of estimated third-party settlements | 38 | (21) |
| Net cash provided by operating activities | 826 | 535 |
| Investing activities | | |
| Payments for business acquisitions, net of cash and cash equivalents acquired | – | (8) |
| Purchases of property, plant and equipment | (662) | (446) |
| Proceeds from disposal of property, plant and equipment | 1 | 3 |
| Purchases and sales or maturities of investments, net | (249) | (212) |
| Other | (13) | 3 |
| Net cash used in investing activities | (923) | (660) |

Sutter Health and Affiliates

Combined Statements of Cash Flows (Continued)

(In Millions)

| | Years Ended December 31, | |
|---|---------------------------------|-------------|
| | 2004 | 2003 |
| Financing activities | | |
| Decrease in short-term borrowings | \$ — | \$ (95) |
| Payments of long-term obligations | (54) | (43) |
| Payments for legal defeasance of bonds | (84) | — |
| Payments for partial refunding of debt | (29) | — |
| Proceeds from issuance of long-term obligations | 272 | 102 |
| Bond issuance costs and discount | (5) | (1) |
| Net proceeds (releases) from restricted contributions and investment loss (income) | 22 | (4) |
| Net cash provided by (used in) financing activities | 122 | (41) |
| Net increase (decrease) in cash and cash equivalents | 25 | (166) |
| Cash and cash equivalents at beginning of year | 71 | 237 |
| Cash and cash equivalents at end of year | \$ 96 | \$ 71 |
| Supplementary disclosures of cash flow information and schedule of noncash investing and financing activities: | | |
| Cash paid during the year for interest (net of capitalized interest costs of \$7 in 2004 and \$4 in 2003) | \$ 56 | \$ 58 |
| Noncash investing and financing activities: | | |
| Assets acquired (\$3 in 2004 and \$16 in 2003) offset by liabilities assumed (\$3 in 2004 and \$5 in 2003) in connection with business acquisitions accounted for as purchases, exchanges or contributions of long-lived assets, excluding cash and cash equivalents | \$ — | \$ (11) |

See accompanying notes.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

1. ORGANIZATION

Organization: Sutter Health is a California not-for-profit multi-provider integrated health care delivery system headquartered in Sacramento, California that includes a centralized support group and various health care-related businesses operating primarily in five service areas, principally in Northern California.

Sutter Health and its affiliates and subsidiaries provide the following services: health care, education, research and administration.

The five service areas include acute care and psychiatric hospitals, skilled nursing facilities, medical foundations, fundraising foundations and a variety of other specialized health care service providers. These entities are commonly referred to as the Affiliates. The acute care hospitals provide a full range of medical services (e.g., surgical, intensive care, emergency room, obstetrics). All emergency rooms provide emergency care, regardless of a patient's ability to pay. Sutter Health and its affiliates also serve their communities with programs including health education, health libraries, school-based clinics, home health care, hospice care, adult day care, prenatal clinics, community clinics, immunization services, and training health professionals.

2. ACCOUNTING POLICIES

Basis of Combination: The combined financial statements include the accounts of Sutter Health and affiliated corporations and subsidiaries ("Sutter"). All significant intercompany accounts and transactions have been eliminated in combination.

Use of Estimates: The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Cash Equivalents: Cash equivalents represent all highly liquid investments with original maturities of 90 days or less, including money market accounts with limited market risk. Financial instruments that potentially subject Sutter to concentrations of credit risk include cash equivalents and investments. Sutter places certain of its cash in banks that are federally insured in limited amounts and in investment-grade debt instruments, many of which are backed by the United States Government or other government agencies. Cash equivalents are stated at fair market value.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

Investments: Investments consist principally of corporate notes and stocks, and U.S. Government and agency securities, all of which are other-than-trading and carried at fair market value. Certain investments are designated as assets held in trust. These include assets held by trustees in accordance with the indentures relating to long-term obligations and assets reserved in accordance with self-insurance requirements. In addition, certain investments are designated by the appropriate governing boards for future capital improvements.

Patient Accounts Receivable: Sutter's primary concentration of credit risk is patient accounts receivable, which consist of amounts owed by various governmental agencies, insurance companies and private patients. Sutter manages the receivables by regularly reviewing its patient accounts and contracts and by providing appropriate allowances for uncollectible amounts. Significant concentrations of gross patient accounts receivable were as follows:

| | December 31, | |
|----------|---------------------|-------------|
| | 2004 | 2003 |
| Medicare | 25% | 23% |
| Medi-Cal | 20% | 19% |

During the year, certain affiliates collected on accounts that were previously deemed uncollectible. Such collections are recognized in the period that cash is received. These collections resulted in an increase of patient service revenue in 2004 of less than 2%. Due to the inherent variability in this area, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term.

Inventories: Inventories, which consist principally of medical and other supplies, are stated on the basis of cost determined by the first-in, first-out method, which is not in excess of market.

Property, Plant and Equipment: Property, plant and equipment are stated on the basis of cost, or in the case of donated items, on the basis of fair market value at the date of donation, less any impairment write-downs. Routine maintenance and repairs are charged to expense as incurred. Expenditures that increase values, change capacities or extend useful lives are capitalized, as is interest on amounts borrowed to finance such constructed assets.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

Depreciation is computed by the straight-line method over the estimated useful lives of the assets, which range from 3 to 40 years for buildings and improvements and leasehold improvements, and from 3 to 20 years for equipment. Amortization of equipment under capital leases is included in depreciation and amortization expense.

Long-lived assets held for sale are stated at the lower of cost or estimated fair value less costs of disposal. The fair market values of these assets, and resultant impairment losses, which were recorded in other expenses in the Statement of Operations, were calculated based on discounted cash flow analyses or independent appraisals. As of December 31, 2004, there were no assets held for sale or to be disposed of. As of December 31, 2003, assets held for sale or to be disposed of were not material to Sutter's combined financial statements.

Other Assets: Goodwill represents the excess of purchase price over the fair market value of net assets acquired and is being amortized over periods ranging from 5 to 15 years using the straight-line method. Based on current estimates, management believes that the goodwill balance of \$15 as of December 31, 2004 will be realized. However, the amount of goodwill considered realizable could be revised in the near term if estimates of future operating cash flows are reduced. Unamortized financing costs associated with the issuance of long-term obligations are amortized ratably over the term of the respective obligations. Sutter has minority interests in various health care-related businesses. The majority of these investments are accounted for on the equity method and the assets, liabilities and results of operations of these unconsolidated investees are not material to Sutter's combined financial statements.

Risk Management: Sutter maintains several self-insured medical and other benefit plans for certain employees and is self-insured for workers' compensation for certain affiliates. Also, certain affiliates of Sutter participate in a wholly owned self-insured captive for professional liability claims and comprehensive general liability. In addition, certain affiliates of Sutter purchase (a) workers' compensation insurance coverage and (b) professional liability insurance coverage that are claims-made policies. The provisions for estimated workers' compensation, professional liability and comprehensive general liability claims include estimates of the ultimate costs for both uninsured reported claims and claims incurred but not reported, in accordance with actuarial projections based on past experience. Such claim reserves are based on the best data available to Sutter; however, these estimates are subject to a significant degree of inherent variability. Accordingly, there is at least a reasonable possibility that a material change to the estimated reserves will occur in the near term. Such estimates are continually monitored

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

and reviewed, and as reserves are adjusted, the differences are reflected in current operations. While the ultimate amount of workers' compensation, professional liability and comprehensive general liability claims is dependent on future developments, management is of the opinion that the associated liabilities recognized in the accompanying combined financial statements are adequate to cover such claims. Sutter has entered into reinsurance and excess policy agreements with independent insurance companies to limit its losses on workers' compensation, professional liability and comprehensive general liability claims. Reserves for workers' compensation claims related to the primary self insurance plan are discounted using a rate of 5.5% and 4.75%, and amount to \$149 and \$104 as of December 31, 2004 and 2003, respectively. Sutter has other workers' compensation plans administered at certain affiliates that are discounted using rates of 5.5% and 6-7% with reserves amounting to \$62 and \$43 as of December 31, 2004 and 2003, respectively. Professional liability loss reserves for reported and incurred but not reported claims, which are discounted using a rate of 5.5% and 4.75%, amount to \$113 and \$96 as of December 31, 2004 and 2003, respectively. Management is aware of no potential professional liability claims whose settlement would have a material adverse effect on Sutter's combined financial position.

Other Liabilities: Other non-current liabilities consist of (a) insurance liabilities, including estimated liabilities for professional liability losses; (b) minority interests in net assets of subsidiaries; (c) obligations to return assets to local hospital districts; (d) the portion of estimated third-party settlements not expected to be settled within a year; and (e) certain other liabilities.

Contingencies: Estimated losses from contingencies are recorded when they are probable and reasonably estimable in accordance with Statement of Financial Accounting Standard No. 5, Accounting for Contingencies.

Net Assets: Net resources that are not restricted by donors are included in unrestricted net assets. Resources restricted by donors for a specified time or purpose are reported as temporarily restricted net assets. When the specific purposes are achieved, either through passage of a stipulated time or the purpose for restriction is accomplished, they are released to other support in the combined statement of operations and changes in net assets. Resources temporarily restricted by donors for additions to property, plant and equipment are initially reported as temporarily restricted net assets and are transferred to unrestricted net assets when expended. Donor-imposed restrictions, which stipulate that the resources be maintained permanently, are reported as permanently restricted net assets. Investment income related to temporarily or permanently restricted net assets is classified as either temporarily restricted or unrestricted based on the intent of the donor, or is added to permanently restricted net assets if required by the donor.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

As part of a reorganization agreement of one of its not-for-profit public benefit corporations, a total of \$13, including \$9 of permanently restricted net assets, was transferred to an unrelated not-for-profit public benefit corporation. The unrestricted net asset portion of the transfer was a contribution recorded as other expense.

Temporarily and permanently restricted net assets were maintained for the following purposes:

| | December 31, | |
|--|---------------------|-------------|
| | 2004 | 2003 |
| Temporarily restricted: | | |
| Capital projects and medical equipment | \$ 75 | \$ 51 |
| Time restricted under trust agreements | 30 | 27 |
| Research and education | 40 | 51 |
| Other | 48 | 49 |
| | \$ 193 | \$ 178 |
| Permanently restricted - Endowment | \$ 74 | \$ 78 |

Donor Gifts: Unconditional promises to give cash or other assets are reported at fair market value at the date the promises are received. Conditional promises to give and indications of intentions to give are reported at fair market value when the conditions are met. Conditional promises were not material at December 31, 2004 and 2003.

As of December 31, 2004, pledges receivable consisted of the following unconditional promises to give:

| | |
|--|-------|
| Pledges due in 2005 | \$ 19 |
| Pledges due 2006-2009 | 18 |
| Pledges due after 2009 | 10 |
| Less allowance for uncollectible pledges | (1) |
| Less discount on pledges receivable | (4) |
| | \$ 42 |

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

Gifts of long-lived operating assets, such as property, plant or equipment, are reported as unrestricted support and excluded from income, unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about the period for which those long-lived assets must be maintained, expirations of donor restrictions are reported when the donated long-lived assets are acquired and placed in service.

Patient Service Revenues: Patient service revenues are reported at the estimated net realizable amounts from patients, third-party payors and others for services rendered, including estimated retroactive adjustments under reimbursement programs with third-party payors. Estimated settlements under third-party reimbursement programs are accrued in the period the related services are rendered and adjusted in future periods, primarily as a result of final settlements.

Capitated Services: Sutter has agreements with various Health Maintenance Organizations (“HMOs”) to provide medical services to subscribing participants. Under these agreements, Sutter receives monthly capitation payments based on the number of each HMOs participants that are covered by the contract, regardless of services provided by Sutter. Certain of these agreements also contain provisions whereby additional amounts may be due or paid. Sutter accrues costs for out-of-area services when services are rendered under these contracts, including estimates of incurred but not reported (“IBNR”) claims and amounts receivable/payable under risk-sharing arrangements. The IBNR accrual is an estimate of the cost of services for which Sutter is responsible.

Performance Indicator: “Income” as reflected in the accompanying combined statements of operations and changes in net assets is a performance indicator. Income includes changes in unrestricted net assets other than contributions of long-lived assets, changes in net unrealized gains and losses on investments, additional minimum pension liability, discontinued operations, cumulative effects of changes in accounting principles and extraordinary items. Impairment of long-lived assets is included in other operating expenses.

Advertising: Sutter expenses advertising costs as incurred. Advertising expense was \$16 and \$11 for the years ended December 31, 2004 and 2003, respectively.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

2. ACCOUNTING POLICIES (Continued)

Research and Development: Sutter expenses research and development costs as incurred. Research and development expense was \$30 and \$27 for the years ended December 31, 2004 and 2003, respectively.

Income Taxes: Sutter Health and substantially all of its affiliates have been determined to be exempt organizations by the Internal Revenue Service, (pursuant to Internal Revenue Code Section 501(c)(3)), and the California Franchise Tax Board (pursuant to California Revenue and Taxation Code 23701(d)) and, generally, are not subject to taxes on income.

Certain activities of Sutter are subject to income taxes; however, such activities are not significant to the combined financial statements. With respect to its for-profit subsidiaries and taxable activities, Sutter records income taxes using the liability method under which deferred tax assets and liabilities are determined based on the differences between the financial accounting and tax bases of assets and liabilities. Deferred tax assets or liabilities at the end of each period are determined using the currently enacted tax rate expected to apply to taxable income in the periods that the deferred tax asset or liability is expected to be realized or settled.

Fair Values of Financial Instruments: The methods and assumptions used by Sutter in estimating its financial instrument fair value disclosures, as well as the resultant amounts, are as indicated in Notes 4, 7, and 8.

Reclassifications: Certain amounts in Sutter's 2003 combined financial statements have been reclassified to conform with the presentation of its 2004 combined financial statements. These reclassifications had no impact on previously reported revenue or income.

3. BUSINESS COMBINATIONS

In July 2003, Sutter acquired certain assets and became responsible for liabilities of Solano Regional Medical Group, Inc. in a transaction accounted for as a purchase.

In January 2003, Sutter received certain assets and became responsible for liabilities of Sutter Roseville Medical Center Foundation in a transaction accounted for as a contribution.

Acquired assets and liabilities from all business combinations have been adjusted to their estimated fair market values as of the date of the acquisition.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

4. INVESTMENTS

Investments were held for the following uses:

| | December 31, | |
|---|---------------------|-------------|
| | 2004 | 2003 |
| Assets held in trust: | | |
| Principal, interest and other reserves held in trust under bond indentures | \$ 373 | \$ 250 |
| Internally designated funded depreciation and other designations | 600 | 541 |
| Investments | 1,072 | 994 |
| | 2,045 | 1,785 |
| Less current portion | (1,034) | (964) |
| | \$ 1,011 | \$ 821 |

The fair market values for investments are based on quoted market prices. Investments consisted of the following:

| | December 31, | | | |
|--|---------------------|------------------------------|-------------|------------------------------|
| | 2004 | | 2003 | |
| | Cost | Fair Market Value | Cost | Fair Market Value |
| Money market funds and other cash equivalents | \$ 151 | \$ 151 | \$ 167 | \$ 167 |
| U.S. Government and agency securities | 788 | 792 | 450 | 459 |
| Foreign Government and Corporate debt securities | 66 | 76 | 61 | 70 |
| Corporate debt securities | 284 | 288 | 383 | 394 |
| Marketable equity securities | 624 | 738 | 601 | 695 |
| | \$ 1,913 | \$ 2,045 | \$ 1,662 | \$ 1,785 |

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

4. INVESTMENTS (Continued)

Investment income was comprised of the following elements:

| | Years Ended December 31, | |
|--|---------------------------------|-------------|
| | 2004 | 2003 |
| Interest and dividends | \$ 65 | \$ 63 |
| Net realized gain on sales of securities, including other-than-temporary impairments | 48 | 16 |
| | 113 | 79 |
| Amounts included in changes in restricted net assets | (5) | (3) |
| Investment income | 108 | 76 |
| Less interest earned on unspent bond project funds | (5) | (5) |
| | \$ 103 | \$ 71 |

Sutter uses the specific identification method to compute realized gains and losses on U.S. Government and agency securities, stocks, and corporate debt securities. Sutter uses the average cost method to compute realized gains and losses on mutual funds. Marketable equity securities, which includes stocks and mutual funds, are primarily held for endowments, future capital improvements, and investment diversification.

5. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment consisted of the following:

| | December 31, | |
|--|---------------------|-------------|
| | 2004 | 2003 |
| Land improvements | \$ 56 | \$ 53 |
| Leasehold improvements | 116 | 101 |
| Buildings and improvements | 1,925 | 1,788 |
| Equipment | 1,535 | 1,439 |
| | 3,632 | 3,381 |
| Less accumulated depreciation and amortization | (1,977) | (1,837) |
| | 1,655 | 1,544 |
| Land | 339 | 208 |
| Construction-in-progress | 368 | 225 |
| | \$ 2,362 | \$ 1,977 |

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

6. OTHER ASSETS

Other assets consisted of the following:

| | December 31, | |
|---|---------------------|---------------|
| | 2004 | 2003 |
| Goodwill, net | \$ 15 | \$ 13 |
| Prepaid rent | 13 | 14 |
| Unamortized financing costs | 30 | 26 |
| Non-current portion of notes receivable | 29 | 11 |
| Non-current portion of pledges receivable | 24 | 22 |
| Reinsurance recoveries receivable | 26 | — |
| Workers compensation deposits | 18 | 11 |
| Other | 31 | 28 |
| | <u>\$ 186</u> | <u>\$ 125</u> |

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

7. LONG-TERM OBLIGATIONS

Long-term obligations consisted of the following:

| | December 31, | |
|--|---------------------|-------------|
| | 2004 | 2003 |
| Hospital revenue bonds and Certificates of Participation under the Sutter Health Master Indenture of Trust, fixed interest at 4.4% to 6.3%, variable interest at 0.8% - 2.0%, due from 2005 to 2042 (net of discount of \$12 and \$14 at December 31, 2004 and 2003, respectively) | \$ 1,438 | \$ 1,237 |
| Hospital revenue bonds under the California Pacific Medical Center (“CPMC”) Master Indenture of Trust (net of discounts of \$0 and \$1 at December 31, 2004 and 2003, respectively) | – | 78 |
| Hospital revenue bonds through the City of Modesto, fixed interest at 4.4% to 6.0%, variable interest based on daily rate (2.0% at December 31, 2004) due from 2005 to 2021 | 25 | 32 |
| Hospital insured taxable revenue bond under St. Luke’s Hospital bond indenture of trust, fixed interest at 7.5%, due October 1, 2012 | 7 | 7 |
| Various collateralized and unsecured obligations | 3 | 3 |
| Obligations under capital leases | 1 | 2 |
| | 1,474 | 1,359 |
| Less current maturities | (24) | (26) |
| | \$ 1,450 | \$ 1,333 |

The aggregate estimated fair market values of Sutter’s short-term borrowings and long-term obligations at December 31, 2004 and 2003 of \$1,518 and \$1,461, respectively, were established using discounted cash flow analyses based on (a) the current market yield to maturity for similar types of publicly traded debt issues and (b) Sutter’s current incremental borrowing rates for all other debt instruments.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

7. LONG-TERM OBLIGATIONS (Continued)

Certain affiliates of Sutter are members of the Sutter Health Obligated Group. As a result, the assets of such affiliates of Sutter are subject to the indebtedness of the Obligated Group. For consistency with Sutter's financial statements, which are prepared in accordance with generally accepted accounting principles, the financial statement presentation for the Obligated Group includes Obligated member affiliates and their taxable and for-profit subsidiaries, when appropriate.

The Obligated Group is not a legal entity. However, under the terms of the California Health Facilities Financing Authority ("CHFFA") and California Statewide Communities Development Authority ("CSCDA") bonds, members of the Obligated Group are jointly and severally liable for the bonds. The related financing documents and various other debt agreements contain certain restrictive covenants requiring compliance by all members, including pledges of gross revenues.

In February 2004, Sutter issued \$239 of Series A, B, C and D CSCDA variable rate bonds. The proceeds of these borrowings were designated to finance certain capital expenditures and to refund a bond issue. In February, a total of \$59 in bonds was refunded and another \$75 was tendered and refinanced. These transactions resulted in a loss of \$9 in 2004, which was recorded as other expense.

In December 2004, Sutter defeased \$48 of Series 1995 A and B CHFFA Revenue Bonds using existing assets. The defeasance resulted in a loss of \$3 in 2004, which was recorded as other expense.

In January 2003, Sutter issued \$101 of Series A and B CSCDA variable rate bonds. The proceeds of these borrowings were designated to retire certain borrowings and finance certain capital expenditures.

Aggregate maturities of long-term obligations, excluding capital leases and bond discounts, were as follows as of December 31, 2004:

| | | |
|------------|----|--------------|
| 2005 | \$ | 24 |
| 2006 | | 25 |
| 2007 | | 26 |
| 2008 | | 27 |
| 2009 | | 29 |
| Thereafter | | 1,354 |
| | \$ | <u>1,485</u> |

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

7. LONG-TERM OBLIGATIONS (Continued)

Sutter had an available \$200 revolving line of credit with a syndicate of banks as of December 31, 2004. Sutter had no outstanding borrowings related to their revolving line of credit at December 31, 2004.

As of December 31, 2004, Sutter had irrevocable standby letters of credit aggregating \$109 to collateralize certain long-term obligations aggregating \$113.

8. INTEREST RATE SWAPS

On February 17, 2004, Sutter entered into various interest rate swap agreements with a notional amount of \$75 associated with the 1993 COP bonds to create a fair value hedge. Under the swap agreements, Sutter receives a fixed rate and pays BMA Municipal Swap Index plus a spread. The swaps expire between 2005 and 2019, with settlement on a semiannual basis. The fair value of the swaps was \$1 at December 31, 2004.

Sutter's objective for the hedge is to protect against changes in the overall fair value of the hedged items. Changes in the fair value of the interest rate swap are expected to be highly effective over time at offsetting the changes in fair value of the associated debt attributable to fluctuations in market interest rates.

Sutter has utilized the "dollar offset approach" to measure the ineffectiveness of the hedge quarterly. Accordingly, the calculation of ineffectiveness will involve a comparison of the change in fair value of the hedging instrument with the change in fair value of the hedged item. The ineffective portion at December 31, 2004 is not material to Sutter's combined financial statements.

The effective portion of the loss on the swap is reported as a change in the carrying value of the associated debt, while the ineffective portion is reported in interest expense.

9. LEASES

Sutter leases various property, plant, office space and equipment. The leases expire at various times and contain certain contingent rental provisions, guarantees and various renewal options. These leases are classified as either capital leases, which were not material as of December 31, 2004 and 2003, or operating leases based on the terms of the respective agreements. Certain operating leases relate to acute care facilities leased from various municipalities. Such operating lease agreements require Sutter to make specified capital improvements to the municipalities' facilities at various times.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

9. LEASES (Continued)

Future minimum payments (net of income from subleases), by year and in the aggregate, under noncancellable operating leases with terms of one year or more at inception consisted of the following as of December 31, 2004:

| | | |
|------------|----|------------|
| 2005 | \$ | 54 |
| 2006 | | 50 |
| 2007 | | 45 |
| 2008 | | 31 |
| 2009 | | 24 |
| Thereafter | | 62 |
| | \$ | <u>266</u> |

10. PATIENT SERVICE AND CAPITATION REVENUES

Sutter has agreements with third-party payors that provide for payments to Sutter at amounts different from its established rates. A summary of the payment arrangements with major third-party payors follows:

- *Medicare* – Inpatient acute care services and outpatient services rendered to Medicare program beneficiaries are paid at prospectively determined rates per diagnosis. These rates vary according to a patient classification system that is based on clinical, diagnostic and other factors. Certain inpatient nonacute services and medical education costs related to Medicare beneficiaries are paid based on a cost reimbursement methodology. Sutter is reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by Sutter and audits thereof by the Medicare fiscal intermediary. Sutter's classification of patients under the Medicare program and the appropriateness of their admission are subject to an independent review. Sutter's Medicare cost reports have been audited by the Medicare fiscal intermediary generally through December 31, 2000.
- *Medi-Cal* – Inpatient and outpatient services rendered to Medi-Cal program beneficiaries are reimbursed either under contracted rates or reimbursed for cost reimbursable items at a tentative rate with final settlement determined after submission of annual cost reports by Sutter and audits thereof by Medi-Cal. Sutter's Medi-Cal cost reports have been audited generally through December 31, 2001.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

10. PATIENT SERVICE AND CAPITATION REVENUES (Continued)

Gross patient charges, including charges related to capitated patients, from the Medicare and Medi-Cal programs accounted for the following percentages of Sutter's gross patient service revenues:

| | Years Ended December 31, | |
|----------|---------------------------------|-------------|
| | 2004 | 2003 |
| Medicare | 38% | 38% |
| Medi-Cal | 16% | 14% |

Laws and regulations governing the Medicare and Medi-Cal programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded cost report estimates will change by a material amount in the near term. Adjustments from the finalization of prior-year cost reports from both Medicare and Medi-Cal resulted in increases in patient service revenues of approximately \$3 and \$9 for the years ended December 31, 2004 and 2003, respectively.

Sutter believes that it is in compliance with all applicable laws and regulations in all material respects and is not aware of any pending or threatened investigations involving allegations of potential wrongdoing that would have a material adverse effect on Sutter's combined financial position. Compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action, including fines, penalties and exclusion from the Medicare and Medi-Cal programs.

Sutter also has entered into payment agreements with certain commercial insurance carriers, HMOs and preferred provider organizations. The basis for payment to Sutter under these agreements includes capitated arrangements, prospectively determined rates per diagnosis, discounts from established charges and prospectively determined daily rates.

11. UNSPONSORED COMMUNITY BENEFIT EXPENSE (UNAUDITED)

Traditional Charity Care covers health care services provided to persons who meet certain criteria and cannot afford to pay. Sutter had write-offs of charges for Charity Care services to their patients that totaled \$155 and \$109 in 2004 and 2003, respectively.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

11. UNSPONSORED COMMUNITY BENEFIT EXPENSE (UNAUDITED) **(Continued)**

The following is a summary of Sutter's estimated costs of providing services to the poor and broader community:

| | Years Ended December 31, | |
|---------------------------------------|---------------------------------|---------------|
| | 2004 | 2003 |
| Services for the poor and underserved | \$ 330 | \$ 288 |
| Benefits for the broader community | 484 | 361 |
| | <u>\$ 814</u> | <u>\$ 649</u> |

Services for the poor and underserved include services provided to persons who cannot afford health care because of inadequate resources and/or are uninsured or underinsured, as well as the unpaid costs of public programs treating Medi-Cal and indigent beneficiaries. Cost is computed based on a relationship of cost to charges. It also includes the cost of other services for indigent populations, and cash donations on behalf of the poor and needy.

Benefits for the broader community include unpaid costs of providing the following services: treating the elderly, health screenings and other health-related services, training health professionals, educating the community with various seminars and classes, the cost of performing medical research and the costs associated with providing free clinics and community services. Contributions Sutter makes to community agencies to fund charitable activities are also included.

12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS

Sutter sponsors or participates in various employee benefit plans, including a noncontributory defined benefit plan (the "retirement plan") and several contributory defined contribution plans. Sutter's total retirement benefit expense was \$96 and \$119 for the years ended December 31, 2004 and 2003, respectively.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

The retirement plan was fully funded after fourth quarter contributions of \$53 and \$129 as of December 31, 2004 and 2003, respectively. Sutter's measurement date for plan assets, pension obligations and net periodic pension cost associated with the retirement plan is September 30. The changes in benefit obligations and plan assets for Sutter's retirement plan were as follows:

| | December 31, | |
|---|---------------------|-------------|
| | 2004 | 2003 |
| Projected benefit obligation at beginning of year | \$ 687 | \$ 598 |
| Service cost | 64 | 48 |
| Interest cost | 44 | 43 |
| Amendments | 1 | 66 |
| Actuarial loss (gain) | 22 | (44) |
| Benefits paid | (28) | (24) |
| | 790 | 687 |
| Projected benefit obligation at measurement date | | |
| Fair value of plan assets at beginning of year | 558 | 409 |
| Actual return on plan assets | 85 | 64 |
| Employer contributions | 129 | 114 |
| Expenses paid | (7) | (5) |
| Benefits paid | (28) | (24) |
| | 737 | 558 |
| Fair value of plan assets at measurement date | | |
| Funded status of the plan at measurement date | (53) | (129) |
| Employer contributions in fourth quarter | 53 | 129 |
| | — | — |
| Funded status of the plan at end of year | | |
| Unrecognized net actuarial loss | 48 | 54 |
| Unamortized prior service cost | 64 | 67 |
| Net prepaid benefit cost at end of year | \$ 112 | \$ 121 |

The accumulated benefit obligation for Sutter's retirement plan was \$654 and \$539 at September 30, 2004 and 2003, respectively.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

The benefits expected to be paid from Sutter's retirement plan in each of the next five years, and in the aggregate for the next five years are as follows:

| | | |
|-----------|-----------|------------|
| 2005 | \$ | 40 |
| 2006 | | 40 |
| 2007 | | 44 |
| 2008 | | 49 |
| 2009 | | 55 |
| 2010-2014 | | 375 |
| | \$ | 603 |

The weighted average assumptions used by Sutter's retirement plan were as follows:

| | December 31, | |
|---|---------------------|-------------|
| | 2004 | 2003 |
| Discount rates | 6.0% | 6.0% |
| Rates of compensation increase | 5.0% | 5.0% |
| Expected long-term rates of return on plan assets | 8.5% | 8.5% |

The components of Sutter's net periodic benefit cost associated with the retirement plan were as follows:

| | Years Ended December 31, | |
|------------------------------------|---------------------------------|-------------|
| | 2004 | 2003 |
| Service cost | \$ 64 | \$ 48 |
| Interest cost | 44 | 43 |
| Expected return on plan assets | (54) | (38) |
| Amortization of prior service cost | 6 | 1 |
| Plan amendments | - | 4 |
| Recognized net actuarial loss | - | 5 |
| Benefit cost | \$ 60 | \$ 63 |

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

The retirement plan weighted average asset allocations at December 31, 2004 and 2003, by asset category were as follows:

| Asset Category | Target Allocation | Percentage of Plan Assets at December 31, | |
|------------------------|-------------------|---|------|
| | 2005 | 2004 | 2003 |
| Interest-Bearing Cash | 1% | 1% | 1% |
| U.S. Equities | 54% | 54% | 54% |
| International Equities | 21% | 21% | 22% |
| Fixed Income | 17% | 15% | 18% |
| Real Estate | 7% | 9% | 5% |
| Total | 100% | 100% | 100% |

Sutter's investment strategy for the retirement plan assets is to balance the liquidity needs of the retirement plan with the long-term return goals necessary to satisfy future obligations. The target asset allocation seeks to reduce volatility while capturing the equity premium from the capital markets over the long-term and maintaining security of principal to meet near term expenses and obligations through the fixed income allocation.

Sutter's retirement plan portfolio return assumption of 8.5% is based on the weighted average return of comparative market indices for the asset classes represented in the portfolio and discounted for retirement plan expenses.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

The changes in benefit obligations for Sutter's noncontributory postretirement health benefit plans were as follows:

| | December 31, | |
|---|---------------------|-------------|
| | 2004 | 2003 |
| Benefit obligation at beginning of year | \$ 79 | \$ 20 |
| Prior period benefit cost | (1) | 40 |
| Service cost | 5 | 3 |
| Interest cost | 5 | 4 |
| Plan amendments | 20 | 8 |
| Actuarial loss | 6 | 6 |
| Benefits paid | (3) | (2) |
| Benefit obligation at end of year | 111 | 79 |
| Funded status of the plans | (111) | (79) |
| Unrecognized net actuarial loss | 11 | 10 |
| Unamortized prior service cost | 43 | 26 |
| Net accrued benefit cost at end of year | \$ (57) | \$ (43) |

Sutter's unfunded noncontributory postretirement health benefit plans had projected benefit obligations of \$111 and \$79 as of December 31, 2004 and 2003, respectively.

The benefits expected to be paid from Sutter's noncontributory postretirement health benefit plans in each of the next five years, and in the aggregate for the next five years are as follows:

| | | |
|--|--------------|---------------------|
| 2005 | \$ 4 | |
| 2006 | 7 | |
| 2007 | 8 | |
| 2008 | 8 | |
| 2009 | 8 | |
| 2010-2014 | 58 | |
| | \$ 93 | |
| | | December 31, |
| | 2004 | 2003 |
| Weighted-average assumption as of December 31: | | |
| Discount rate | 6.00% | 6.75% |

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

| | Years Ended December 31, | |
|--|---------------------------------|--------------|
| | 2004 | 2003 |
| Components of net periodic benefit cost: | | |
| Service cost | \$ 5 | \$ 3 |
| Interest cost | 5 | 4 |
| Amortization of prior service cost | 4 | 17 |
| Benefit cost | \$ 14 | \$ 24 |

Sutter's projected medical cost trend rate related to its noncontributory postretirement health benefit plan in 2005 ranges from 10-11%. The assumed medical cost trend rate is expected to gradually decrease in subsequent years to 5-6% in 2010 and thereafter. A one-percentage-point change in assumed health care cost trend rates would not have a material effect on Sutter's combined financial statements.

On December 8, 2003, the Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") was signed into law. The Act introduces a prescription drug benefit under Medicare as well as a federal subsidy to certain sponsors of postretirement healthcare benefit plans that provide a prescription drug benefit to their enrollees. Sutter believes certain of its postretirement benefit plans qualify for the subsidy under the Act.

In accordance with FASB Staff Position 106-1, Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003, the projected postretirement benefit obligation and net accrued retirement benefit cost do not reflect any effect of the Act as Sutter has elected to defer the accounting. In 2004, the FASB issued FASB Staff Position 106-2 ("FSP 106-2"), which provides the authoritative guidance for the implementation of the provisions of the Act in fiscal year 2005. Once implemented, FSP 106-2 may require Sutter to modify previously reported financial information.

Two Sutter affiliates are members of a multiemployer defined benefit retirement plan that covers substantially all of their employees. For the multiemployer plan as a whole, the net assets available for benefits exceeded the actuarially computed value of vested benefits as of the most recent actuarial valuation (January 1, 2004). The funding policy for employers participating in this plan requires a contribution of a percentage of the employer's unfunded liability when the employer's attributable assets are less than ninety percent of their liabilities. Sutter did not have any net pension expense associated with this multiemployer plan in 2004. The associated expense was \$19 in 2003.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

12. RETIREMENT PLANS AND POSTRETIREMENT BENEFITS (Continued)

Sutter maintains various defined contribution plans for eligible employees. Sutter's contributions to such plans were \$22 and \$13 in 2004 and 2003, respectively.

13. INCOME TAXES

Deferred income tax assets, which as of December 31, 2004 and 2003 had been fully reserved, reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting and the amounts used for income tax purposes. As of December 31, 2004 and 2003, Sutter had deferred tax assets of \$32 and \$33, respectively, relating principally to net operating loss carryovers. As of December 31, 2004 and 2003, such deferred tax assets were offset by a valuation allowance of \$32 and \$33, respectively. The valuation allowance decreased by \$1 and \$2 during the years ended December 31, 2004 and 2003, respectively.

Federal net operating loss carryovers totaled \$81 at December 31, 2004 and will expire between 2005 and 2024. State of California net operating loss carryovers totaled \$15 at December 31, 2004 and will expire between 2005 and 2014.

14. FUNCTIONAL CLASSIFICATION OF EXPENSES

The following is a summary of management's functional classification of Sutter's expenses:

| | Years Ended December 31, | |
|----------------------------|--------------------------|-----------------|
| | 2004 | 2003 |
| Health services | \$ 5,415 | \$ 4,867 |
| General and administrative | 437 | 340 |
| | <u>\$ 5,852</u> | <u>\$ 5,207</u> |

15. CONTINGENCIES AND COMMITMENTS

Contingencies: Mills-Peninsula Health Services ("MPHS") leases Mills-Peninsula Medical Center in Burlingame, California from Peninsula Health Care District (the "Peninsula District") pursuant to a lease between MPHS and the Peninsula District (the "Peninsula Lease"). MPHS was a defendant in a lawsuit filed by the Peninsula District in 1997 seeking, among other things, a declaration that certain contracts relating to the consolidation of the hospital and medical facilities and operations of the Peninsula District and MPHS were void and canceled. The parties previously agreed to extend the

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

15. CONTINGENCIES AND COMMITMENTS (Continued)

time for the Peninsula District to bring the case to trial until June 20, 2003. As of December 31, 2003, the plaintiff had failed to bring the case to trial. In 2004, there was no change to the status of this case and, as a result, management continues to believe this case will be dismissed by the court.

As a result of regulatory examinations, two Sutter hospitals are in receipt of notices from Centers for Medicare and Medicaid Services ("CMS") alleging failure to comply with Medicare Conditions of Participation. These matters may be resolved by submitting documentation of actions to correct the alleged deficiencies. Another Sutter hospital received a notice from the Joint Commission on Accreditation of Healthcare Organizations (JCAHO) of its recommendation for preliminary denial of accreditation. This JCAHO matter may be resolved through a request for a review and/or hearing. In the opinion of management, after consultation with legal counsel, all ongoing matters are expected to be resolved without a material adverse effect on Sutter's combined financial position. However, there can be no assurance that this will be the case.

Sutter Health is named in four class action lawsuits that allege charge and collection practices with respect to uninsured patients are unlawful. These lawsuits are similar to other lawsuits filed by the same lawyers against other hospitals across the country. In the opinion of management, after consultation with legal counsel, all ongoing matters are expected to be resolved without a material adverse effect on Sutter's combined financial position. However, there can be no assurance that this will be the case.

Sutter is involved in other litigation, as both plaintiff and defendant, and other routine labor matters, tax examinations and regulatory examinations arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, these matters should be resolved without a material adverse effect on Sutter's combined financial position. However, there can be no assurance that this will be the case.

Sutter, in the ordinary course of business, enters into various incentive-based risk sharing agreements with managed care payors and other providers. These agreements require retroactive settlement based on data that may not be available or finalized until all claims are processed. Settlement amounts have been estimated for such risk-based incentives based on available information. However, it is reasonably possible that these estimates may change in the near term.

As of December 31, 2004, approximately 30% of Sutter's employees were represented by collective bargaining units. Employee strikes or other adverse labor actions may have a material adverse impact on Sutter's operations in the future.

Sutter Health and Affiliates

Notes to Combined Financial Statements (Continued)

(Dollars in Millions)

15. CONTINGENCIES AND COMMITMENTS (Continued)

As of December 31, 2004 and 2003, Sutter had covered deposits with the State of California of \$116 and \$91 to satisfy legal requirements for self-insured workers' compensation plans.

Commitments: Sutter's combined budgeted operations and master facility related projects, as approved or committed to by the Board of Directors as of December 31, 2004 for the period from January 1, 2005 to December 31, 2009 amounted to approximately \$2,332.

In July 2004, Sutter entered into an agreement with the Eden Township Hospital District (the "District") to lease the San Leandro Hospital for a term of 20 years. This transaction has been accounted for by Sutter as an operating lease. In conjunction with the terms of the lease, by the year 2011 Sutter must either construct a new hospital for a minimum price of \$262 (at which time the lease becomes cancelable by Sutter) or purchase the existing leased hospital for an amount equal to the District's net book value of the hospital at that time.

Seismic Standards (Unaudited): Sutter is assessing its earthquake retrofit requirements for healthcare facilities under a State of California law that requires compliance with certain seismic standards by 2008. Based on management estimates, Sutter will spend at least \$2,200 before inflation and not including costs due to disruption and loss of business to meet the minimum compliance standards for its facilities or to replace them. Planning measures are underway that may result in certain of the seismically noncompliant facilities being withdrawn from use.