

ERIE INDEMNITY CO  
Form 10-Q  
July 30, 2008

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q  
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended June 30, 2008  
Commission file number 0-24000  
ERIE INDEMNITY COMPANY**

(Exact name of registrant as specified in its charter)

PENNSYLVANIA

25-0466020

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

100 Erie Insurance Place, Erie, Pennsylvania

16530

(Address of principal executive offices)

(Zip Code)

(814) 870-2000

(Registrant's telephone number, including area code)

Not applicable

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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

Large  
accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes

No

The number of shares outstanding of the registrant's Class A Common Stock as of the latest practicable date, with no par value and a stated value of \$.0292 per share, was 51,376,513 at July 17, 2008.

The number of shares outstanding of the registrant's Class B Common Stock as of the latest practicable date, with no par value and a stated value of \$70 per share, was 2,551 at July 17, 2008.



INDEX  
ERIE INDEMNITY COMPANY

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

Consolidated Statements of Financial Position June 30, 2008 and December 31, 2007

Consolidated Statements of Operations Three months and six months ended June 30, 2008 and 2007

Consolidated Statements of Comprehensive Income Three months and six months ended June 30, 2008 and 2007

Consolidated Statements of Cash Flows Six months ended June 30, 2008 and 2007

Notes to Consolidated Financial Statements June 30, 2008

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

PART II. OTHER INFORMATION

Item 1A. Risk Factors

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Item 4. Submission of Matters to a Vote of Security Holders

Item 5. Other Information

Item 6. Exhibits

SIGNATURES

**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

**ERIE INDEMNITY COMPANY**  
**CONSOLIDATED STATEMENTS OF FINANCIAL POSITION**  
(dollars in thousands, except share data)

|  | June 30,<br>2008<br>(Unaudited) | December 31,<br>2007 |
|--|---------------------------------|----------------------|
| <b>Assets</b>  |                                 |                      |
| Investments  |                                 |                      |
| Available-for-sale securities, at fair value:  |                                 |                      |
| Fixed maturities (amortized cost of \$636,138 and \$702,488, respectively)                         | \$ 630,116                      | \$ 703,406           |
| Equity securities (cost of \$102,488 and \$204,005, respectively)                                  | 99,754                          | 218,270              |
| Trading securities, at fair value (cost of \$92,232)   | 91,133                          | 0                    |
| Limited partnerships (cost of \$254,987 and \$235,886, respectively)                               | 312,645                         | 292,503              |
| Real estate mortgage loans   | 1,260                           | 4,556                |
| <b>Total investments</b>   | <b>1,134,908</b>                | <b>1,218,735</b>     |
| Cash and cash equivalents  | 16,201                          | 31,070               |
| Accrued investment income  | 8,455                           | 9,713                |
| Premiums receivable from policyholders   | 257,658                         | 243,612              |
| Federal income taxes recoverable   | 2,839                           | 1,451                |
| Reinsurance recoverable from Erie Insurance Exchange on unpaid losses and loss adjustment expenses | 813,141                         | 833,554              |
| Ceded unearned premiums to Erie Insurance Exchange   | 110,931                         | 110,524              |
| Note receivable from Erie Family Life Insurance  | 25,000                          | 25,000               |
| Other receivables due from Erie Insurance Exchange and affiliates                                  | 221,462                         | 208,752              |
| Reinsurance recoverable from non-affiliates  | 2,364                           | 2,323                |
| Deferred policy acquisition costs  | 16,758                          | 16,129               |
| Equity in Erie Family Life Insurance   | 56,540                          | 59,046               |
| Securities lending collateral  | 22,910                          | 30,370               |
| Pension plan asset   | 45,143                          | 32,460               |
| Other assets   | 70,442                          | 55,884               |
| <b>Total assets</b>  | <b>\$2,804,752</b>              | <b>\$2,878,623</b>   |

See accompanying notes to Consolidated Financial Statements.

ERIE INDEMNITY COMPANY  
CONSOLIDATED STATEMENTS OF FINANCIAL POSITION (Continued)  
(dollars in thousands, except share data)

|   | June 30,<br>2008<br>(Unaudited) | December 31,<br>2007 |
|---|---------------------------------|----------------------|
| <b>Liabilities and shareholders equity</b>  |                                 |                      |
| <b>Liabilities</b>  |                                 |                      |
| Unpaid losses and loss adjustment expenses  | \$1,004,553                     | \$1,026,531          |
| Unearned premiums   | 437,094                         | 421,263              |
| Commissions payable and accrued   | 135,105                         | 122,473              |
| Agent bonuses   | 39,296                          | 94,458               |
| Securities lending collateral   | 22,910                          | 30,370               |
| Bank line of credit   | 75,000                          | 0                    |
| Accounts payable and accrued expenses   | 47,104                          | 41,057               |
| Deferred executive compensation   | 15,775                          | 23,499               |
| Deferred income taxes   | 8,145                           | 14,598               |
| Dividends payable   | 22,783                          | 23,637               |
| Employee benefit obligations  | 25,453                          | 29,458               |
| <b>Total liabilities</b>  | <b>1,833,218</b>                | <b>1,827,344</b>     |
| <b>Shareholders Equity</b>  |                                 |                      |
| Capital stock:  |                                 |                      |
| Class A common, stated value \$.0292 per share; authorized 74,996,930 shares; issued 68,277,600 shares; 51,396,513 and 53,338,937 shares outstanding, respectively    | 1,991                           | 1,991                |
| Class B common, convertible at a rate of 2,400 Class A shares for one Class B share, stated value \$70 per share; and 2,551 shares authorized, issued and outstanding | 179                             | 179                  |
| Additional paid-in capital  | 7,830                           | 7,830                |
| Accumulated other comprehensive (loss) income   | (8,543)                         | 10,048               |
| Retained earnings, before cumulative effect adjustment  | 1,765,576                       | 1,740,174            |
| Cumulative effect adjustment from adoption of Statement of Financial Accounting Standards No. 159, net of tax   | 11,191                          | 0                    |
| Retained earnings, after cumulative effect adjustment   | 1,776,767                       | 1,740,174            |
| Total contributed capital and retained earnings   | 1,778,224                       | 1,760,222            |
| Treasury stock, at cost, 16,881,087 and 14,938,663 shares, respectively   | (806,690)                       | (708,943)            |
| <b>Total shareholders equity</b>  | <b>971,534</b>                  | <b>1,051,279</b>     |
| <b>Total liabilities and shareholders equity</b>  | <b>\$2,804,752</b>              | <b>\$2,878,623</b>   |

See accompanying notes to Consolidated Financial Statements.

ERIE INDEMNITY COMPANY  
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)  
(dollars in thousands, except per share data)

|  | Three months ended<br>June 30, |                  | Six months ended<br>June 30, |                   |
|--|--------------------------------|------------------|------------------------------|-------------------|
|  | 2008                           | 2007             | 2008                         | 2007              |
| <b>OPERATING REVENUE</b>   |                                |                  |                              |                   |
| Management fee revenue, net  | \$ 241,646                     | \$ 242,324       | \$ 458,617                   | \$ 458,343        |
| Premiums earned  | 51,736                         | 52,122           | 103,662                      | 104,096           |
| Service agreement revenue  | 7,748                          | 7,299            | 15,139                       | 14,717            |
| <b>Total operating revenue</b>   | <b>301,130</b>                 | <b>301,745</b>   | <b>577,418</b>               | <b>577,156</b>    |
| <b>OPERATING EXPENSES</b>  |                                |                  |                              |                   |
| Cost of management operations  | 201,338                        | 195,969          | 382,456                      | 375,855           |
| Losses and loss adjustment expenses incurred   | 33,823                         | 29,789           | 67,583                       | 62,023            |
| Policy acquisition and other underwriting expenses                                       | 12,281                         | 11,695           | 24,281                       | 23,689            |
| <b>Total operating expenses</b>  | <b>247,442</b>                 | <b>237,453</b>   | <b>474,320</b>               | <b>461,567</b>    |
| <b>INVESTMENT INCOME</b>   |                                |                  |                              |                   |
| <b>UNAFFILIATED</b>  |                                |                  |                              |                   |
| Investment income, net of expenses   | 11,467                         | 14,138           | 23,139                       | 28,116            |
| Net realized (losses) gains on investments   | (14,267)                       | 2,222            | (38,846)                     | 4,112             |
| Equity in earnings of limited partnerships   | 11,275                         | 20,180           | 19,253                       | 32,698            |
| <b>Total investment income unaffiliated</b>  | <b>8,475</b>                   | <b>36,540</b>    | <b>3,546</b>                 | <b>64,926</b>     |
| Income before income taxes and equity in (losses) earnings of Erie Family Life Insurance | 62,163                         | 100,832          | 106,644                      | 180,515           |
| Provision for income taxes   | 20,288                         | 31,505           | 34,539                       | 56,098            |
| Equity in (losses) earnings of Erie Family Life Insurance, net of tax                    | (560)                          | 1,159            | (813)                        | 2,430             |
| <b>Net income</b>  | <b>\$ 41,315</b>               | <b>\$ 70,486</b> | <b>\$ 71,292</b>             | <b>\$ 126,847</b> |
| <b>Net income per share</b>  |                                |                  |                              |                   |
| Class A common stock basic   | \$ 0.80                        | \$ 1.22          | \$ 1.36                      | \$ 2.19           |
| <b>Class A common stock diluted</b>  | <b>0.71</b>                    | <b>1.11</b>      | <b>1.22</b>                  | <b>1.99</b>       |
| Class B common stock basic and diluted   | 116.10                         | 187.31           | 200.67                       | 336.32            |
| <b>Weighted average shares outstanding basic</b>   |                                |                  |                              |                   |

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

|  |            |            |            |            |
|--|------------|------------|------------|------------|
| Class A common stock                               | 51,754,896 | 57,337,436 | 52,291,387 | 57,513,372 |
| Class B common stock                               | 2,551      | 2,571      | 2,551      | 2,572      |
| <b>Weighted average shares outstanding diluted</b> |            |            |            |            |
| Class A common stock                               | 57,898,022 | 63,556,114 | 58,434,513 | 63,734,450 |
| Class B common stock                               | 2,551      | 2,571      | 2,551      | 2,572      |
| <b>Dividends declared per share:</b>               |            |            |            |            |
| Class A common stock                               | \$ 0.44    | \$ 0.40    | \$ 0.88    | \$ 0.80    |
| Class B common stock                               | 66.00      | 60.00      | 132.00     | 120.00     |

See accompanying notes to Consolidated Financial Statements.



ERIE INDEMNITY COMPANY  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)  
(dollars in thousands)

|  | Three months ended June<br>30, |                   | Six months ended June<br>30, |                   |
|--|--------------------------------|-------------------|------------------------------|-------------------|
|  | 2008                           | 2007              | 2008                         | 2007              |
| <b>Accumulated other comprehensive income</b>  |                                |                   |                              |                   |
| Balance, beginning of period   | \$ (2,453)                     | \$ 6,660          | \$ 10,048                    | \$ 5,422          |
| Adjustment to opening balance, net of tax*   | 0                              | 0                 | (11,191)                     | 0                 |
| Adjusted balance, beginning of period  | (2,453)                        | 6,660             | (1,143)                      | 5,422             |
| Gross unrealized losses arising during period  | (19,032)                       | (10,115)          | (31,935)                     | (6,321)           |
| Less: reclassification adjustment for gross realized losses (gains) included in net income | 9,663                          | (2,222)           | 20,550                       | (4,112)           |
| Change in comprehensive income, before tax   | (9,369)                        | (12,337)          | (11,385)                     | (10,433)          |
| Income tax benefit related to items of other comprehensive income                          | 3,279                          | 4,318             | 3,985                        | 3,652             |
| Change in other comprehensive income, net of tax   | (6,090)                        | (8,019)           | (7,400)                      | (6,781)           |
| Balance, end of period   | <b>\$ (8,543)</b>              | <b>\$ (1,359)</b> | <b>\$ (8,543)</b>            | <b>\$ (1,359)</b> |
| <b>Comprehensive income</b>  |                                |                   |                              |                   |
| Net income   | \$ 41,315                      | \$ 70,486         | \$ 71,292                    | \$ 126,847        |
| Net change in accumulated other comprehensive income                                       | (6,090)                        | (8,019)           | (7,400)                      | (6,781)           |
| <b>Total comprehensive income</b>  | <b>\$ 35,225</b>               | <b>\$ 62,467</b>  | <b>\$ 63,892</b>             | <b>\$ 120,066</b> |

\* Unrealized gains related to common stock were reclassified to retained earnings upon the adoption of the fair value option at January 1, 2008 in accordance with SFAS No. 159. See Note 6 for

further  
discussion.

See accompanying notes to Consolidated Financial Statements.

6

---

ERIE INDEMNITY COMPANY  
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)  
(dollars in thousands)

|  | Six months ended June 30, |                 |
|--|---------------------------|-----------------|
|  | 2008                      | 2007            |
| <b>Cash flows from operating activities</b>                |                           |                 |
| Management fee received                                    | \$ 447,607                | \$ 455,189      |
| Service agreement fee received                             | 15,140                    | 14,617          |
| Premiums collected   | 104,154                   | 104,262         |
| Settlement of commutation received from Exchange           | 0                         | 6,782           |
| Net investment income received                             | 27,626                    | 30,030          |
| Limited partnership distributions                          | 16,774                    | 45,796          |
| Salaries and wages paid                                    | (57,365)                  | (58,979)        |
| Pension contribution and employee benefits paid            | (32,546)                  | (29,043)        |
| Commissions paid to agents                                 | (208,580)                 | (210,616)       |
| Agent bonuses paid   | (94,855)                  | (91,742)        |
| General operating expenses paid                            | (61,118)                  | (44,187)        |
| Interest paid on bank line of credit                       | (503)                     |                 |
| Losses paid  | (58,922)                  | (57,614)        |
| Loss adjustment expenses paid                              | (10,346)                  | (11,079)        |
| Other underwriting and acquisition costs paid              | (30,654)                  | (28,753)        |
| Income taxes paid  | (41,920)                  | (30,373)        |
| <b>Net cash provided by operating activities</b>           | <b>14,492</b>             | <b>94,290</b>   |
| <br><b>Cash flows from investing activities</b>            |                           |                 |
| Purchase of investments:                                   |                           |                 |
| Fixed maturities   | (124,407)                 | (98,099)        |
| Preferred stock  | (29,565)                  | (16,593)        |
| Common stock   | (42,570)                  | (33,049)        |
| Limited partnerships                                       | (36,016)                  | (47,650)        |
| Sales/maturities of investments:                           |                           |                 |
| Fixed maturity sales                                       | 112,392                   | 39,084          |
| Fixed maturity calls/maturities                            | 69,575                    | 51,419          |
| Preferred stock  | 29,203                    | 15,995          |
| Common stock   | 46,490                    | 38,591          |
| Sale and return of limited partnerships                    | 19,932                    | 4,320           |
| Purchase of property and equipment                         | (5,463)                   | (2,429)         |
| Net distributions on agent loans                           | (2,784)                   | (662)           |
| <b>Net cash provided by (used in) investing activities</b> | <b>36,787</b>             | <b>(49,073)</b> |
| <br><b>Cash flows from financing activities</b>            |                           |                 |
| Proceeds from bank line of credit                          | 75,000                    | 0               |
| Purchase of treasury stock                                 | (94,403)                  | (31,749)        |
| Dividends paid to shareholders                             | (46,745)                  | (46,417)        |

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

|   |                  |                  |
|---|------------------|------------------|
| (Decrease) increase in collateral from securities lending | (7,460)          | 847              |
| Acquisition (redemption) of securities lending collateral | 7,460            | (847)            |
| <b>Net cash used in financing activities</b>              | <b>(66,148)</b>  | <b>(78,166)</b>  |
| Net decrease in cash and cash equivalents                 | (14,869)         | (32,949)         |
| Cash and cash equivalents at beginning of period          | 31,070           | 60,241           |
| <b>Cash and cash equivalents at end of period</b>         | <b>\$ 16,201</b> | <b>\$ 27,292</b> |

See accompanying notes to Consolidated Financial Statements.

ERIE INDEMNITY COMPANY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements, which include the accounts of Erie Indemnity Company and our wholly owned property/casualty insurance subsidiaries, Erie Insurance Company (EIC), Erie Insurance Company of New York (EINY) and Erie Insurance Property and Casualty Company (EIPC), have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles (GAAP) for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six-month period ended June 30, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008. For further information, refer to the consolidated financial statements and footnotes included in our Form 10-K for the year ended December 31, 2007 as filed with the Securities and Exchange Commission on February 27, 2008. Erie Insurance Exchange (Exchange), for whom we serve as attorney-in-fact, and its property/casualty subsidiary, Flagship City Insurance Company, our three insurance subsidiaries, EIC, EICNY and EIPC and Erie Family Life Insurance Company (EFL) operate collectively as the Erie Insurance Group (Group).

NOTE 2 RECENTLY ADOPTED ACCOUNTING PRONOUNCEMENTS

In 2007, The Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 159, The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159) which became effective for us on January 1, 2008. SFAS 159 gave us the irrevocable option to report selected financial assets and liabilities at fair value. SFAS 159 also established presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement bases for similar types of assets and liabilities. We adopted the fair value option for our common stock portfolio as of January 1, 2008 because it better reflects the way we manage our common stock portfolio under a total return approach. These assets were formerly accounted for as available-for-sale under SFAS 115, Accounting for Certain Investments in Debt and Equity Securities, with changes in fair value recorded in other comprehensive income. Beginning January 1, 2008 all changes in fair value of our common stock are recognized in earnings as they occur. The adoption of SFAS 159 required the unrealized gains and losses on these securities at January 1, 2008 to be included in a cumulative effect adjustment to beginning retained earnings. The net impact of the cumulative effect adjustment for our common stock portfolio on January 1, 2008 increased retained earnings and reduced other comprehensive income by \$11.2 million, net of tax. See also Note 6 herein.

In 2006, SFAS 157, Fair Value Measurements, was issued and provides guidance for using fair value to measure assets and liabilities as well as enhances disclosures about fair value measurements which became effective for us on January 1, 2008. The standard applies whenever other standards require, or permit, assets or liabilities to be measured at fair value. The standard did not expand the use of fair value in any new circumstances and thus, did not have an impact on our financial position, results of operations or cash flows. The statement established a fair value hierarchy that prioritizes the observable and unobservable inputs to valuation techniques used to measure fair value into three levels. Quantitative and qualitative disclosures will focus on the inputs used to measure fair value for these measurements and the effects of these measurements in the financial statements. We implemented this standard during the first quarter of 2008 and have provided the required disclosures concerning inputs used to measure fair value in Note 6 herein.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 3 SIGNIFICANT ACCOUNTING POLICIES

Available-for-sale securities

Fixed maturity and preferred stock securities are classified as available-for-sale and are reported at fair value. Unrealized holding gains and losses, net of related tax effects, on fixed maturities and preferred stock are charged or credited directly to shareholders' equity as accumulated other comprehensive (loss) income.

Realized gains and losses on sales of fixed maturity and preferred stock securities are recognized in income based upon the specific identification method. Interest and dividend income are recognized as earned.

Fixed income and preferred stock securities are evaluated quarterly for other-than-temporary impairment loss. Some factors considered in evaluating whether a decline in fair value is other-than-temporary include:

the extent and duration to which fair value is less than cost;

historical operating performance and financial condition of the issuer;

short and long-term prospects of the issuer and its industry based on analysts' recommendations;

specific events that occurred affecting the issuer, including a ratings downgrade; and

our ability and intent to hold the investment for a period of time sufficient to allow for a recovery in value.

An investment that is deemed other than temporarily impaired is written down to its estimated fair value. Impairment charges are included in net realized (losses) gains in the Consolidated Statements of Operations.

Trading securities

Common stock securities were classified from available-for-sale at December 31, 2007 to trading in the first quarter of 2008 with our adoption of SFAS 159. Common stock securities are reported at fair value. As of January 1, 2008, unrealized gains and losses on these securities are included in net realized (losses) gains in the Consolidated Statements of Operations. Realized gains and losses on sales of common stock are recognized in income based upon the specific identification method. Dividend income is recognized as earned.

NOTE 4 RECLASSIFICATIONS

Certain amounts previously reported in the 2007 financial statements have been reclassified to conform to the current period's presentation. Such reclassifications only affected the statements of cash flows.

NOTE 5 EARNINGS PER SHARE

Earnings per share are calculated under the two-class method, which allocates earnings to each class of stock based on its dividend rights. Class B shares are convertible into Class A shares at a conversion ratio of 2,400 to 1. Class A diluted earnings per share are calculated under the if-converted method which reflects the conversion of Class B shares and the effect of potentially dilutive outstanding employee stock-based awards under the long-term incentive plan and awards not yet vested related to the outside directors' stock compensation plan.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 5 EARNINGS PER SHARE (Continued)

A reconciliation of the numerators and denominators used in the basic and diluted per-share computations is presented below for each class of common stock:

|   | Three Months Ended June 30,               |                                     |                     |   |                                     |                     |
|---|---|-------------------------------------|---------------------|---|-------------------------------------|---------------------|
|   | 2008                                      |                                     |                     | 2007                                      |                                     |                     |
|   | Allocated<br>Net<br>Income<br>(Numerator) | Weighted<br>Shares<br>(Denominator) | Per-Share<br>Amount | Allocated<br>Net<br>Income<br>(Numerator) | Weighted<br>Shares<br>(Denominator) | Per-Share<br>Amount |
| <i>(dollars in thousands except per share data)</i>                   |   |                                     |                     |   |                                     |                     |
| <b>Class A Basic EPS:</b>   |   |                                     |                     |   |                                     |                     |
| Income available to Class A stockholders                              | \$ 41,019                                 | 51,754,896                          | \$ 0.80             | \$ 70,004                                 | 57,337,436                          | \$ 1.22             |
| Dilutive effect of stock awards                                       |   | 20,726                              |                     |   | 48,278                              |                     |
| Assumed conversion of Class B shares                                  | 296                                       | 6,122,400                           |                     | 482                                       | 6,170,400                           |                     |
| <b>Class A Diluted EPS:</b>   |   |                                     |                     |   |                                     |                     |
| Income available to Class A stockholders on Class A equivalent shares | \$ 41,315                                 | 57,898,022                          | \$ 0.71             | \$ 70,486                                 | 63,556,114                          | \$ 1.11             |
| <b>Class B Basic and Diluted EPS:</b>                                 |   |                                     |                     |   |                                     |                     |
| Income available to Class B stockholders                              | \$ 296                                    | 2,551                               | \$ 116.10           | \$ 482                                    | 2,571                               | \$ 187.31           |
| <b>Six Months Ended June 30,</b>                                      |   |                                     |                     |   |                                     |                     |
| 2008  |   |                                     | 2007                |   |                                     |                     |
|   | Allocated<br>Net<br>Income<br>(Numerator) | Weighted<br>Shares<br>(Denominator) | Per-Share<br>Amount | Allocated<br>Net<br>Income<br>(Numerator) | Weighted<br>Shares<br>(Denominator) | Per-Share<br>Amount |
| <i>(dollars in thousands except per share data)</i>                   |   |                                     |                     |   |                                     |                     |
| <b>Class A Basic EPS:</b>   |   |                                     |                     |   |                                     |                     |
| Income available to Class A stockholders                              | \$ 70,780                                 | 52,291,387                          | \$ 1.36             | \$ 125,982                                | 57,513,372                          | \$ 2.19             |
| Dilutive effect of stock awards                                       |   | 20,726                              |                     |   | 48,278                              |                     |
| Assumed conversion of Class B shares                                  | 512                                       | 6,122,400                           |                     | 865                                       | 6,172,800                           |                     |
| <b>Class A Diluted EPS:</b>   |   |                                     |                     |   |                                     |                     |
| Income available to Class A stockholders on Class A equivalent shares | \$ 71,292                                 | 58,434,513                          | \$ 1.22             | \$ 126,847                                | 63,734,450                          | \$ 1.99             |

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Class B Basic and Diluted EPS:

|  |    |     |       |           |    |     |       |           |
|--|----|-----|-------|-----------|----|-----|-------|-----------|
| Income available to Class B stockholders | \$ | 512 | 2,551 | \$ 200.67 | \$ | 865 | 2,572 | \$ 336.32 |
|--|----|-----|-------|-----------|----|-----|-------|-----------|

Included in the restricted stock awards not yet vested are awards of 12,535 and 37,716 for the second quarter of 2008 and 2007, respectively, related to our pre-2004 long-term incentive plan for executive and senior management. Awards not yet vested related to the outside directors stock compensation plan were 8,191 and 10,562 for the second quarters of 2008 and 2007, respectively.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 6 FAIR VALUE

Fair Value Measurement (SFAS 157)

SFAS 157 provides guidance for using fair value to measure assets and liabilities and enhances disclosures about fair value measurement (see Note 2). The standard describes three levels of inputs that may be used to measure fair value, which are provided below.

Valuation techniques used to derive fair value of our available-for-sale and trading securities are based on observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources. Unobservable inputs reflect our own assumptions regarding exit market pricing for these securities. These techniques provide the inputs for the following fair value hierarchy:

- Level 1 Quoted prices for identical instruments in active markets. Such prices are obtained from third party nationally recognized pricing services. Level 1 securities primarily include publicly traded common stock, nonredeemable preferred stocks and treasury securities.
- Level 2 Observable inputs other than quoted prices in Level 1. These would include prices obtained from third party pricing services who model prices based on observable inputs. Included in this category are primarily municipal securities, asset backed securities, collateralized-mortgage obligations, foreign and domestic corporate bonds and redeemable preferred stocks. Nonredeemable preferred stocks for which a quote in an active market is unavailable and a value is obtained from a third party pricing service are also included in this level.
- Level 3 One or more of the inputs used to determine the value of the security are unobservable. Fair values for these securities are determined using comparable securities or valuations received from outside brokers or dealers. Examples of Level 3 fixed maturities may include certain private preferred stock and bond securities, collateralized debt and loan obligations, and credit linked notes.

The following table represents the fair value measurements on a recurring basis for our invested assets by major category and level of input as required by SFAS 157:

|                                |           | June 30, 2008  |  |  |
|--------------------------------|-----------|--|--|--|
|                                |           | Fair value measurements using:   |  |  |
|                                |           | Quoted<br>prices<br>in active<br>markets for<br>identical<br>assets<br>Level 1 | Significant<br>observable<br>inputs<br>Level 2 | Significant<br>unobservable<br>inputs<br>Level 3 |
| <i>(dollars in thousands)</i>  | Total     |  |  |  |
| Available-for-sale securities: |           |  |  |  |
| Fixed maturities               | \$630,116 | \$ 5,611   | \$ 615,366                                     | \$ 9,139   |
| Preferred stock                | 99,754    | 65,576   | 21,205   | 12,973   |
| Trading securities:            |           |  |  |  |
| Common stock                   | 91,133    | 90,972   | 140  | 21   |
| Total                          | \$821,003 | \$162,159  | \$ 636,711                                     | \$22,133   |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 6 FAIR VALUE (Continued)

The following tables provide a reconciliation of assets measured at fair value on a recurring basis for securities using Level 3 inputs:

|                                | Beginning<br>balance at<br>March 31,<br>2008 | Net Realized/Unrealized<br>Gains and Losses<br>Included in |                                  | Purchases<br>and sales,<br>net | Transfers<br>in<br>and (out)<br>of<br>Level 3 (2) | Ending<br>balance at<br>June 30,<br>2008 |
|--------------------------------|--|--|----------------------------------|--------------------------------|---|--|
|                                |  | Included<br>in<br>earnings(1)                              | other<br>comprehensive<br>income |                                |   |  |
| <i>(dollars in thousands)</i>  |  |  |                                  |                                |   |  |
| Available-for-sale securities: |  |  |                                  |                                |   |  |
| Fixed maturities               | \$10,546                                     | \$(600)  | \$ 536                           | \$1,675                        | \$(3,018)   | \$ 9,139                                 |
| Preferred stock                | 6,867  | (148)  | (258)                            | 0                              | 6,512   | 12,973                                   |
| Trading securities:            |  |  |                                  |                                |   |  |
| Common stock                   | 21   | 0  | 0                                | 0                              | 0   | 21                                       |
| Total Level 3 assets           | \$17,434                                     | \$(748)  | \$ 278                           | \$1,675                        | \$ 3,494  | \$22,133                                 |

|                                | Beginning<br>balance at<br>December<br>31,<br>2007 | Net Realized/Unrealized<br>Gains and Losses<br>Included in |                                  | Purchases<br>and sales,<br>net | Transfers<br>in<br>and (out)<br>of<br>Level 3 (2) | Ending<br>balance at<br>June 30,<br>2008 |
|--------------------------------|--|--|----------------------------------|--------------------------------|---|--|
|                                |  | Included in<br>earnings(1)                                 | other<br>comprehensive<br>income |                                |   |  |
| <i>(dollars in thousands)</i>  |  |  |                                  |                                |   |  |
| Available-for-sale securities: |  |  |                                  |                                |   |  |
| Fixed maturities               | \$ 10,941  | \$(600)  | \$ 370                           | \$ 1,446                       | \$(3,018)   | \$ 9,139                                 |
| Preferred stock                | 5,858  | (600)  | (797)                            | 2,000                          | 6,512   | 12,973                                   |
| Trading securities:            |  |  |                                  |                                |   |  |
| Common stock                   | 21   | 0  | 0                                | 0                              | 0   | 21                                       |
| Total Level 3 assets           | \$ 16,820  | \$(1,200)  | \$ (427)                         | \$ 3,446                       | \$ 3,494  | \$ 22,133                                |

(1) These losses are a result of other-than-temporary impairments and are reported in the Consolidated

Statements of Operations. There were no unrealized gains or losses included in earnings at June 30, 2008 on Level 3 securities.

- (2) Transfers in and out of Level 3 would be attributable to changes in the ability to observe significant inputs in determining fair value exit pricing.

We have no assets that were measured at fair value on a nonrecurring basis during the six months ended June 30, 2008.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 6 FAIR VALUE (Continued)

Fair Value Option (SFAS 159)

Effective January 1, 2008, the Company adopted SFAS 159 for our common stock portfolio (See Note 2). The following table represents the December 31, 2007 carrying value of these assets, the transition adjustment booked to retained earnings and the carrying value as of January 1, 2008.

| <i>(dollars in thousands)</i>                  | December<br>31, 2007<br>(carrying<br>value<br>prior to<br>adoption) | Cumulative effect<br>adjustment to<br>January 1,<br>2008 retained<br>earnings | January 1, 2008<br>fair value<br>(carrying<br>value after<br>adoption) |
|--|---|---|--|
| Common stock                                   | \$ 108,090  | \$ 17,216   | \$ 108,090   |
| Deferred tax adjustment                        |   | (6,025)   |  |
| Carrying value, net of deferred tax adjustment |   | \$ 11,191   |  |

The decrease in fair value for the second quarter and six months of 2008 of \$4.6 million and \$18.3 million, respectively, were reported in realized (losses) gains on investments in the Consolidated Statement of Operations.

## NOTE 7 INVESTMENTS

Fixed maturities and equity securities

Fixed maturities consist of bonds, notes and redeemable preferred stock. Equity securities include nonredeemable preferred stock at June 30, 2008 and common and preferred stock at December 31, 2007. The following tables summarize the cost and fair value of our available-for-sale securities:

| <i>(dollars in thousands)</i>           | June 30, 2008     |                              |                               | Estimated<br>fair value |
|---|-------------------|------------------------------|-------------------------------|-------------------------|
|   | Amortized<br>cost | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses |                         |
| <b>Available-for-sale securities</b>    |                   |                              |                               |                         |
| <b>Fixed maturities</b>                 |                   |                              |                               |                         |
| U.S. treasuries and government agencies | \$ 3,460          | \$ 304                       | \$ 0                          | \$ 3,764                |
| Foreign government                      | 1,997             | 0                            | 12                            | 1,985                   |
| Municipal securities                    | 211,323           | 458                          | 2,400                         | 209,381                 |
| U.S. corporate debt                     | 301,258           | 3,182                        | 6,904                         | 297,536                 |
| Foreign corporate debt                  | 75,115            | 895                          | 1,797                         | 74,213                  |
| Mortgage-backed securities              | 14,110            | 557                          | 160                           | 14,507                  |
| Asset-backed securities                 | 15,841            | 424                          | 228                           | 16,037                  |
| Total bonds                             | 623,104           | 5,820                        | 11,501                        | 617,423                 |
| Redeemable preferred stock              | 13,034            | 286                          | 627                           | 12,693                  |
| Total fixed maturities                  | \$636,138         | \$6,106                      | \$12,128                      | \$630,116               |

|  |                   |                 |                  |                   |
|--|-------------------|-----------------|------------------|-------------------|
| <b>Equity securities</b>                   |                   |                 |                  |                   |
| U.S. nonredeemable preferred stock         | \$ 97,358         | \$ 1,920        | \$ 4,372         | \$ 94,906         |
| Foreign nonredeemable preferred stock      | 5,130             | 81              | 363              | 4,848             |
| Total equity securities                    | \$ 102,488        | \$ 2,001        | \$ 4,735         | \$ 99,754         |
| <b>Total available-for-sale securities</b> | <b>\$ 738,626</b> | <b>\$ 8,107</b> | <b>\$ 16,863</b> | <b>\$ 729,870</b> |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 7 INVESTMENTS (Continued)

| <i>(dollars in thousands)</i>           | Amortized<br>cost | December 31, 2007            |                               | Estimated<br>fair value |
|---|-------------------|------------------------------|-------------------------------|-------------------------|
|   |                   | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses |                         |
| <b>Fixed maturities</b>                 |                   |                              |                               |                         |
| U.S. treasuries and government agencies | \$ 4,406          | \$ 272                       | \$ 0                          | \$ 4,678                |
| Municipal securities                    | 247,412           | 2,314                        | 358                           | 249,368                 |
| U.S. corporate debt                     | 324,218           | 5,231                        | 5,921                         | 323,528                 |
| Foreign corporate debt                  | 83,335            | 2,175                        | 1,106                         | 84,404                  |
| Mortgage-backed securities              | 11,565            | 602                          | 38                            | 12,129                  |
| Asset-backed securities                 | 16,329            | 0                            | 2,189                         | 14,140                  |
| Total bonds                             | 687,265           | 10,594                       | 9,612                         | 688,247                 |
| Redeemable preferred stock              | 15,223            | 614                          | 678                           | 15,159                  |
| Total fixed maturities                  | \$702,488         | \$11,208                     | \$10,290                      | \$703,406               |
| <b>Equity securities</b>                |                   |                              |                               |                         |
| U.S. common stock                       | \$ 66,449         | \$12,754                     | \$ 0                          | \$ 79,203               |
| Foreign common stock                    | 24,408            | 4,549                        | 70                            | 28,887                  |
| U.S. nonredeemable preferred stock      | 108,018           | 1,978                        | 4,960                         | 105,036                 |
| Foreign nonredeemable preferred stock   | 5,130             | 250                          | 236                           | 5,144                   |
| Total equity securities                 | \$204,005         | \$19,531                     | \$ 5,266                      | \$218,270               |

Trading securities

Trading securities consist of our common stock portfolio. With the adoption of SFAS 159 as of January 1, 2008, any unrealized gains or losses on these securities are recorded as realized gains and losses in our Consolidated Statements of Operations. See also Note 6 for further discussion.

The following table summarizes the cost and fair value of our common stock.

| <i>(dollars in thousands)</i> | Amortized<br>cost | June 30, 2008                |                               | Estimated<br>fair value |
|-------------------------------|-------------------|------------------------------|-------------------------------|-------------------------|
|                               |                   | Gross<br>unrealized<br>gains | Gross<br>unrealized<br>losses |                         |
| <b>Trading securities</b>     |                   |                              |                               |                         |
| U.S. common stock             | \$65,926          | \$ 8,140                     | \$ 8,639                      | \$65,427                |
| Foreign common stock          | 26,306            | 2,412                        | 3,012                         | 25,706                  |
| Total trading securities      | \$92,232          | \$10,552                     | \$11,651                      | \$91,133                |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 7 INVESTMENTS (Continued)

The components of net realized losses and gains on investments as reported in the Consolidated Statements of Operations are included below. Continued declines in the financial services industry, specifically the banking industry, and declining bond and preferred stock prices, have resulted in further impairment charges during the second quarter of 2008.

| <i>(dollars in thousands)</i>              | Three months ended June |             | Six months ended June |             |
|--|-------------------------|-------------|-----------------------|-------------|
|  | 2008                    | 30,<br>2007 | 2008                  | 30,<br>2007 |
| <b>Available-for-sale securities:</b>      |                         |             |                       |             |
| <u>Fixed maturities</u>                    |                         |             |                       |             |
| Gross realized gains                       | \$ 879                  | \$ 99       | \$ 2,173              | \$ 415      |
| Gross realized losses                      | (203)                   | (113)       | (340)                 | (222)       |
| Impairment charges                         | (8,019)                 | (1,389)     | (13,970)              | (1,635)     |
| Net realized losses                        | (7,343)                 | (1,403)     | (12,137)              | (1,442)     |
| <u>Equity securities</u>                   |                         |             |                       |             |
| Gross realized gains                       | 2,295                   | 5,296       | 2,683                 | 8,630       |
| Gross realized losses                      | (2,295)                 | (1,047)     | (4,603)               | (2,044)     |
| Impairment charges                         | (4,430)                 | (624)       | (10,433)              | (1,032)     |
| Net realized (losses) gains                | (4,430)                 | 3,625       | (12,353)              | 5,554       |
| <b>Trading securities:</b>                 |                         |             |                       |             |
| <u>Common stock</u>                        |                         |             |                       |             |
| Gross realized gains                       | 4,766                   | 0           | 6,745                 | 0           |
| Gross realized losses                      | (2,656)                 | 0           | (4,433)               | 0           |
| Valuation adjustments                      | (4,604)                 | 0           | (18,296)              | 0           |
| Net realized losses                        | (2,494)                 | 0           | (15,984)              | 0           |
| <b>Limited partnerships:</b>               |                         |             |                       |             |
| Gross realized gains                       | 0                       | 0           | 3,541                 | 0           |
| Gross realized losses                      | 0                       | 0           | (1,913)               | 0           |
| Net realized gains                         | 0                       | 0           | 1,628                 | 0           |
| Net realized (losses) gains on investments | \$ (14,267)             | \$ 2,222    | \$ (38,846)           | \$ 4,112    |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 7 INVESTMENTS (Continued)

Limited partnerships

For the six months ended June 30, 2008 our equity in earnings from these partnerships as reported in the Consolidated Statements of Operations totaled 18.1% of our pre-tax income. While we do not exert significant influence over any of these partnerships, because we account for them under the equity method of accounting, we are providing summarized financial information in the following tables as of June 30, 2008 and December 31, 2007. Amounts provided in the recorded by partnerships section of the table are presented using the latest available financial statements received from the partnerships.

Recorded by Erie Indemnity Company  
as of and for the six months ended June 30, 2008

| Investment percentage of partnership<br>for Erie Insurance Group | Number<br>of<br>partnerships | Asset<br>recorded<br><i>(dollars in thousands)</i> | Income<br>(loss)<br>recognized<br>due to<br>valuation<br>adjustments<br>by the<br>partnerships | Net<br>income<br>recorded |
|--|------------------------------|--|--|---------------------------|
| <b>Private equity:</b>   |                              |  |  |                           |
| Less than 10%  | 27                           | \$ 85,897  | \$ (87)  | \$ 6,003                  |
| Greater than or equal to 10% but less than 50%                   | 5                            | 6,941  | (716)  | 1,253                     |
| Greater than or equal to 50%                                     | 1                            | 4,328  | 0  | 0                         |
| Total private equity   | 33                           | 97,166   | (803)  | 7,256                     |
| <b>Mezzanine debt:</b>   |                              |  |  |                           |
| Less than 10%  | 13                           | 39,980   | 3,619  | 1,348                     |
| Greater than or equal to 10% but less than 50%                   | 3                            | 13,701   | 836  | 179                       |
| Greater than or equal to 50%                                     | 1                            | 4,074  | (176)  | 268                       |
| Total mezzanine debt   | 17                           | 57,755   | 4,279  | 1,795                     |
| <b>Real estate:</b>  |                              |  |  |                           |
| Less than 10%  | 19                           | 102,813  | (2,994)  | 5,504                     |
| Greater than or equal to 10% but less than 50%                   | 6                            | 31,870   | 59   | 1,094                     |
| Greater than or equal to 50%                                     | 5                            | 23,041   | 848  | 2,215                     |
| Total real estate  | 30                           | 157,724  | (2,087)  | 8,813                     |
| Total limited partnerships                                       | 80                           | \$312,645  | \$ 1,389   | \$17,864                  |



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 7 INVESTMENTS (Continued)

Recorded by Partnerships  
as of and for the six months ended June 30, 2008

| Investment percentage of partnership<br>for Erie Insurance Group | Total<br>assets | Total<br>liabilities | Income<br>(loss)<br>recognized<br>due to<br>valuation<br>adjustments<br>by the<br>partnerships | Net income  |
|--|-----------------|----------------------|--|-------------|
|  |                 |                      | <i>(dollars in thousands)</i>  |             |
| <b>Private equity:</b>   |                 |                      |  |             |
| Less than 10%  | \$22,570,229    | \$ 542,342           | \$ 352,825   | \$2,031,071 |
| Greater than or equal to 10% but less than 50%                   | 517,915         | 2,213                | 28,279   | 12,652      |
| Greater than or equal to 50%                                     | 10,666          | 166                  | 0  | 0           |
| Total private equity   | 23,098,810      | 544,721              | 381,104  | 2,043,723   |
| <b>Mezzanine debt:</b>   |                 |                      |  |             |
| Less than 10%  | 5,375,954       | 420,576              | (76,893)   | 119,904     |
| Greater than or equal to 10% but less than 50%                   | 534,349         | 181,168              | (416)  | 8,738       |
| Greater than or equal to 50%                                     | 28,274          | 9,605                | (201)  | 494         |
| Total mezzanine debt   | 5,938,577       | 611,349              | (77,510)   | 129,136     |
| <b>Real estate:</b>  |                 |                      |  |             |
| Less than 10%  | 18,910,670      | 8,197,918            | (123,197)  | 452,424     |
| Greater than or equal to 10% but less than 50%                   | 1,441,729       | 732,097              | (8,344)  | 21,233      |
| Greater than or equal to 50%                                     | 255,307         | 138,141              | 10,527   | 12,179      |
| Total real estate  | 20,607,706      | 9,068,156            | (121,014)  | 485,836     |
| Total limited partnerships                                       | \$49,645,093    | \$ 10,224,226        | \$ 182,580   | \$2,658,695 |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 7 INVESTMENTS (Continued)

Recorded by Erie Indemnity Company  
as of and for the year ended December 31, 2007

| Investment percentage of partnership<br>for Erie Insurance Group | Number<br>of<br>partnerships | Asset<br>recorded<br><i>(dollars in thousands)</i> | Income<br>(loss)<br>recognized<br>due to<br>valuation<br>adjustments<br>by the<br>partnerships | Net<br>income<br>(loss)<br>recorded |
|--|------------------------------|--|--|-------------------------------------|
| <b>Private equity:</b>   |                              |  |  |                                     |
| Less than 10%  | 35                           | \$ 92,077  | \$ 7,468   | \$12,541                            |
| Greater than or equal to 10% but less than 50%                   | 7                            | 10,708   | 1,449  | 1,566                               |
| Greater than or equal to 50%                                     | 1                            | 3,831  | 0  | (76)                                |
| Total private equity   | 43                           | 106,616  | 8,917  | 14,031                              |
| <b>Mezzanine debt:</b>   |                              |  |  |                                     |
| Less than 10%  | 13                           | 30,841   | 109  | 3,446                               |
| Greater than or equal to 10% but less than 50%                   | 3                            | 10,493   | (1,396)  | 3,243                               |
| Greater than or equal to 50%                                     | 1                            | 3,533  | 207  | 926                                 |
| Total mezzanine debt   | 17                           | 44,867   | (1,080)  | 7,615                               |
| <b>Real estate:</b>  |                              |  |  |                                     |
| Less than 10%  | 19                           | 88,426   | 8,841  | 14,246                              |
| Greater than or equal to 10% but less than 50%                   | 9                            | 29,707   | 3,357  | 1,293                               |
| Greater than or equal to 50%                                     | 7                            | 22,887   | 2,387  | 83                                  |
| Total real estate  | 35                           | 141,020  | 14,585   | 15,622                              |
| Total limited partnerships                                       | 95                           | \$292,503  | \$22,422   | \$37,268                            |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 7 INVESTMENTS (Continued)

| Investment percentage of partnership<br>for Erie Insurance Group | Total<br>assets | Total<br>liabilities | Recorded by Partnerships<br>as of and for the year ended December 31, 2007                  |                      |
|--|-----------------|----------------------|---|----------------------|
|  |                 |                      | Income (loss)<br>recognized<br>due to<br>valuation<br>adjustments<br>by the<br>partnerships | Net income<br>(loss) |
|  |                 |                      | <i>(dollars in thousands)</i>   |                      |
| <b>Private equity:</b>   |                 |                      |   |                      |
| Less than 10%  | \$24,802,587    | \$ 558,874           | \$ 303,611  | \$2,836,059          |
| Greater than or equal to 10% but less than<br>50%                | 416,487         | 2,232                | 65,969  | 3,836                |
| Greater than or equal to 50%                                     | 10,349          | 25                   | 0   | (229)                |
| Total private equity   | 25,229,423      | 561,131              | 369,580   | 2,839,666            |
| <b>Mezzanine debt:</b>   |                 |                      |   |                      |
| Less than 10%  | 4,284,587       | 366,896              | (95,681)  | 470,929              |
| Greater than or equal to 10% but less than<br>50%                | 434,269         | 159,209              | (34,872)  | 84,384               |
| Greater than or equal to 50%                                     | 204,909         | 233                  | 3,855   | 32,947               |
| Total mezzanine debt   | 4,923,765       | 526,338              | (126,698)   | 588,260              |
| <b>Real estate:</b>  |                 |                      |   |                      |
| Less than 10%  | 23,626,981      | 14,153,607           | 766,150   | 629,172              |
| Greater than or equal to 10% but less than<br>50%                | 1,106,697       | 401,752              | 15,824  | 49,592               |
| Greater than or equal to 50%                                     | 260,058         | 140,389              | 9,234   | 2,108                |
| Total real estate  | 24,993,736      | 14,695,748           | 791,208   | 680,872              |
| Total limited partnerships                                       | \$55,146,924    | \$15,783,217         | \$1,034,090   | \$4,108,798          |

During the first six months of 2008, we sold 10 private equity limited partnerships in the secondary market and completed our commitment to five real estate limited partnerships. Proceeds from these sales totaled \$18.0 million from which we recognized \$1.6 million in net realized gains. The proceeds received from the sales will help to fund the remaining commitments of existing limited partnerships.

See also Note 14 for investment commitments related to limited partnerships.

Securities lending program

To generate additional investment revenue we participate in a program whereby marketable securities from our investment portfolio are lent to independent brokers or dealers based on, among other things, their creditworthiness, in exchange for collateral initially equal to 102% of the value of the securities on loan and is thereafter maintained at a minimum of 100% of the fair value of the securities loaned. The fair value of the securities on loan to each borrower is monitored daily by the third-party custodian and the borrower is required to deliver additional collateral if the fair value of the collateral falls below 100% of the fair value of the securities on loan.

We had loaned securities included as part of our invested assets with a fair value of \$21.8 million and \$29.4 million at June 30, 2008 and December 31, 2007, respectively. We have incurred no losses on the securities lending program since the program's inception.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 8 LINE OF CREDIT

Our \$75 million line of credit with a bank was increased to \$100 million at June 30, 2008. The line of credit expires on December 31, 2008. Borrowings on the line of credit were \$75 million at June 30, 2008. Interest is charged on the line at the Federal Funds Rate (currently at 2.0%) plus 50 basis points. Interest expense related to this line of credit totaled \$0.5 million for the quarter ended June 30, 2008. Bonds with a value of \$129.8 million are held as collateral on the line at June 30, 2008. These securities have no restrictions and are reported as available-for-sale fixed maturities in the Consolidated Statements of Financial Position. The bank requires compliance with certain covenants which include minimum net worth and leverage ratios. We are in compliance with all of these bank covenants at June 30, 2008.

## NOTE 9 SUMMARIZED FINANCIAL STATEMENT INFORMATION OF EFL

EFL is an affiliated Pennsylvania-domiciled life insurance company operating in 10 states and the District of Columbia. We own 21.6% of EFL's outstanding common shares and account for this investment using the equity method of accounting. The remaining 78.4% of EFL is owned by Erie Insurance Exchange.

The following represents unaudited condensed financial statement information for EFL on a GAAP basis:

| <i>( in thousands)</i>            | Three months ended June 30, |          | Six months ended June 30, |          |
|-----------------------------------|-----------------------------|----------|---------------------------|----------|
|                                   | 2008                        | 2007     | 2008                      | 2007     |
| Revenues                          | \$ 20,281                   | \$40,761 | \$ 46,939                 | \$81,336 |
| Benefits and expenses             | 24,442                      | 32,109   | 53,818                    | 64,214   |
| (Loss) income before income taxes | (4,161)                     | 8,652    | (6,879)                   | 17,122   |
| Net (loss) income                 | (2,786)*                    | 5,764    | (4,431)*                  | 12,079   |
| Comprehensive (loss) income       | (11,266)                    | (5,774)  | (11,974)                  | 2,905    |

\* In the first and second quarters of 2008, EFL recognized impairment charges of \$14.9 million and \$20.5 million, respectively, primarily related to its fixed maturities and preferred stock investments in the financial services industry sector. There were no impairment charges recognized by EFL in the first half of 2007.

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

| <i>(in thousands)</i>                | June 30,<br>2008 | As of<br>December 31,<br>2007 |
|--------------------------------------|------------------|-------------------------------|
| Investments                          | \$1,485,668      | \$1,511,319                   |
| Total assets                         | 1,743,983        | 1,744,704                     |
| Liabilities                          | 1,482,570        | 1,471,317                     |
| Accumulated other comprehensive loss | (9,008)          | (1,465)                       |
| Total shareholders' equity           | 261,413          | 273,387                       |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 10 POSTRETIREMENT AND OTHER BENEFITS

The liabilities for the plans described in this note are presented in total for all employees of the Group. The gross liability for the pension plans is presented in the Consolidated Statements of Financial Position as employee benefit obligations. A portion of annual expenses related to the pension plans is allocated to related entities within the Group. We offer a noncontributory defined benefit pension plan that covers substantially all employees. This is the largest benefit plan we offer. We also offer an unfunded supplemental retirement plan for certain members of the Erie Insurance Group retirement plan for employees (SERP) for executive and senior management. The components of net periodic benefit cost for our pension benefits are:

|   | Three months ended |          | Six months ended |          |
|---|--------------------|----------|------------------|----------|
|   | June 30,           |          | June 30,         |          |
| <i>(dollars in thousands)</i>               | 2008               | 2007     | 2008             | 2007     |
| Service cost                                | \$ 3,169           | \$ 3,486 | \$ 6,272         | \$ 7,061 |
| Interest cost                               | 4,386              | 4,207    | 8,895            | 8,382    |
| Expected return on plan assets              | (6,042)            | (5,414)  | (12,085)         | (10,514) |
| Amortization of prior service (credit) cost | (42)               | 147      | 66               | 247      |
| Amortization of actuarial loss              | 153                | 354      | 155              | 704      |
| Settlement                                  | 74                 |          | 74               |          |
| Net periodic benefit cost                   | \$ 1,698           | \$ 2,780 | \$ 3,377         | \$ 5,880 |

Defined benefit pension plan

We contributed \$15.0 million and \$14.8 million to the employee pension plan during the second quarters ended June 30, 2008 and 2007, respectively. The 2008 and 2007 contributions were made in accordance with the Pension Protection Act of 2006 and exceeded the minimum required contributions for those years.

The decrease in the net periodic benefit cost of the pension plans is primarily due to change in discount rate of the defined benefit pension plan to 6.62% for 2008 compared to 6.25% in 2007. Additionally, contributions made in the second quarter of 2007 have increased the asset market value and as a result, the expected returns on such assets have increased in 2008.

SERP

The discount rate of the SERP was 6.62% for 2008 compared to 6.25% for 2007. The discount rate assumption was re-evaluated on April 1, 2008 when our former president and chief executive officer received a final lump sum distribution from the SERP, resulting in the re-measurement of the current year net periodic benefit cost using the April 1 service date. The discount rate assumption increased from 6.62% to 6.75% at the re-measurement date to reflect current market rates. As a result of this settlement, a one-time gain of \$0.1 million was realized in 2008. As the result of the resignation of an executive officer in June 2008, a settlement charge of \$0.2 million was recorded for the SERP in the second quarter of 2008. The SERP payout for the executive officer is expected in the first quarter of 2009.

Other benefits

In the second quarter, a severance charge of \$1.7 million, including the SERP settlement charge above, was recorded for an executive officer who resigned in June 2008, of which our share was \$1.0 million. For the six months ended June 30, 2008, we recorded \$2.1 million in severance charges, which included the two executive officers who resigned in the first half of 2008.

## NOTE 11 NOTE RECEIVABLE FROM ERIE FAMILY LIFE INSURANCE COMPANY

We are due \$25 million from EFL in the form of a surplus note. The note may be repaid only out of unassigned surplus of EFL and repayment is subject to prior approval by the Pennsylvania Insurance Commissioner. The note bears an annual interest rate of 6.70% and is payable on demand on or after December 31, 2018. EFL paid its semi-annual interest to us of \$0.8 million in each of the second quarters ended June 30, 2008 and 2007.





## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 12 STATUTORY INFORMATION

Cash and securities with carrying values of \$6.4 million and \$6.3 million were deposited by our property/casualty insurance subsidiaries with regulatory authorities under statutory requirements at June 30, 2008 and December 31, 2007, respectively.

## NOTE 13 SUPPLEMENTARY DATA ON CASH FLOWS

A reconciliation of net income to net cash provided by operating activities as presented in the Consolidated Statements of Cash Flows is as follows:

| <i>(dollars in thousands)</i>   | Six months ended June 30, |                   |
|---|---------------------------|-------------------|
|   | 2008                      | 2007              |
| <b>Cash flows from operating activities</b>   |                           |                   |
| <b>Net income</b>   | <b>\$ 71,292</b>          | <b>\$ 126,847</b> |
| Adjustments to reconcile net income to net cash provided by operating activities:               |                           |                   |
| Depreciation and amortization   | 18,236                    | 17,342            |
| Deferred income tax (expense) benefit   | (6,054)                   | 11,867            |
| Realized loss (gain) on investments   | 38,846                    | (4,112)           |
| Equity in earnings of limited partnerships  | (19,253)                  | (32,698)          |
| Net amortization of bond premium  | 799                       | 1,085             |
| Undistributed losses (earnings) of Erie Family Life Insurance                                   | 874                       | (2,613)           |
| Decrease in deferred compensation   | (7,725)                   | (11,760)          |
| Limited partnership distributions   | 16,774                    | 45,796            |
| (Increase) decrease in receivables and reinsurance recoverable from the Exchange and affiliates | (6,921)                   | 37,186            |
| Increase in prepaid expenses and other assets   | (37,857)                  | (28,888)          |
| Increase in accounts payable and accrued expenses   | 6,789                     | 5,155             |
| Decrease in accrued agent bonuses   | (55,162)                  | (46,423)          |
| Decrease in loss reserves   | (21,978)                  | (37,209)          |
| Increase in unearned premiums   | 15,832                    | 12,715            |
| <b>Net cash provided by operating activities</b>  | <b>\$ 14,492</b>          | <b>\$ 94,290</b>  |

## NOTE 14 COMMITMENTS AND CONTINGENCIES

We have contractual commitments to invest up to \$111.6 million of additional funds in limited partnership investments at June 30, 2008. These commitments will be funded as required by the partnerships' agreements through 2012. At June 30, 2008, the total commitment to fund limited partnerships that invest in private equity securities is \$50.2 million, real estate activities is \$38.4 million and mezzanine debt securities is \$23.0 million. We expect to have sufficient cash flows from operations and from cash inflows (distributions) from existing limited partnership investments to meet these future partnership commitments.

We are involved in litigation arising in the ordinary course of business. In our opinion, the effects, if any, of such litigation are not expected to be material to our consolidated financial condition, cash flows or operations.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 15 VARIABLE INTEREST ENTITY

Erie Insurance Exchange (Exchange) is a reciprocal insurance company, domiciled in Pennsylvania, for which we serve as attorney-in-fact. We hold a variable interest in the Exchange, however, we are not the primary beneficiary as defined under Financial Accounting Standards Interpretation 46, Consolidation of Variable Interest Entities. We have a significant interest in the financial condition of the Exchange because net management fee revenues are based on the direct written premiums of the Exchange and the other members of the Property and Casualty Group.

The selected financial data below is derived from the Exchange's financial statements prepared in accordance with Statutory Accounting Principles (SAP) required by the National Association of Insurance Commissioners (NAIC) *Accounting Practices and Procedures Manual*, as modified to include prescribed practices of the Insurance Department of the Commonwealth of Pennsylvania. In the opinion of management, all adjustments, consisting only of normal recurring accruals, considered necessary for a fair presentation, have been included. The condensed financial data set forth below represents the Exchange's share of underwriting results after accounting for intercompany pooling transactions.

**Erie Insurance Exchange****Condensed statutory statements of operations**

| <i>(in thousands)</i>   | Three months ended June<br>30, |                   | Six months ended June 30, |                   |
|---|--------------------------------|-------------------|---------------------------|-------------------|
|   | 2008                           | 2007              | 2008                      | 2007              |
| Premiums earned   | \$ 905,050                     | \$ 913,316        | \$ 1,792,542              | \$ 1,802,867      |
| Losses, loss adjustment expenses and other underwriting expenses* | 844,022                        | 766,464           | 1,665,440                 | 1,560,891         |
| <b>Net underwriting income</b>                                    | <b>61,028</b>                  | <b>146,852</b>    | <b>127,102</b>            | <b>241,976</b>    |
| Total investment (loss) income**                                  | (54,492)                       | 212,935           | (24,263)                  | 349,581           |
| Net income before federal income tax                              | 6,536                          | 359,787           | 102,839                   | 591,557           |
| Federal income tax expense  | 52,564                         | 110,527           | 113,364                   | 182,519           |
| <b>Net (loss) income</b>  | <b>\$ (46,028)</b>             | <b>\$ 249,260</b> | <b>\$ (10,525)</b>        | <b>\$ 409,038</b> |

\* Includes management fees paid or accrued as payable to the Company.

\*\* In the first and second quarters of 2008, the Exchange recognized impairment charges before tax of

\$104.9 million and \$155.9 million, respectively, on fixed maturities and equity securities primarily in the financial services industry sector. Impairment charges on fixed maturities and equity securities in the first and second quarters of 2007 were \$6.0 million and \$4.4 million, respectively.

**Erie Insurance Exchange**

**Condensed statutory statements of financial position**

| <i>(dollars in thousands)</i>                       | June 30,<br>2008    | As of<br>December 31,<br>2007 |
|---|---------------------|-------------------------------|
| Fixed maturities                                    | \$ 4,297,968        | \$ 4,353,977                  |
| Equity securities                                   | 2,813,003           | 3,016,607                     |
| Alternative investments                             | 1,458,327           | 1,389,224                     |
| Other invested assets                               | 174,500             | 168,189                       |
| <b>Total invested assets</b>                        | <b>8,743,798</b>    | <b>8,927,997</b>              |
| Other assets  | 1,247,042           | 1,033,852                     |
| <b>Total assets</b>                                 | <b>\$ 9,990,840</b> | <b>\$ 9,961,849</b>           |
| Loss and loss adjustment expense reserves           | \$ 3,389,410        | \$ 3,418,221                  |
| Unearned premium reserves                           | 1,484,504           | 1,430,328                     |
| Accrued liabilities                                 | 360,699             | 345,776                       |
| <b>Total liabilities</b>                            | <b>5,234,613</b>    | <b>5,194,325</b>              |
| Total policyholders' surplus                        | 4,756,227           | 4,767,524                     |
| <b>Total liabilities and policyholders' surplus</b> | <b>\$ 9,990,840</b> | <b>\$ 9,961,849</b>           |

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 15 VARIABLE INTEREST ENTITY (Continued)

**Erie Insurance Exchange****Condensed statutory statements of cash flows**

| <i>(dollars in thousands)</i>                              | Six months ended  |                  |
|--|-------------------|------------------|
|  | June 30,          |                  |
|  | 2008              | 2007             |
| <b>Cash flows from operating activities</b>                |                   |                  |
| Premiums collected net of reinsurance                      | \$ 1,785,067      | \$ 1,794,949     |
| Losses and loss adjustment expenses paid                   | (1,016,543)       | (989,481)        |
| Management fee and expenses paid                           | (691,606)         | (681,384)        |
| Net investment income received                             | 239,570           | 267,294          |
| Federal income taxes and other expenses paid               | (126,652)         | (180,808)        |
| <b>Net cash provided by operating activities</b>           | <b>189,836</b>    | <b>210,570</b>   |
| <b>Net cash used in investing activities</b>               | <b>(184,779)</b>  | <b>(190,192)</b> |
| <b>Net cash provided by (used in) financing activities</b> | <b>14,231</b>     | <b>(6,345)</b>   |
| Net increase in cash and cash equivalents                  | 19,288            | 14,033           |
| Cash and cash equivalents-beginning of period              | 98,712            | 85,784           |
| <b>Cash and cash equivalents-end of period</b>             | <b>\$ 118,000</b> | <b>\$ 99,817</b> |

## NOTE 16 SEGMENT INFORMATION

We operate our business as three reportable segments management operations, insurance underwriting operations and investment operations. Accounting policies for segments are the same as those described in the summary of significant accounting policies Note 3 of our Annual Report on Form 10-K for the year ended December 31, 2007 as filed with the Securities and Exchange Commission on February 27, 2008. The management fee revenues received from the property/casualty insurance subsidiaries are not eliminated in the segment detail that follows as management bases its decisions on the segment presentation. Summarized financial information for our operating segments is presented as follows:

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 16 SEGMENT INFORMATION (Continued)

| <i>(in thousands)</i>                             | Three months ended June |             | Six months ended June |             |
|---|-------------------------|-------------|-----------------------|-------------|
|   | 2008                    | 30,<br>2007 | 2008                  | 30,<br>2007 |
| <b>Management Operations</b>                      |                         |             |                       |             |
| <i>Operating revenue</i>                          |                         |             |                       |             |
| Management fee revenue                            | \$ 255,809              | \$ 256,462  | \$ 485,408            | \$ 485,106  |
| Service agreement revenue                         | 7,748                   | 7,299       | 15,139                | 14,717      |
| Total operating revenue                           | 263,557                 | 263,761     | 500,547               | 499,823     |
| Cost of management operations                     | 213,114                 | 207,392     | 404,774               | 397,777     |
| Income before income taxes                        | \$ 50,443               | \$ 56,369   | \$ 95,773             | \$ 102,046  |
| Net income from management operations             | \$ 33,980               | \$ 38,756   | \$ 64,755             | \$ 70,334   |
| <b>Insurance Underwriting Operations</b>          |                         |             |                       |             |
| <i>Operating revenue</i>                          |                         |             |                       |             |
| Premiums earned:                                  |                         |             |                       |             |
| Personal lines                                    | \$ 36,628               | \$ 36,200   | \$ 73,048             | \$ 72,000   |
| Commercial lines                                  | 15,369                  | 15,769      | 30,802                | 31,989      |
| Reinsurance nonaffiliates                         | (261)                   | 153         | (188)                 | 107         |
| Total premiums earned                             | 51,736                  | 52,122      | 103,662               | 104,096     |
| <i>Operating expenses</i>                         |                         |             |                       |             |
| Losses and expenses:                              |                         |             |                       |             |
| Personal lines                                    | 33,641                  | 31,809      | 65,832                | 62,639      |
| Commercial lines                                  | 14,444                  | 12,801      | 29,415                | 27,668      |
| Reinsurance nonaffiliates                         | 406                     | (411)       | 1,090                 | 246         |
| Total losses and expenses                         | 48,491                  | 44,199      | 96,337                | 90,553      |
| Income before income taxes                        | \$ 3,245                | \$ 7,923    | \$ 7,325              | \$ 13,543   |
| Net income from insurance underwriting operations | \$ 2,186                | \$ 5,448    | \$ 4,953              | \$ 9,334    |
| <b>Investment Operations</b>                      |                         |             |                       |             |
| Investment income, net of expenses                | \$ 11,467               | \$ 14,138   | \$ 23,139             | \$ 28,116   |
| Net realized (losses) gains on investments        | (14,267)                | 2,222       | (38,846)              | 4,112       |
| Equity in earnings of limited partnerships        | 11,275                  | 20,180      | 19,253                | 32,698      |
| Total investment income-unaffiliated              | \$ 8,475                | \$ 36,540   | \$ 3,546              | \$ 64,926   |
| Net income from investment operations             | \$ 5,709                | \$ 25,123   | \$ 2,397              | \$ 44,749   |

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

|  |          |          |          |          |
|--|----------|----------|----------|----------|
| Equity in (losses) earnings of EFL, net of tax | \$ (560) | \$ 1,159 | \$ (813) | \$ 2,430 |
|--|----------|----------|----------|----------|

25

---

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 16 SEGMENT INFORMATION (Continued)

Reconciliation of reportable segment revenues and operating expenses to the Consolidated Statements of Operations is as follows:

| <i>(in thousands)</i>                              | Three months ended June |            | Six months ended June |            |
|--|-------------------------|------------|-----------------------|------------|
|  | 2008                    | 2007       | 2008                  | 2007       |
| Segment revenues, excluding investment operations  | \$ 315,293              | \$ 315,883 | \$ 604,209            | \$ 603,919 |
| Elimination of intersegment management fee revenue | (14,163)                | (14,138)   | (26,791)              | (26,763)   |
| Total operating revenue                            | \$ 301,130              | \$ 301,745 | \$ 577,418            | \$ 577,156 |
| Segment operating expenses                         | \$ 261,605              | \$ 251,591 | \$ 501,111            | \$ 488,330 |
| Elimination of intersegment management fee revenue | (14,163)                | (14,138)   | (26,791)              | (26,763)   |
| Total operating expenses                           | \$ 247,442              | \$ 237,453 | \$ 474,320            | \$ 461,567 |

The intersegment revenues and expenses that are eliminated in the Consolidated Statements of Operations relate to our property/casualty insurance subsidiaries' 5.5% share of the intersegment management fees paid to us.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 16 SEGMENT INFORMATION (Continued)

The growth rate of policies in force, policy retention (the percentage of policyholders eligible for renewals who have renewed their policies measured on a twelve-month rolling basis) and average premium per policy trends directly impact our management operations and insurance underwriting operating segments. Below is a summary of each major line of business for the Property and Casualty Group.

**Growth rates of policies in force for Property and Casualty Group insurance operations:**

| Date       | Private Passenger Auto | 12-mth. growth rate | Homeowners | 12-mth. growth rate | All Other Personal Lines | 12-mth. growth rate | Total Personal Lines | 12-mth. growth rate |
|------------|------------------------|---------------------|------------|---------------------|--------------------------|---------------------|----------------------|---------------------|
| 12/31/2006 | 1,633,882              | (0.4)%              | 1,377,965  | 1.8%                | 301,497                  | 5.2%                | 3,313,344            | 1.0%                |
| 03/31/2007 | 1,635,714              | 0.0                 | 1,384,856  | 2.1                 | 305,591                  | 5.4                 | 3,326,161            | 1.3                 |
| 06/30/2007 | 1,644,561              | 0.4                 | 1,398,034  | 2.3                 | 311,761                  | 5.9                 | 3,354,356            | 1.7                 |
| 09/30/2007 | 1,649,801              | 0.8                 | 1,408,114  | 2.5                 | 316,786                  | 6.2                 | 3,374,701            | 2.0                 |
| 12/31/2007 | 1,651,234              | 1.1                 | 1,413,712  | 2.6                 | 321,431                  | 6.6                 | 3,386,377            | 2.2                 |
| 03/31/2008 | 1,655,869              | 1.2                 | 1,420,250  | 2.6                 | 325,926                  | 6.7                 | 3,402,045            | 2.3                 |
| 06/30/2008 | 1,667,446              | 1.4                 | 1,433,504  | 2.5                 | 332,922                  | 6.8                 | 3,433,872            | 2.4                 |

| Date       | CML* Auto | 12-mth. growth rate | CML* Multi-Peril | 12-mth. growth rate | Workers Comp. | 12-mth. growth rate | All Other CML* Lines | 12-mth. growth rate | Total CML* Lines | 12-mth. growth rate |
|------------|-----------|---------------------|------------------|---------------------|---------------|---------------------|----------------------|---------------------|------------------|---------------------|
| 12/31/2006 | 119,801   | 0.9%                | 218,542          | 2.4%                | 53,923        | (4.1)%              | 92,687               | 2.7%                | 484,953          | 1.3%                |
| 03/31/2007 | 119,907   | 1.1                 | 219,300          | 2.3                 | 53,498        | (3.2)               | 92,857               | 2.8                 | 485,562          | 1.5                 |
| 06/30/2007 | 121,587   | 1.8                 | 223,670          | 3.0                 | 53,955        | (1.7)               | 94,612               | 3.3                 | 493,824          | 2.2                 |
| 09/30/2007 | 122,154   | 2.2                 | 226,302          | 3.9                 | 54,341        | (0.1)               | 96,167               | 3.8                 | 498,964          | 3.0                 |
| 12/31/2007 | 122,558   | 2.3                 | 228,214          | 4.4                 | 54,720        | 1.5                 | 96,464               | 4.1                 | 501,956          | 3.5                 |
| 03/31/2008 | 122,882   | 2.5                 | 229,577          | 4.7                 | 54,927        | 2.7                 | 96,511               | 3.9                 | 503,897          | 3.8                 |
| 06/30/2008 | 123,955   | 1.9                 | 234,393          | 4.8                 | 55,801        | 3.4                 | 97,745               | 3.3                 | 511,894          | 3.7                 |

| Date       | Total All Lines | 12-mth. growth rate |
|------------|-----------------|---------------------|
| 12/31/2006 | 3,798,297       | 1.0%                |
| 03/31/2007 | 3,811,723       | 1.3                 |
| 06/30/2007 | 3,848,180       | 1.8                 |
| 09/30/2007 | 3,873,665       | 2.1                 |
| 12/31/2007 | 3,888,333       | 2.4                 |
| 03/31/2008 | 3,905,942       | 2.5                 |
| 06/30/2008 | 3,945,766       | 2.5                 |

\* CML = Commercial



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 16 SEGMENT INFORMATION (Continued)

**Policy retention trends for Property and Casualty Group insurance operations:**

| Date       | Private           | CML*  | Homeowners | CML*        | Workers | All Other | Total     |
|------------|-------------------|-------|------------|-------------|---------|-----------|-----------|
|            | Passenger<br>Auto | Auto  |            | Multi-Peril | Comp.   | Lines     | All Lines |
| 12/31/2006 | 90.8%             | 87.7% | 89.4%      | 86.0%       | 85.7%   | 87.1%     | 89.5%     |
| 03/31/2007 | 91.0              | 88.0  | 89.7       | 86.1        | 86.2    | 87.2      | 89.7      |
| 06/30/2007 | 91.1              | 88.1  | 89.9       | 86.0        | 86.3    | 87.6      | 89.9      |
| 09/30/2007 | 91.3              | 88.2  | 90.1       | 86.1        | 86.8    | 87.5      | 90.0      |
| 12/31/2007 | 91.5              | 88.2  | 90.3       | 86.0        | 86.8    | 87.8      | 90.2      |
| 03/31/2008 | 91.6              | 88.4  | 90.5       | 86.5        | 87.6    | 87.9      | 90.4      |
| 06/30/2008 | 91.6              | 87.9  | 90.7       | 86.2        | 87.5    | 88.1      | 90.4      |

\* CML =  
Commercial

**Average premium per policy trends for Property and Casualty Group insurance operations:**

| Date       | Private           | 12-mth.           | Homeowners | 12-mth.           | All                        | 12-mth.           | Total             | 12-mth.           |
|------------|-------------------|-------------------|------------|-------------------|----------------------------|-------------------|-------------------|-------------------|
|            | Passenger<br>Auto | percent<br>change |            | percent<br>change | Other<br>Personal<br>Lines | percent<br>change | Personal<br>Lines | percent<br>change |
| 12/31/2006 | \$1,110           | (5.5)%            | \$526      | (3.1)%            | \$349                      | 0.3%              | \$797             | (5.2)%            |
| 03/31/2007 | 1,100             | (5.3)             | 524        | (2.8)             | 349                        | 0.0               | 791               | (4.9)             |
| 06/30/2007 | 1,094             | (4.0)             | 520        | (2.8)             | 351                        | 0.9               | 786               | (3.9)             |
| 09/30/2007 | 1,093             | (2.6)             | 519        | (2.1)             | 352                        | 1.1               | 783               | (2.9)             |
| 12/31/2007 | 1,092             | (1.6)             | 518        | (1.5)             | 353                        | 1.1               | 782               | (1.9)             |
| 03/31/2008 | 1,091             | (0.8)             | 518        | (1.1)             | 354                        | 1.4               | 781               | (1.3)             |
| 06/30/2008 | 1,088             | (0.5)             | 514        | (1.2)             | 353                        | 0.6               | 777               | (1.1)             |

| Date       | CML*    | 12-mth.           | Workers<br>Comp. | 12-mth.           | All                    | 12-mth.           | Total         | 12-mth.           | Total        | 12-mth.           |
|------------|---------|-------------------|------------------|-------------------|------------------------|-------------------|---------------|-------------------|--------------|-------------------|
|            |         | percent<br>change |                  | percent<br>change | Other<br>CML*<br>Lines | percent<br>change | CML*<br>Lines | percent<br>change | All<br>Lines | percent<br>change |
| 12/31/2006 | \$2,687 | (3.4)%            | \$5,985          | (3.7)%            | \$1,657                | (2.8)%            | \$2,393       | (4.3)%            | \$1,001      | (4.8)%            |
| 03/31/2007 | 2,664   | (4.1)             | 5,914            | (5.7)             | 1,641                  | (4.0)             | 2,365         | (5.4)             | 991          | (5.1)             |
| 06/30/2007 | 2,627   | (3.8)             | 5,901            | (3.9)             | 1,616                  | (3.6)             | 2,333         | (4.5)             | 984          | (4.1)             |
| 09/30/2007 | 2,600   | (3.9)             | 5,780            | (4.4)             | 1,592                  | (4.6)             | 2,295         | (5.0)             | 978          | (3.3)             |
| 12/31/2007 | 2,577   | (4.1)             | 5,602            | (6.4)             | 1,581                  | (4.6)             | 2,262         | (5.5)             | 973          | (2.8)             |
| 03/31/2008 | 2,568   | (3.6)             | 5,453            | (7.8)             | 1,576                  | (4.0)             | 2,240         | (5.3)             | 969          | (2.2)             |
| 06/30/2008 | 2,530   | (3.7)             | 5,236            | (11.3)            | 1,546                  | (4.3)             | 2,187         | (6.3)             | 960          | (2.4)             |

\* CML =  
Commercial

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

The following information should be read in conjunction with the historical financial information and the notes thereto included in Item 1 of this Quarterly Report on Form 10-Q and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Annual Report on Form 10-K for the year ended December 31, 2007 as filed with the Securities and Exchange Commission on February 27, 2008. The following discussion of financial results focuses heavily on our three primary segments: management operations, insurance underwriting operations and investment operations consistent with the presentation in Item 1, Note 16 in the Notes to Consolidated Financial Statements. That presentation, which management uses internally to monitor and evaluate results, is an alternative presentation of our Consolidated Statements of Operations.

Certain statements contained herein are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements are not in the present or past tense and can generally be identified by the use of words such as anticipate, believe, estimate, expect, intend, likely, plan, project, seek, should, target, will, and other expressions that indicate future events. Forward-looking statements include, without limitation, statements and assumptions on which such statements are based that are related to our plans, strategies, objectives, expectations, intentions and adequacy of resources. Examples of such statements are discussions relating to management fee revenue, cost of management operations, underwriting, premium and investment income volumes, and agency appointments. Such statements are not guarantees of future performance and involve risks and uncertainties that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Among the risks and uncertainties that could cause actual results and future events to differ materially from those set forth or contemplated in the forward-looking statements are the following: factors affecting the property/casualty and life insurance industries generally, including price competition, legislative and regulatory developments, government regulation of the insurance industry including approval of rate increases, the size, frequency and severity of claims, natural disasters, exposure to environmental claims, fluctuations in interest rates, inflation and general business conditions; the geographic concentration of our business as a result of being a regional company; the accuracy of our pricing and loss reserving methodologies; changes in driving habits; our ability to maintain our business operations including our information technology system; our dependence on the independent agency system; the quality and liquidity of our investment portfolio; our dependence on our relationship with Erie Insurance Exchange; and the other risks and uncertainties discussed or indicated in all documents filed by the Company with the Securities and Exchange Commission, including those described in Part I, Item 1A. Risk Factors of the 2007 Form 10-K, which information is incorporated by reference, updated by Part II, Item 1A. Risk Factors of this Form 10-Q. A forward-looking statement speaks only as of the date on which it is made and reflects the Company's analysis only as of that date. The Company undertakes no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events, changes in assumptions, or otherwise.

**NATURE OF ORGANIZATION**

The following organizational chart depicts the organization of the various entities of the Erie Insurance Group:

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS** (Continued)

We serve as the attorney-in-fact for the policyholders of Erie Insurance Exchange (Exchange), a reciprocal insurance exchange, and operate predominantly as a provider of certain management services to the Exchange. We also own subsidiaries that are property and casualty insurers. The Exchange and its property/casualty insurance subsidiary, Flagship City Insurance Company, and our three property/casualty insurance subsidiaries, Erie Insurance Company (EIC), Erie Insurance Company of New York (EINY) and Erie Insurance Property and Casualty Company (EIPC), (collectively, the Property and Casualty Group) underwrite personal and commercial lines property and casualty insurance exclusively through over 2,000 independent agencies comprising over 8,600 licensed independent agents. The entities within the Property and Casualty Group pool their underwriting results. The financial position and results of operations of the Exchange are not consolidated with ours. We, together with the Property and Casualty Group and Erie Family Life Insurance Company (EFL), operate collectively as the Erie Insurance Group.

**RECENT ACCOUNTING PRONOUNCEMENTS**

See Note 2 to the Consolidated Financial Statements for a discussion of recently adopted accounting pronouncements.

**OVERVIEW**

The financial information presented herein reflects our management operations from serving as attorney-in-fact for the Exchange, our insurance underwriting results from our wholly-owned subsidiaries (EIC, EINY and EIPC) and our investment operations. The bases of calculations used for segment data are described in more detail in Item 1, Note 16 in the Notes to Consolidated Financial Statements.

***Segment Results***

|  | Three months ended June 30, |           |             | Six months ended June 30, |            |             |
|--|-----------------------------|-----------|-------------|---------------------------|------------|-------------|
|  | 2008                        | 2007      | %<br>Change | 2008                      | 2007       | %<br>Change |
| <i>(dollars in thousands, except per share data)</i> | <i>(Unaudited)</i>          |           |             | <i>(Unaudited)</i>        |            |             |
| Income from management operations                    | \$ 50,443                   | \$ 56,369 | (10.5)%     | \$ 95,773                 | \$ 102,046 | (6.1)%      |
| Underwriting income                                  | 3,245                       | 7,923     | (59.0)      | 7,325                     | 13,543     | (45.9)      |
| Net revenue from investment operations               | 7,873                       | 37,787    | (79.2)      | 2,672                     | 67,539     | (96.0)      |
| Income before income taxes                           | 61,561                      | 102,079   | (39.7)      | 105,770                   | 183,128    | (42.2)      |
| Provision for income taxes                           | 20,246                      | 31,593    | (35.9)      | 34,478                    | 56,281     | (38.7)      |
| Net income   | \$ 41,315                   | \$ 70,486 | (41.4)%     | \$ 71,292                 | \$ 126,847 | (43.8)%     |
| Net income per share diluted                         | \$ 0.71                     | \$ 1.11   | (35.7)%     | \$ 1.22                   | \$ 1.99    | (38.7)%     |

**KEY POINTS**

Decrease in net income per share-diluted in the second quarter of 2008 was impacted by net realized losses on investments due to \$12.4 million of impairment charges and \$4.6 million of changes in fair value on our common stock in accordance with SFAS 159 coupled with a decrease of \$8.9 million in equity in earnings of limited partnerships.

Gross margins from management operations decreased to 19.1% in the second quarter of 2008 from 21.4% in the second quarter of 2007.

GAAP combined ratios of the insurance underwriting operations was 93.7% in the second quarter of 2008 compared to 84.8% in the second quarter of 2007.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS** (Continued)

The property/casualty insurance industry is well capitalized, however, it continues to be faced with the negative indications of a generally softening underwriting cycle and an unsteady economy. Forecasters for the industry are projecting overall premium rate reductions and continued increases in the combined ratio in 2008. The cyclical nature of the insurance industry has a direct impact on our income from management operations as our management fee revenues are based on the direct written premiums of the Property and Casualty Group and the management fee rate we charge. Our management fee revenue was flat, as direct written premiums of the Property and Casualty Group remained flat in the second quarter of 2008 compared to the second quarter of 2007.

Cost of management operations increased 2.8% to \$213.1 million in the second quarter of 2008 driven by increases in personnel costs, advertising and sales expenses and information technology consulting fees. Our current estimate for growth in non-commission operating costs is about 13% for 2008 as we plan to increase investments in information technology during the second half of the year.

The insurance underwriting operations continued to experience favorable development of prior accident year loss and loss adjustment expense reserves, the extent of which was not as great as the second quarter of 2007. We had a slight increase in catastrophe losses in the second quarter of 2008 compared to the second quarter of 2007.

Concerns persist surrounding the credit markets and more specifically the financial services industry. We actively evaluate our bond and preferred stock portfolios for impairments. The impairment charges we recognized in the second quarter of 2008 of \$12.4 million were the result of writedowns in value due to continued declines in fair value and credit deterioration on certain of our bonds and preferred stocks in the financial services industry sector. The majority of the impairments relate to securities that are performing in line with anticipated or contractual cash flows. Effective January 1, 2008, we adopted SFAS 159 for our common stock portfolio. As a result of adopting this standard, all changes in the fair value of our common stock are now reflected in our Consolidated Statements of Operations. We recognized \$4.6 million of net unrealized losses on common stock in the second quarter of 2008 and \$18.3 million for the first six months of 2008.

**ANALYSIS OF BUSINESS SEGMENTS*****Management Operations***

|  | Three months ended June 30, |            |             | Six months ended June 30, |            |             |
|--|-----------------------------|------------|-------------|---------------------------|------------|-------------|
|  | 2008                        | 2007       | %<br>Change | 2008                      | 2007       | %<br>Change |
| <i>(dollars in thousands)</i>            | <i>(Unaudited)</i>          |            |             | <i>(Unaudited)</i>        |            |             |
| Management fee revenue                   | \$ 255,809                  | \$ 256,462 | (0.3)%      | \$ 485,408                | \$ 485,106 | 0.1%        |
| Service agreement revenue                | 7,748                       | 7,299      | 6.2         | 15,139                    | 14,717     | 2.9         |
| Total revenue from management operations | 263,557                     | 263,761    | (0.1)       | 500,547                   | 499,823    | 0.1         |
| Cost of management operations            | 213,114                     | 207,392    | 2.8         | 404,774                   | 397,777    | 1.8         |
| Income from management operations        | \$ 50,443                   | \$ 56,369  | (10.5)%     | \$ 95,773                 | \$ 102,046 | (6.1)%      |
| Gross margin                             | 19.1%                       | 21.4%      |             | 19.1%                     | 20.4%      |             |

**KEY POINTS**

The management fee rate was 25% in the second quarters of 2008 and 2007.

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

Direct written premiums of the Property and Casualty Group were flat, up only 0.2% in the second quarter of 2008, compared to the second quarter of 2007.

Year-over-year policies in force grew 2.5%, or 97,586 policies, to 3,945,766 at June 30, 2008 compared to year-over-year growth of 66,622 policies in the second quarter of 2007.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS** (Continued)

Year-over-year average premium per policy was \$960 and \$984 at June 30, 2008 and 2007, respectively, a decrease of 2.4%.

During the second quarter of 2008, premium rate changes resulted in a net \$8.3 million reduction in written premiums.

Commission costs remained flat while costs other than commissions increased 9.8% in the second quarter of 2008.

Estimates for agent bonuses decreased \$2.3 million, offset by a \$1.3 million increase in scheduled rate commissions compared to the second quarter of 2007.

Personnel costs increased \$1.7 million primarily as a result of increases in salaries and wages from higher average pay rates for employees and \$1.0 million in executive severance costs. Sales and policy issuance costs increased \$1.9 million and all other operating costs increased \$1.8 million.

**Management fee revenue**

The following table presents the direct written premium of the Property and Casualty Group, shown by major line of business, and the calculation of our management fee revenue.

|  | Three months ended June 30, |            |             | Six months ended June 30, |            |             |
|--|-----------------------------|------------|-------------|---------------------------|------------|-------------|
|  | 2008                        | 2007       | %<br>Change | 2008                      | 2007       | %<br>Change |
| <i>(dollars in thousands)</i>  | <i>(Unaudited)</i>          |            |             | <i>(Unaudited)</i>        |            |             |
| Private passenger auto   | \$ 483,217                  | \$ 474,770 | 1.8%        | \$ 920,216                | \$ 909,476 | 1.2%        |
| Homeowners   | 207,022                     | 206,265    | 0.4         | 358,159                   | 354,637    | 1.0         |
| Commercial multi-peril   | 119,800                     | 120,466    | (0.6)       | 234,775                   | 235,519    | (0.3)       |
| Commercial auto  | 86,552                      | 88,500     | (2.2)       | 169,422                   | 171,666    | (1.3)       |
| Workers compensation   | 77,960                      | 85,283     | (8.6)       | 162,817                   | 177,187    | (8.1)       |
| All other lines of business  | 55,485                      | 52,963     | 4.8         | 103,043                   | 97,940     | 5.2         |
| Property and Casualty Group direct written premiums                    | 1,030,036                   | 1,028,247  | 0.2         | 1,948,432                 | 1,946,425  | 0.1         |
| Management fee rate  | 25.00%                      | 25.00%     |             | 25.00%                    | 25.00%     |             |
| Management fee revenue, gross  | 257,509                     | 257,062    | 0.2         | 487,108                   | 486,606    | 0.1         |
| Change in allowance for management fee returned on cancelled policies* | (1,700)                     | (600)      | NM          | (1,700)                   | (1,500)    | NM          |
| Management fee revenue, net of allowance                               | \$ 255,809                  | \$ 256,462 | (0.3)%      | \$ 485,408                | \$ 485,106 | 0.1%        |

NM = not meaningful

\* Management fees are returned to the Exchange when policies are cancelled mid-term and unearned premiums are refunded. We record an estimated allowance for management fees returned on mid-term policy cancellations.

Management fee revenue is based upon the management fee rate, determined by our Board of Directors, and the direct written premiums of the Property and Casualty Group. The management fee rate was set at 25%, the maximum rate, for both 2008 and 2007. In the second quarter of 2008, although the mid-term cancellations of policies for the Property and Casualty Group trended downward, the seasonal effects on the unearned premium reserve resulted in an increase in the allowance for management fees returned on cancelled policies. The policy retention ratio improved slightly for all lines of business to 90.4% at June 30, 2008 from 90.2% at December 31, 2007.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS** (Continued)

Direct written premiums of the Property and Casualty Group were flat at \$1.0 billion in the second quarter of 2008 reflecting reductions in average premium offset by an increase in policies in force. Total year-over-year policies in force increased by 2.5% to 3,945,766 at June 30, 2008. Growth in policies in force is the result of continuing improvements in policyholder retention and increased new policies sold. The year-over-year average premium per policy declined 2.4% to \$960 at June 30, 2008 from \$984 at June 30, 2007. The impact of these rate decreases is seen primarily in the renewal premiums.

We continuously evaluate pricing and estimate that those pricing actions approved, filed and contemplated for filing could reduce the direct written premiums of the Property and Casualty Group by approximately \$31.4 million during 2008, of which approximately \$17.3 million occurred in the first half of 2008. The most significant rate reductions effective in 2008 are in workers compensation in Pennsylvania and homeowners in Maryland. Segmented pricing in auto and home, where we offer lower prices to better risks, has accelerated the decline in average premium per policy. Premiums generated from new business increased 1.0% to \$113.5 million from \$112.4 million in the second quarter of 2008 as compared to 2007. Underlying the trend in new business premiums is an increase in new business policies in force of 3.2% to 467,747 for the twelve months ended June 30, 2008 from 453,207 at June 30, 2007, while the year-over-year average premium per policy on new business increased 1.6% to \$866 at June 30, 2008 from \$852 at June 30, 2007.

Premiums generated from renewal business increased slightly to \$916.5 million at June 30, 2008 from \$915.9 million at June 30, 2007. Renewal policies in force increased 2.5% to 3,478,019 from 3,394,973, while the year-over-year average premium per policy on renewal business decreased 3.0% to \$972 from \$1,002 for the same respective periods in 2008 and 2007.

**Personal lines** The Property and Casualty Group's personal lines new policies in force increased 1.8% to 379,005 for the twelve months ended June 30, 2008 compared to June 30, 2007, while the year-over-year average premium per policy on personal lines new business remained flat at \$687 at both June 30, 2008 and 2007. The Property and Casualty Group's personal lines new business premiums written remained flat at \$71.2 million in the second quarter of 2008 despite the increase in policies in force.

Private passenger auto new premiums written increased 3.8% to \$45.8 million during the second quarter of 2008 driven by a 4.8% increase in new business policies in force to 161,482. The private passenger auto new business year-over-year average premium per policy decreased 0.6% to \$1,016 at June 30, 2008. A private passenger auto incentive program was implemented in July 2006 to stimulate policy growth and has contributed to the increase in new business policies in force. Under the program, eligible agents receive a bonus depending on the number of new private passenger auto policies issued. This program was further revised effective June 1, 2008. See Private Passenger Auto Bonus section herein for further details of the change. Homeowners new business premium decreased to \$20.1 million in the second quarter of 2008 from \$22.1 million in the second quarter of 2007. Homeowners new policies in force decreased 2.5% to 165,133, while the year-over-year average premium per policy on homeowners new business decreased 1.7% to \$463. The decline in homeowners new business policies is partly impacted by the slow down in the housing market in our region.

Renewal premiums written on personal lines policies increased during the second quarter of 2008 to \$652.4 million from \$640.9 million, or 1.8%. The impact of rate reductions was offset by improving policy retention ratio trends. The year-over-year average premium per policy on personal lines renewal business decreased 1.3% to \$788 at June 30, 2008 from \$798 at June 30, 2007. The policy retention ratio for private passenger auto improved to 91.6% at June 30, 2008, from 91.5% at December 31, 2007 and 91.1% at June 30, 2007, while the policy retention for homeowners improved to 90.7% at June 30, 2008, from 90.3% at December 31, 2007 and 89.9% at June 30, 2007.

**Commercial lines** - The commercial lines new business premiums written increased 3.2% to \$42.2 million in the second quarter of 2008 from \$40.9 million in the second quarter of 2007. Commercial lines new policies in force increased 9.6% to 88,742 for the twelve months ended June 30, 2008, while the average premium per policy on commercial lines increased 1.4%. Factors contributing to the increase in new commercial lines premiums written in 2008 include more proactive communications between us and our commercial agents, continued refinement and



enhancements to our quote processing systems and our use of more refined pricing based on predictive modeling. The increase in the average premium per policy on commercial lines new business resulted from certain commercial multi-peril pricing actions that increased rates.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS** (Continued)

Renewal premiums for commercial lines decreased 4.0% to \$264.1 million from \$275.0 million in the second quarters of 2008 and 2007, respectively. While renewal policies in force increased 2.5% to 423,152 for the twelve months ended June 30, 2008, the year-over-year average premium per policy on commercial lines renewal business declined 7.0% due primarily to the workers compensation and commercial multi-peril line of business trends.

**Future trends premium revenue** We are continuing our efforts to grow premiums and improve our competitive position in the marketplace. Our new policy growth was influenced somewhat by the timing of our annual sales contests for our independent agents. These contests are intended to generate policy sales through various annual promotional incentives and recognition awards. These spring annual sales contests in 2008 did not begin until April, nearly one month later than their start date in 2007. Thus the spring contests had more of an impact on the number of policies placed in the second quarter of 2008 as compared to the second quarter of 2007. Also contributing to our current and future growth is the continued expansion of our agency force as new agents build up their books of business with the Property and Casualty Group. We appointed 84 new agencies in the first half of 2008, for a total of 2,016 agencies at June 30, 2008. We expect to meet our goal of appointing 140 new agencies in 2008. In 2007, we appointed 214 new agencies. As previously announced, with West Virginia's workers compensation system transitioning to an open-market system in July 2008, the Property and Casualty Group began writing workers compensation business in West Virginia effective July 1, 2008.

**Service agreement revenue**

Service agreement revenue includes service charges we collect from policyholders for providing extended payment terms on policies written by the Property and Casualty Group. The service charges are fixed dollar amounts per billed installment. Gross service agreement revenue amounted to \$8.1 million and \$7.8 million for the quarters ended June 30, 2008 and 2007, respectively. Effective March 1, 2008, we introduced late payment and policy reinstatement fees, where permitted on policyholder accounts, that are past due or lapsed in coverage due to non-payment of premiums. Service agreement revenue is expected to increase between \$2.0 million and \$3.0 million in 2008 as a result of these new fees. This estimate was revised at June 30, 2008 to reflect the most recent late payment service fee experience. Policyholder late payment patterns were expected to be influenced by the imposition of these fees, and therefore could be less than estimated by management.

Cost of management operations

|                                     | Three months ended June 30, |            |             | Six months ended June 30, |            |             |
|-------------------------------------|-----------------------------|------------|-------------|---------------------------|------------|-------------|
|                                     | 2008                        | 2007       | %<br>Change | 2008                      | 2007       | %<br>Change |
| <i>(in thousands)</i>               | (Unaudited)                 |            |             | (Unaudited)               |            |             |
| Commissions                         | \$ 148,818                  | \$ 148,855 | 0.0%        | \$ 278,575                | \$ 279,704 | (0.4)%      |
| Personnel costs                     | 36,307                      | 34,596     | 4.9         | 73,282                    | 68,509     | 7.0         |
| Survey and underwriting costs       | 6,288                       | 5,888      | 6.8         | 12,203                    | 12,173     | 0.2         |
| Sales and policy issuance costs     | 7,584                       | 5,733      | 32.3        | 13,177                    | 10,966     | 20.2        |
| All other operating costs           | 14,117                      | 12,320     | 14.6        | 27,537                    | 26,425     | 4.2         |
| Non-commission expense              | 64,296                      | 58,537     | 9.8         | 126,199                   | 118,073    | 6.9         |
| Total cost of management operations | \$ 213,114                  | \$ 207,392 | 2.8%        | \$ 404,774                | \$ 397,777 | 1.8%        |

**KEY POINTS**

Commissions in the second quarter of 2008 include:

a decrease in the estimate for agent bonuses of \$2.3 million,

an increase in normal and accelerated rate commissions of \$1.8 million in the second quarter of 2008 driven by an increase in certain workers compensation commissions and commercial commission rate increases for five commercial lines of business and higher accelerated commissions due to more newly appointed agents, and

an increase in promotional incentives and the private passenger auto bonus of \$1.1 million.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS** (Continued)

Driving the 4.9% increase in personnel costs in the second quarter of 2008 is a \$1.0 million charge for executive severance costs and an increase of \$0.6 million in average pay rates partially offset by lower staffing levels. Excluding the severance charge, personnel costs rose 2.0%.

Sales and policy issuance costs increased 32.3% due to a \$1.3 million increase in advertising expenses.

All other operating costs increased 14.6% driven by a \$2.2 million increase in consulting fees, primarily contract labor costs related to our current technology program.

**Commissions** - Commissions to independent agents, which are the largest component of the cost of management operations, include scheduled commissions earned by independent agents on premiums written, accelerated commissions and agent bonuses and are outlined in the following table:

|   | Three months ended June 30, |            |             | Six months ended June 30, |            |             |
|---|-----------------------------|------------|-------------|---------------------------|------------|-------------|
|   | 2008                        | 2007       | %<br>Change | 2008                      | 2007       | %<br>Change |
| <i>(in thousands)</i>   | <i>(Unaudited)</i>          |            |             | <i>(Unaudited)</i>        |            |             |
| Scheduled rate commissions  | \$ 124,510                  | \$ 123,164 | 1.1%        | \$ 233,333                | \$ 231,126 | 1.0%        |
| Accelerated rate commissions                                      | 1,135                       | 651        | 74.3        | 2,105                     | 1,164      | 80.8        |
| Agent bonuses   | 21,581                      | 23,864     | (9.6)       | 39,355                    | 45,192     | (12.9)      |
| Promotional incentives  | 745                         | (65)       | NM          | 1,506                     | 29         | NM          |
| Private passenger auto bonus                                      | 1,847                       | 1,541      | 19.9        | 3,276                     | 2,993      | 9.5         |
| Change in commissions allowance for mid-term policy cancellations | (1,000)                     | (300)      | NM          | (1,000)                   | (800)      | NM          |
| Total commissions   | \$ 148,818                  | \$ 148,855 | 0.0%        | \$ 278,575                | \$ 279,704 | (0.4)%      |

NM = not meaningful

*Scheduled and accelerated rate commissions* - The direct written premiums of the Property and Casualty Group remained flat in the second quarter of 2008 compared to the second quarter of 2007. The increase in scheduled rate commissions is reflective of an increase in certain workers compensation commission rates which became effective August 1, 2007 in certain states, and added \$0.6 million of commission expense in the second quarter of 2008. Effective July 1, 2008, commission rates have been increased for certain commercial lines new business premiums. We recognized \$0.5 million in the second quarter of 2008 of additional commission expense for those commercial premiums written but not yet collected at June 30, 2008. The higher commercial commission rates are expected to increase commission expense by approximately \$1.5 million for the remainder of 2008 and \$2 million for 2009.

Accelerated rate commissions are offered under specific circumstances to certain newly-recruited agents for their initial three years of operations. Accelerated rate commissions increased during the second quarter of 2008 as expected given the additional new agency appointments in recent years as part of our growth strategy. We appointed 65 new agencies in 2005, 139 in 2006 and 214 in 2007. In the first half of 2008 we appointed another 84 new agencies and expect to appoint a total of 140 for the year. As new agency appointments continue, accelerated commissions are expected to increase.

*Agent bonuses* Agent bonuses are based predominantly on an individual agency's property/casualty underwriting profitability over a three-year period. There is also a growth component to the bonus, paid only if the agency is profitable. The estimate for the bonus is modeled on a monthly basis using the two prior year's actual underwriting data by agency combined with the current year-to-date actual data. The decrease in the estimate for agent bonuses in the second quarter of 2008 reflects a reduction in our estimate of the profitability component of the bonus. The agent bonus award is estimated at \$77.2 million for 2008. Of this estimate, \$73.9 million represents the profitability component and \$3.3 million represents the growth component.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS** (Continued)

**Private passenger auto bonus** In July 2006, an incentive program was implemented that paid a \$50 bonus to agents for each qualifying new private passenger auto policy issued. Effective June 1, 2008, a tiered payout structure was introduced. The new structure pays out between \$50 and \$200 per private passenger auto application based on the number of qualifying new private passenger auto policies placed by an agency. As a result of the new tiered payout structure, the total cost of this program is expected to approximate \$9.0 million for 2008 and \$9.7 million for 2009. For the second quarter 2008, \$0.2 million additional commission expense was recorded as a result of the new tiered bonus.

**Other costs of management operations** The cost of management operations excluding commission costs increased \$5.8 million, or 9.8%, for the second quarter of 2008. Personnel costs, increased 4.9%, in the second quarter of 2008. Driving this increase was a \$1.0 million charge for severance costs for an executive officer who resigned during the quarter and a \$0.6 million increase in salaries and wages due to higher average pay rates partially offset by lower staffing levels. All other operating costs increased 14.6% driven by a \$2.2 million increase in consulting fees primarily due to contract labor costs related to our technology development efforts. Also in the second quarter of 2008, sales and policy issuance costs increased due to a \$1.3 million increase in advertising expenses.

For the six months ended June 30, 2008, personnel costs increased 7.0% or \$4.8 million. The first half of 2008 includes \$2.1 million of severance costs for two executive officers who resigned during the year. Included in this amount is \$0.3 million for the accelerated recording of the full obligation, rather than the pro-rata amount, under the long-term incentive plan related to the two resigned executives. During 2008, investments continue to be made to support our effort to remain competitive in the marketplace. As noted previously, increased expenses related to commission and incentive changes, advertising to support our Agents, as well as investments in new technologies, are being incurred to help stimulate growth for our Property and Casualty Group. We invested \$2.1 million in software purchases related to upgrading the policy administration system that have been capitalized on the Consolidated Statement of Financial Position. We have also incurred \$1.9 million of additional expense recognized in the Consolidated Statement of Operations, of which \$1.7 million relates to external costs for consultant fees in conjunction with the planning and designing of the upgraded system. See also *Factors That May Affect Future Results*, herein.

**Future trends cost of management operations** The competitive position of the Property and Casualty Group is based on many factors including price considerations, service levels, ease of doing business, product features and billing arrangements, among others. Our estimate for growth in non-commission operating expenses for the year 2008 is 13%. In the second half of the year we will be working to develop the detailed planning and design of our policy administration replacement system and as a result expect to incur external expenses of approximately \$10 million.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS** (Continued)**Insurance Underwriting Operations**

Our insurance underwriting operations originate through direct business of our property/casualty insurance subsidiaries but net underwriting results are a product of the intercompany reinsurance pooling agreement between our subsidiaries and the Erie Insurance Exchange.

|  | Three months ended June 30, |           |             | Six months ended June 30, |            |             |
|--|-----------------------------|-----------|-------------|---------------------------|------------|-------------|
|  | 2008                        | 2007      | %<br>Change | 2008                      | 2007       | %<br>Change |
| <i>(in thousands)</i>                              | <i>(Unaudited)</i>          |           |             | <i>(Unaudited)</i>        |            |             |
| Premiums earned                                    | \$ 51,736                   | \$ 52,122 | (0.7)%      | \$ 103,662                | \$ 104,096 | (0.4)%      |
| Losses and loss adjustment expenses incurred       | 33,823                      | 29,789    | 13.5        | 67,583                    | 62,023     | 9.0         |
| Policy acquisition and other underwriting expenses | 14,668                      | 14,410    | 1.8         | 28,754                    | 28,530     | 0.8         |
| Total losses and expenses                          | 48,491                      | 44,199    | 9.7         | 96,337                    | 90,553     | 6.4         |
| Underwriting income                                | \$ 3,245                    | \$ 7,923  | (59.0)%     | \$ 7,325                  | \$ 13,543  | (45.9)%     |

**KEY POINTS**

Earned premiums declined slightly in the second quarter of 2008 reflecting the trend of rate decreases.

Losses related to the current accident year contributed 6.7 points to the combined ratio in the second quarter of 2008, compared to 0.7 points in the second quarter of 2007. Increased severity in homeowners and three catastrophic liability workers compensation claims incurred in the second quarter were the primary contributors to the 2008 losses.

Development of prior accident year loss reserves continued to be favorable improving the loss ratio 3.9 points, or \$2.0 million, in the second quarter 2008 compared to an improvement of 4.3 points for the second quarter of 2007. This development is reflective of improved frequency and severity trends.

Catastrophe losses contributed 3.0 points and 2.2 points to the GAAP combined ratio in the second quarters of 2008 and 2007, respectively.

**Profitability measures**

|  | Three months ended June 30, |       | Six months ended June 30, |       |
|--|-----------------------------|-------|---------------------------|-------|
|  | 2008                        | 2007  | 2008                      | 2007  |
| Erie Indemnity Company GAAP loss and LAE ratio*  | 65.4%                       | 57.2% | 65.2%                     | 59.6% |
| Erie Indemnity Company GAAP combined ratio*      | 93.7                        | 84.8  | 92.9                      | 87.0  |
| P&C Group statutory combined ratio               | 91.2                        | 82.4  | 92.1                      | 86.0  |
| P&C Group adjusted statutory combined ratio**    | 87.0                        | 77.7  | 88.0                      | 81.5  |
| Direct business:                                 |                             |       |                           |       |
| Personal lines adjusted statutory combined ratio | 85.5                        | 80.9  | 85.4                      | 81.3  |

Edgar Filing: ERIE INDEMNITY CO - Form 10-Q

|   |        |        |        |        |
|---|--------|--------|--------|--------|
| Commercial lines adjusted statutory combined ratio      | 90.1   | 76.6   | 90.9   | 82.6   |
| Prior accident year reserve development redundancy      | (3.9)  | (4.3)  | (4.6)  | (7.4)  |
| Prior year salvage and subrogation recoveries collected | (1.6)  | (1.8)  | (2.4)  | (2.4)  |
| Total loss ratio points from prior accident years       | (5.5)% | (6.1)% | (7.0)% | (9.8)% |

\* The GAAP loss and LAE ratio and the combined ratio, expressed as a percentage, is the ratio of losses, loss adjustment, acquisition and other underwriting expenses incurred to earned premiums for our property/casualty insurance subsidiaries. Our GAAP combined ratios are different than the results of the Property and Casualty Group due to certain GAAP adjustments.

\*\* The adjusted statutory combined ratio removes the profit margin on the management fee we earn from the Property and Casualty Group.



**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS** (Continued)

**Development of direct loss reserves**

Our 5.5% share of the Property and Casualty Group's favorable development of prior accident year losses, after removing the effects of salvage and subrogation recoveries, was \$2.0 million and \$2.2 million, and improved the loss ratio by 3.9 points and 4.3 points in the second quarters of 2008 and 2007, respectively. The favorable development in 2008 resulted from improvements in frequency trends on automobile bodily injury and uninsured/underinsured motorist bodily injury. Severity trends in the second quarter of 2008 reflected slight improvements over anticipated trends. In the second quarter of 2007, a majority of the favorable development resulted from improved severity trends on automobile bodily injury and improved frequency trends and flattening severity trends on uninsured/underinsured motorist bodily injury. Overall, loss costs for private passenger auto have remained relatively flat.

**Catastrophe losses**

Our share of catastrophe losses, as defined by the Property and Casualty Group, amounted to \$1.5 million and \$1.1 million in the second quarters of 2008 and 2007, respectively. The second quarter of 2008 included wind, tornado and hail storms primarily in the states of Indiana, Maryland and North Carolina, while 2007 included tornados and flooding in Ohio, North Carolina and Virginia. These catastrophe losses contributed 3.0 points and 2.2 points to the GAAP combined ratio in the second quarters of 2008 and 2007, respectively. Catastrophe losses incurred for the first half of 2008 and 2007 were \$2.4 million and \$1.4 million, respectively, and contributed 2.3 points and 1.3 points to the combined ratio, respectively.

Underwriting losses are seasonally higher in the second through fourth quarters and as a consequence, our combined ratio generally increases as the year progresses. In the second quarter of 2008, our share of the increase to incurred but not reported reserves related to seasonality adjustments was \$0.9 million, compared to \$1.5 million in the second quarter of 2007. In the first quarter of 2008, the seasonality adjustment reduced our share of the incurred but not reported reserves by \$3.5 million.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)Investment Operations

|  | Three months ended June 30, |           |             | Six months ended June 30, |           |             |
|--|-----------------------------|-----------|-------------|---------------------------|-----------|-------------|
|  | 2008                        | 2007      | %<br>Change | 2008                      | 2007      | %<br>Change |
| <i>(in thousands)</i>                      | <i>(Unaudited)</i>          |           |             | <i>(Unaudited)</i>        |           |             |
| Net investment income                      | \$ 11,467                   | \$ 14,138 | (18.9)%     | \$ 23,139                 | \$ 28,116 | (17.7)%     |
| Net realized (losses) gains on investments | (14,267)                    | 2,222     | NM          | (38,846)                  | 4,112     | NM          |
| Equity in earnings of limited partnerships | 11,275                      | 20,180    | (44.1)      | 19,253                    | 32,698    | (41.1)      |
| Equity in (losses) earnings of EFL         | (602)                       | 1,247     | NM          | (874)                     | 2,613     | NM          |
| Net revenue from investment operations     | \$ 7,873                    | \$ 37,787 | (79.2)%     | \$ 2,672                  | \$ 67,539 | (96.0)%     |

NM = not meaningful

**KEY POINTS**

Net investment income decreased 18.9% for the quarter due to lower invested asset balances as a result of our continued share repurchase activity.

Net realized losses on investments in the second quarter of 2008 include \$12.4 million of impairment charges in the second quarter of 2008, and \$4.6 million of unrealized losses on common stock recognized as a result of adopting SFAS 159. Impairment charges were \$2.0 million in the second quarter of 2007.

Equity in earnings of limited partnerships decreased \$8.9 million in the second quarter of 2008.

Impairment charges of \$12.4 million included \$8.0 million on fixed maturities and \$4.4 million on preferred stock for the three months ended June 30, 2008. Impairment charges were taken on securities in the financial services industry sector due to continued declines in fair value and credit deterioration that occurred in the second quarter of 2008. For the six months ended June 30, 2008 and 2007, impairment charges on fixed maturities were \$14.0 million and \$1.6 million, respectively, and impairment charges on preferred stock were \$10.4 million and \$0.4 million, respectively. In the second quarter of 2008, valuation losses on common stock that were reported in earnings were \$4.6 million. See Note 6 to the Consolidated Financial Statements for additional information on our adoption of SFAS 159.

Private equity and mezzanine debt limited partnerships generated earnings of \$7.2 million and \$8.1 million for the quarters ended June 30, 2008 and 2007, respectively. Real estate limited partnerships generated earnings of \$4.1 million and \$12.1 million in the second quarters of 2008 and 2007, respectively. Although we have no direct exposure, the reduced valuation adjustments recorded by our real estate limited partnerships are the result of a general slow-down in the real estate markets.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS** (Continued)  
**FINANCIAL CONDITION**

**Investments**

Our investment strategy takes a long-term perspective emphasizing investment quality, diversification and superior investment returns. Investments are managed on a total return approach that focuses on current income and capital appreciation. Our investment strategy also provides for liquidity to meet our short- and long-term commitments. At June 30, 2008, our investment portfolio of investment-grade bonds and preferred stock, common stock and cash and cash equivalents represents \$801 million, or 28.6%, of total assets.

Our investments are subject to certain risks, including interest rate, credit and price risk. Our exposure to interest rates is concentrated in our fixed maturities portfolio. The fixed maturities portfolio comprises 55.5% and 57.7% of invested assets at June 30, 2008 and December 31, 2007, respectively. We calculate the duration and convexity of the fixed maturities portfolio each month to measure the price sensitivity of the portfolio to interest rate changes. Duration measures the relative sensitivity of the fair value of an investment to changes in interest rates. Convexity measures the rate of change of duration with respect to changes in interest rates. These factors are analyzed monthly to ensure that both the duration and convexity remain in the targeted ranges established by management.

We continually review the fixed maturity and preferred stock portfolios to evaluate positions that might incur other-than-temporary declines in value. For all investment holdings, general economic conditions and/or conditions specifically affecting the underlying issuer or its industry, including downgrades by the major rating agencies, are considered in evaluating impairment in value. In addition to specific factors, other factors considered in our review of investment valuation are the length of time and amount the fair value is below cost.

For fixed maturity and preferred stock investments, we individually analyze all positions with emphasis on those that have, in management's opinion, declined significantly below cost. We consider market conditions, industry characteristics and the fundamental operating results of the issuer to determine if the decline is due to changes in interest rates, changes relating to a decline in credit quality, or other issues affecting the investment. A charge is recorded in the Consolidated Statements of Operations for positions that have experienced other-than-temporary impairments due to credit quality or other factors, or for which it is not our intent or ability to hold the position until recovery has occurred. (See Analysis of Investment Operations section herein.)

If our policy for determining the recognition of impaired positions were different, our Consolidated Results of Operations could be significantly impacted. Management believes its investment valuation philosophy and accounting practices result in appropriate and timely measurement of value and recognition of impairment.

We adopted SFAS 157 Fair Value Measurement during the first quarter of 2008. This standard did not require us to make any changes to our valuation methods. Furthermore, our use of Level 3 or Unobservable inputs accounted for less than 3% of our available-for-sale and trading securities at June 30, 2008.

**Fixed maturities**

We continue to monitor the municipal bond market and the effect of recent downgrades by rating agencies specific to certain municipal bond insurers. Our municipal bond portfolio accounts for \$209.4 million, or 33.2%, of the total fixed maturity portfolio. Insurance enhanced municipal bonds total 78.1% of the total municipal bond portfolio. This insurance guarantees the payment of principal and interest on a bond if the issuer defaults. Our municipal bond portfolio is highly rated and includes all investment grade holdings (BBB or higher). The overall credit quality rating of our municipal bond portfolio is AA. The overall credit quality rating of our municipal bond portfolio giving no effect to insurance is AA-.

Approximately 5.9%, or \$37.0 million, of our fixed maturities portfolio is invested in structured products. Our structured product portfolio is highly rated with an average rating of AA- or higher. We continually monitor these investments for material declines in quality and value.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (Continued)Property/casualty loss reserves

Loss reserves are established to account for the estimated ultimate costs of loss and loss adjustment expenses for claims that have been reported but not yet settled and claims that have been incurred but not reported.

Among the factors that may potentially cause the greatest variation between current reserve estimates and the actual future paid amounts are: unforeseen changes in statutory or case law altering the amounts to be paid on existing claim obligations, new medical procedures and/or drugs whose cost is significantly different from that seen in the past, and claims patterns on current business that differ significantly from historical claims patterns.

Loss and loss adjustment expense reserves are presented in our Consolidated Statements of Financial Position on a gross basis for EIC, EINY, and EIPC. Our property/casualty insurance subsidiaries wrote about 17% of the direct property/casualty premiums of the Property and Casualty Group during the first six months of 2008. Under the terms of the Property and Casualty Group's quota share and intercompany pooling arrangement, a significant portion of these reserve liabilities are recoverable. Recoverable amounts are reflected as an asset in our Consolidated Statements of Financial Position. The direct and assumed loss and loss adjustment expense reserves by major line of business and the related amount recoverable under the intercompany pooling arrangement are presented as follows:

| <i>(in thousands)</i>                    | June 30,<br>2008 | As of<br>December 31,<br>2007 |
|--|------------------|-------------------------------|
| Gross reserve liability:                 |                  |                               |
| Private passenger auto                   | \$ 303,379       | \$ 321,320                    |
| Pre-1986 automobile catastrophic injury  | 180,951          | 192,764                       |
| Homeowners                               | 29,571           | 28,506                        |
| Workers compensation                     | 155,124          | 146,402                       |
| Workers compensation catastrophic injury | 100,447          | 108,589                       |
| Commercial auto                          | 76,750           | 79,848                        |
| Commercial multi-peril                   | 78,737           | 75,169                        |
| All other lines of business              | 79,594           | 73,933                        |
| Gross reserves                           | 1,004,553        | 1,026,531                     |
| Reinsurance recoverables                 | 813,958          | 834,453                       |
| Net reserve liability                    | \$ 190,595       | \$ 192,078                    |

The reserves that have the greatest potential for variation are the catastrophic injury liability reserves. We are currently reserving for about 300 claimants requiring lifetime medical care, of which less than 150 involve catastrophic injuries. The reserve carried by the Property and Casualty Group for the catastrophic injury claimants, which is our best estimate of this liability at this time, was \$526.3 million at June 30, 2008, which is net of \$173.2 million of anticipated reinsurance recoverables. Our property/casualty subsidiaries' share of the net catastrophic injury liability reserves is \$28.9 million at June 30, 2008.

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

Off-balance sheet arrangements

There are no off-balance sheet obligations related to the variable interest we have in the Exchange. Any liabilities between the Exchange and us are recorded in our Consolidated Statements of Financial Position. We have no other material off-balance sheet obligations or guarantees, other than the limited partnership investment commitments discussed in Note 14 to the Consolidated Financial Statements herein.

LIQUIDITY AND CAPITAL RESOURCES

We have historically generated sufficient positive cash flow from our operations to fund our commitments and build our investment portfolios. In 2007 and 2008, operating cash flows have been used to fund our financing activities, particularly our dividends to shareholders and share repurchases. When dividends to shareholders and share repurchases exceed operating cash flows, the investment portfolios of the Company may be used as a funding source. However, given the recent illiquid market environment for certain of our bond and preferred stock holdings, we borrowed \$75.0 million on our line of credit during the first quarter of 2008 to support our current repurchase program while allowing us to meet our operating cash obligations.

Also during the first quarter of 2008, we borrowed \$30.0 million from EIC, our property/casualty insurance subsidiary, to fund these operating and financing cash flow activities. We repaid the entire balance during the second quarter of 2008 and paid interest of less than \$0.1 million at that time. This intercompany borrowing was eliminated upon consolidation and therefore had no impact on our Consolidated Statements of Financial Position or Operations. Lower operating cash flows in the first six months of 2008, compared to the first six months of 2007, were primarily related to a decrease in management fees received from the Exchange, lower distributions from our limited partnerships and higher operating expenses. We made pension contributions of \$15.0 million and \$14.8 million to our pension plan in 2008 and 2007, respectively. We also prepaid a software maintenance agreement for a three year period in 2008, whereas in 2007 we had only prepaid the agreement for one year, resulting in higher cash outlay in 2008 of \$5.8 million.

During the second quarter of 2008, we repurchased 737,773 shares of our outstanding Class A common stock in conjunction with our stock repurchase plan that was authorized in February 2006. The shares were repurchased at a cost of \$36.9 million. In the first half of 2008, 1.9 million shares were repurchased at a total cost of \$97.7 million. At June 30, 2008, approximately \$94.2 million repurchase authority remains under this plan. (See Item 2. of Part II. Unregistered Sales of Equity Securities and Use of Proceeds).

As discussed in the *Factors That May Affect Future Results* section, herein, future operating cash flows will also be affected by commitments made by us for our information technology initiatives. Also impacting our future investing activities will be our limited partnership commitments, which at June 30, 2008 total almost \$112 million required to be funded through 2012.

We expect to meet our future funding requirements through various alternatives. Outside of our normal operating and investing cash activities we have available: (1) a bank line of credit limit of \$100 million of which we currently have borrowings of \$75.0 million at June 30, 2008 thus providing an additional \$25 million if needed, (2) dividend payments from our wholly-owned property/casualty insurance subsidiaries, EIC, EPC and EICNY, up to their statutory limits, (3) our more liquid investments that can be sold, such as our common stock and cash and cash equivalents, which total approximately \$107 million at June 30, 2008 and (4) the ability to modify our share repurchase activities until the investment markets better support our financing activities. We believe we have the funding sources available to us to support future cash flow requirements.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS** (Continued)

**CRITICAL ACCOUNTING ESTIMATES**

We make estimates and assumptions that have a significant effect on the amounts and disclosures reported in the financial statements. The most significant estimates relate to valuation of investments, reserves for property/casualty insurance unpaid losses and loss adjustment expenses and retirement benefits. While management believes its estimates are appropriate, the ultimate amounts may differ from estimates provided. Our most critical accounting estimates are described in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations of our Annual Report on Form 10-K for the year ended December 31, 2007. There have been no significant changes to the policies surrounding these estimates since that time.

**FACTORS THAT MAY AFFECT FUTURE RESULTS**

**Financial condition of the Exchange**

We have a direct interest in the financial condition of the Exchange because management fee revenues are based on the direct written premiums of the Exchange and the other members of the Property and Casualty Group. Additionally, we participate in the underwriting results of the Exchange through the pooling arrangement in which our insurance subsidiaries have 5.5% participation. A concentration of credit risk exists related to the unsecured receivables due from the Exchange for certain fees, costs and reimbursements.

To the extent that the Exchange incurs underwriting losses or investment losses resulting from declines in the value of its marketable securities, the Exchange's policyholders' surplus would be adversely affected. If the surplus of the Exchange were to decline significantly from its current level, the Property and Casualty Group could find it more difficult to retain its existing business and attract new business. A decline in the business of the Property and Casualty Group would have an adverse effect on the amount of the management fees we receive and the underwriting results of the Property and Casualty Group. In addition, a significant decline in the surplus of the Exchange from its current level would make it more likely that the management fee rate would be reduced. At June 30, 2008, the Exchange had \$4.8 billion in statutory surplus and a premium to surplus ratio of less than 1 to 1. We believe the Exchange's capital levels are very strong.

Additional information, including condensed statutory financial statements of the Exchange, is presented in Note 15 to the Consolidated Financial Statements herein.

**Insurance premium rate actions**

The changes in premium rates of the Property and Casualty Group directly affect direct written premium levels and underwriting profitability of the Property and Casualty Group, the Exchange and us, and also have a direct bearing on management fees. Rate reductions have been implemented and continue to be sought in 2008 by the Property and Casualty Group. Pricing actions contemplated or taken by the Property and Casualty Group are subject to various regulatory requirements of the states in which these insurers operate. The pricing actions already implemented, or to be implemented through 2008, will also have an effect on the market competitiveness of the Property and Casualty Group's insurance products. Such pricing actions, and those of competitors, could affect the ability of our agents to sell and/or renew business. Management estimates that pricing actions approved, filed and awaiting approval or contemplated through 2008, will reduce premiums for the Property and Casualty Group by \$14.1 million through the remainder of the year for a total of \$31.4 million in 2008. Given our experience and the potential turn in the market, we continue to project rate increases of about 0% and 1% overall that will affect our 2009 pricing.

The Property and Casualty Group continues refining its pricing segmentation model for the private passenger auto and homeowners lines of business. The refined rating plans include significantly more pricing segments than the former plans, providing us greater flexibility in pricing for policyholders with varying degrees of risk. Refining pricing segmentation should enable us to provide more competitive rates to policyholders with varying risk characteristics, as risks can be more accurately priced over time. The continued introduction of new pricing variables could impact retention of existing policyholders and could affect the Property and Casualty Group's ability to attract new policyholders. These outcomes will then impact the Property and Casualty Group's premium dollars and ultimately our management fee revenue.



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

Policy growth

Premium levels attributable to growth in policies in force of the Property and Casualty Group directly affect the profitability of our management operations. The continued focus on underwriting discipline and maturing of our pricing segmentation model has contributed to growth in new policies in force and improved retention ratios. The continued growth of the policy base of the Property and Casualty Group is dependent upon its ability to retain existing and attract new policyholders. A lack of new policy growth or the inability to retain existing customers could have an adverse effect on the growth of premium levels for the Property and Casualty Group and, consequently, lower management fees for us.

Catastrophe losses

The Property and Casualty Group conducts business in 11 states and the District of Columbia, primarily in the mid-Atlantic, mid-western and southeastern portions of the United States. A substantial portion of the business is private passenger and commercial automobile, homeowners and other commercial lines of business in Ohio, Maryland, Virginia and particularly, Pennsylvania. As a result, a single catastrophe occurrence or destructive weather pattern could have a material adverse affect on the results of operations and surplus position of the members of the Property and Casualty Group. Common catastrophic events include severe winter storms, hurricanes, earthquakes, tornadoes, wind and hail storms. In its homeowners line of insurance, the Property and Casualty Group is particularly exposed to an Atlantic hurricane, which might strike the states of North Carolina, Maryland, Virginia and Pennsylvania. The Property and Casualty Group maintains catastrophe occurrence reinsurance coverage to mitigate the future potential catastrophe loss exposure.

Incurred but not reported (IBNR) losses

The Property and Casualty Group is exposed to new claims on previously closed files and to larger than historical settlements on pending and unreported claims. We are exposed to increased losses by virtue of our 5.5% participation in the intercompany reinsurance pooling agreement with the Exchange. We exercise professional diligence to establish reserves at the end of each period that are fully reflective of the ultimate value of all claims incurred. However, these reserves are, by their nature, only estimates and cannot be established with absolute certainty.

The reserve that has the greatest potential for variation is the catastrophic injury liability reserve. The workers compensation product and the automobile no-fault law in Pennsylvania from 1975 until 1985 provided for unlimited medical benefits. The estimation of ultimate liabilities for these claims is subject to significant judgment due to variations in claimant health and mortality over time. Actual experience, different than that assumed, could have a significant impact on the reserve estimates.

Market volatility

With the adoption of SFAS 159 as of January 1, 2008, all changes to unrealized gains and losses on the common stock portfolio are recognized in investment income as net realized gains or losses in the Consolidated Statements of Operations. The fair value of the common stock portfolio is subject to fluctuation from period to period resulting from changes in prices. Depending upon market conditions, this could cause considerable fluctuation in reported total investment income in 2008 and beyond. See Note 6 to the Consolidated Financial Statements for a discussion of the adoption of SFAS 159.

Information technology development

During 2008, we are continuing a broad program of initiatives to enhance the functionality of our legacy processing and agency interface systems aimed at improving the ease of doing business, enhancing agent and employee productivity and access to information. We are also continuing a program in 2008 to evaluate our policy administration system replacement which we initiated in 2007. In the second half of 2008 we will be working to develop the detailed planning and design of the policy administration replacement system and expect to incur approximately \$10 million of external consulting and contract labor fees as a result. The next phase of the project and the related expenses will be approved before the end of the initial phase of the project.



**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our exposure to market risk is primarily related to fluctuations in prices and interest rates. Quantitative and qualitative disclosures about market risk resulting from changes in prices and interest rates are included in Item 7A. in our 2007 Annual Report on Form 10-K. There have been no material changes in such risks or our periodic reviews of asset and liability positions during the six months ended June 30, 2008. The information contained in the investments section of Management's Discussion and Analysis of Financial Condition and Results of Operations is incorporated herein by reference.

Our objective is to earn competitive returns by investing in a diversified portfolio of securities. We are exposed to credit risk through our portfolios of fixed maturity securities, nonredeemable preferred stock, mortgage loans and to a lesser extent short-term investments. This risk is defined as the potential loss in fair value resulting from adverse changes in the borrower's ability to repay the debt. We manage this risk by performing up front underwriting analysis and ongoing reviews of credit quality by position and for the fixed maturity portfolio in total. We do not hedge credit risk inherent in our fixed maturity investments.

Our investment portfolio is diversified with 97.3% of the fixed income portfolio rated investment grade (BBB or higher). Approximately 5.9% of our fixed income portfolio is invested in structured products which include mortgage-backed securities, collateralized debt/loan obligations, asset-backed and credit-linked notes. Our structured product portfolio has an average rating of AA- or higher. We believe we have no significant direct exposure to the subprime residential mortgage market through investments in structured products.

We have significant receivables from the Exchange, which are subject to credit risk. Our results are directly related to the financial strength of the Exchange. Credit risks related to the receivables from the Exchange are evaluated periodically by management. Similar to our investment portfolio, the Exchange maintains 95.6% of its bond portfolio rated investment grade. Approximately 10.4% of the Exchange's bond portfolio is invested in structured products with an average rating of AA or higher.

**ITEM 4. CONTROLS AND PROCEDURES**

We carried out an evaluation, with the participation of management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (pursuant to Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective. Our management evaluated, with the participation of the Chief Executive Officer and Chief Financial Officer, any change in our internal control over financial reporting and determined that there has been no change in our internal control over financial reporting during the quarter ended June 30, 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II. OTHER INFORMATION****ITEM 1A. RISK FACTORS**

There have been no material changes from the risk factors previously disclosed in our annual report on Form 10-K for the fiscal year ended December 31, 2007.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Issuer Purchases of Equity Securities**

| Period           | Total<br>Number<br>of Shares<br>Purchased | Average<br>Price Paid<br>Per Share | Total Number<br>of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plan | Approximate<br>Dollar Value<br>of Shares that<br>May Yet Be<br>Purchased<br>Under the Plan |
|------------------|---|------------------------------------|--|--|
| April 1 30, 2008 | 332,674                                   | \$51.50                            | 332,674  |  |
| May 1 31, 2008   | 0   | 0.00                               | 0  |  |
| June 1 30, 2008  | 405,099                                   | 48.72                              | 405,099  |  |
| Total            | 737,773                                   |                                    | 737,773  | \$94,200,000   |

In April 2008, our Board of Directors approved a continuation of the stock repurchase program for an additional \$100 million authorizing repurchases through June 30, 2009.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

The election of directors to serve on our Board occurred at our Annual Meeting of Shareholders held on April 22, 2008. All nominees to the Board were elected by a unanimous 2,518 votes. This information is incorporated by reference to our Form 8-K as filed with the Securities and Exchange Commission on April 23, 2008.

**ITEM 5. OTHER INFORMATION**

As discussed in our 8-K filing with the Securities and Exchange Commission on June 26, 2008, Erie Indemnity Company entered into an Executive Retention Agreement with Philip A. Garcia, Executive Vice President and Chief Financial Officer, on June 25, 2008. This agreement provides for the retention of Mr. Garcia's services to the Company as Executive Vice President and Chief Financial Officer for a period defined as the earliest of his death or disability, 30 days after the filing with the Securities and Exchange Commission of the Company's Annual Report on Form 10-K for the fiscal year 2008, the date of termination of his employment by the Company for other than cause or by him for good reason, or April 30, 2009, the retention period.

As discussed in our 8-K filing with the Securities and Exchange Commission on July 18, 2008, Erie Indemnity Company announced the selection of Terrence W. Cavanaugh, formerly of the Chubb Corporation, as President and Chief Executive Officer. Mr. Cavanaugh was elected to the Company's Board of Directors effective July 29, 2008.

PART II. OTHER INFORMATION (Continued)

ITEM 6. EXHIBITS

| Exhibit Number | Description of Exhibit   |
|----------------|--|
| 10.1*          | Separation Agreement between Erie Indemnity Company and Michael J. Krahe dated June 25, 2008                           |
| 10.2*          | Executive Retention Agreement between Erie Indemnity Company and Philip A. Garcia dated June 25, 2008                  |
| 31.1           | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                     |
| 31.2           | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                     |
| 32             | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

\* Such exhibit is incorporated by reference to the like titled exhibit in the Registrant's Form 8-K that was filed with the Commission on June 26, 2008.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Erie Indemnity Company

(Registrant)

Date: July 29, 2008

/s/ John J. Brinling, Jr.

John J. Brinling, Jr., President & CEO

/s/ Philip A. Garcia

Philip A. Garcia, Executive Vice President & CFO

49