ERIE INDEMNITY CO
Form 10-Q
November 04, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

QUARTERLY REPORT PERSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2010
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 þ No o

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 þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes þ No o

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 þ	Accelerated Filer o	Non-Accelerated Filer o (Do not check if a smaller reporting company)	Smaller Reporting Company o

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

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 $0.0292 per share, was 50,153,649 at October 22, 2010.

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 2,546 at October 22, 2010.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

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

	Three months ended September 30, 2010	Three months ended September 30, 2009 (As adjusted Note 2)	Nine months ended September 30, 2010	Nine months ended September 30, 2009 (As adjusted Note 2)
Revenues				
Premiums earned	$ 1,005	$ 977	$ 2,972	$ 2,898
Net investment income	110	102	322	324
Net realized investment gains	205	251	117	304
Net impairment losses recognized in earnings	0	(16)	(6)	(99)
Equity in earnings (losses) of limited partnerships	28	(37)	58	(324)
Other income	9	9	26	27
Total revenues	1,357	1,286	3,489	3,130
Benefits and expenses				
Insurance losses and loss expenses	710	631	2,208	2,094
Policy acquisition and underwriting expenses	242	299	699	762
Total benefits and expenses	952	930	2,907	2,856
Income from operations before income taxes and noncontrolling interest	405	356	582	274
Provision for income taxes	130	104	176	2
Net income	**$ 275**	**$ 252**	**$ 406**	**$ 272**
Less: Net income attributable to noncontrolling interest in consolidated entity Exchange	**221**	**212**	**256**	**188**
Net income attributable to Indemnity	**$ 54**	**$ 40**	**$ 150**	**$ 84**
Earnings Per Share				
Net income attributable to Indemnity per share				
Class A common stock basic	$ 1.05	$ 0.77	$ 2.92	$ 1.62
Class A common stock diluted	**$ 0.94**	**$ 0.69**	**$ 2.62**	**$ 1.46**

Class B common stock basic and diluted	$ 150.87	$ 112.06	$ 421.91	$ 239.96
Weighted average shares outstanding attributable to Indemnity Basic				
Class A common stock	50,499,551	51,252,693	50,897,035	51,255,234
Class B common stock	2,546	2,546	2,546	2,549
Weighted average shares outstanding attributable to Indemnity Diluted				
Class A common stock	56,624,310	57,383,900	57,021,794	57,393,641
Class B common stock	2,546	2,546	2,546	2,549
Dividends declared per share				
Class A common stock	$ 0.48	$ 0.45	$ 1.44	$ 1.35
Class B common stock	$ 72.00	$ 67.50	$ 216.00	$ 202.50

See accompanying notes to Consolidated Financial Statements.

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

	September 30, 2010 (Unaudited)	December 31, 2009
Assets		
Investments Indemnity		
Available-for-sale securities, at fair value:		
Fixed maturities (amortized cost of $649 and $642, respectively)	$ 695	$ 664
Equity securities (cost of $40 and $35, respectively)	46	38
Trading securities, at fair value (cost of $22 and $36, respectively)	26	42
Limited partnerships (cost of $263 and $281, respectively)	234	235
Other invested assets	1	1
Investments Exchange		
Available-for-sale securities, at fair value:		
Fixed maturities (amortized cost of $6,453 and $6,277, respectively)	7,019	6,517
Equity securities (cost of $467 and $425, respectively)	538	472
Trading securities, at fair value (cost of $1,689 and $1,556, respectively)	1,985	1,835
Limited partnerships (cost of $1,333 and $1,392, respectively)	1,148	1,116
Other invested assets	19	20
Total investments	**11,711**	**10,940**
Cash and cash equivalents (Exchange portion of $239 and $158, respectively)	312	234
Premiums receivable from policyholders (Exchange portion of $780 and $715, respectively)	993	906
Reinsurance recoverable (Exchange portion of $201 and $212, respectively)	204	215
Deferred income taxes (Exchange portion of $0 and $75, respectively)	11	116
Deferred acquisition costs (Exchange portion of $416 and $416, respectively)	473	467
Other assets (Exchange portion of $337 and $306, respectively)	454	409
Total assets	**$ 14,158**	**$ 13,287**
Liabilities and shareholders equity		
Liabilities		
Indemnity liabilities		
Losses and loss expense reserves	$ 743	$ 752
Unearned premiums	355	325
Other liabilities	370	387
Exchange liabilities		
Losses and loss expense reserves	2,870	2,846
Life policy and deposit contract reserves	1,600	1,540
Unearned premiums	1,803	1,656
Deferred income taxes	103	0
Other liabilities	88	56

Total liabilities	**7,932**	**7,562**
Indemnity s shareholders equity		
Class A common stock, stated value $0.0292 per share; authorized 74,996,930 shares; 68,289,600 issued; 50,252,872 and 51,203,473 shares outstanding, respectively	2	2
Class B common stock, convertible at a rate of 2,400 Class A shares for one Class B share, stated value $70 per share; 2,546 authorized, issued and outstanding, respectively	0	0
Additional paid-in-capital	8	8
Accumulated other comprehensive loss	(17)	(43)
Retained earnings, before cumulative effect adjustment	1,825	1,743
Cumulative effect of accounting changes, net of tax	0	6
Retained earnings, after cumulative effect adjustment	1,825	1,749
Total contributed capital and retained earnings	1,818	1,716
Treasury stock, at cost, 18,036,728 and 17,086,127 shares, respectively	(860)	(814)
Total Indemnity shareholders equity	**958**	**902**
Noncontrolling interest in consolidated entity Exchange	**5,268**	**4,823**
Total equity	**6,226**	**5,725**
Total liabilities, shareholders equity and noncontrolling interest	**$ 14,158**	**$ 13,287**

See accompanying notes to Consolidated Financial Statements. See Note 14 for supplemental consolidating statements of financial position information.

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

	Erie Insurance Group			
	Three months ended September 30,		Nine months ended September 30,	
	2010	2009 (As adjusted Note 2)	2010	2009 (As adjusted Note 2)
Accumulated other comprehensive loss:				
Balance, beginning of period Indemnity	$ (32)	$ (101)	$ (43)	$ (136)
Cumulative effect of accounting changes, net of tax*				(6)
Adjusted balance, beginning of period	(32)	(101)	(43)	(142)
Gross unrealized holding gains on investments arising during period	25	47	44	101
Reclassification adjustment for gross (gains) losses included in net income	(2)	3	(4)	12
Unrealized gains on investments	23	50	40	113
Income tax expense related to unrealized gains	(8)	(18)	(14)	(40)
Change in other comprehensive income, net of tax Indemnity	15	32	26	73
Balance, end of period Indemnity	$ (17)	$ (69)	$ (17)	$ (69)
Change in other comprehensive income, net of tax Indemnity	$ 15	$ 32	$ 26	$ 73
Change in other comprehensive income, net of tax Exchange	$ 118	$ 198	$ 189	$ 491
Change in other comprehensive income, net of tax Erie Insurance Group	$ 133	$ 230	$ 215	$ 564
Comprehensive income:				
Net income Erie Insurance Group	$ 275	$ 252	$ 406	$ 272
Change in other comprehensive income, net of tax Erie Insurance Group	133	230	215	564
Total comprehensive income Erie Insurance Group	408	482	621	836
Less: Noncontrolling interest in consolidated entity Exchange	339	410	445	679

Total comprehensive income	**Indemnity**	$ 69	$ 72	$ 176	$ 157

* Previously recognized non-credit other-than-temporary impairment losses were reclassified from retained earnings to other comprehensive income upon the adoption of Financial Accounting Standards Board Accounting Standards Codification 320, *Investments Debt and Equity Securities*, during the second quarter of 2009.

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

	Nine months ended September 30, 2010	2009 (As adjusted Note 2)
Cash flows from operating activities		
Premiums collected	$ 3,068	$ 3,025
Net investment income received	325	306
Limited partnership distributions	88	57
Service agreement fee received	26	26
Commissions and bonuses paid to agents	(414)	(420)
Losses paid	(1,808)	(1,701)
Loss expenses paid	(321)	(306)
Other underwriting and acquisition costs paid	(394)	(435)
Income taxes (paid) recovered	(105)	161
Net cash provided by operating activities	**465**	**713**
Cash flows from investing activities		
Purchase of investments:		
Fixed maturities	(1,415)	(1,339)
Preferred stock	(146)	(132)
Common stock	(787)	(1,129)
Limited partnerships	(105)	(133)
Sales/maturities of investments:		
Fixed maturity sales	486	386
Fixed maturity calls/maturities	794	531
Preferred stock	117	146
Common stock	740	1,082
Net policy loans	0	1
Sale of and returns on limited partnerships	40	8
Purchase of property and equipment	(27)	(10)
Net collections (distributions) on agent loans	2	(2)
Net cash used in investing activities	**(301)**	**(591)**
Cash flows from financing activities		
Annuity and supplementary contract deposits and interest	87	134
Annuity and supplementary contract surrenders and withdrawals	(59)	(107)
Universal life deposits and interest	30	27
Universal life surrenders	(26)	(27)
Purchase of treasury stock	(44)	(1)
Dividends paid to shareholders	(74)	(70)

Decrease in collateral from securities lending	0	(119)
Redemption of securities lending collateral	0	119
Net cash used in financing activities	**(86)**	**(44)**
Net increase in cash and cash equivalents	78	78
Cash and cash equivalents at beginning of period	234	277
Cash and cash equivalents at end of period	**$ 312**	**$ 355**

See accompanying notes to Consolidated Financial Statements. See Note 14 for supplemental cash flow information.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1. Nature of Operations

Erie Indemnity Company (Indemnity) is a publicly held Pennsylvania business corporation that since 1925 has been the managing Attorney-in-Fact for the subscribers (policyholders) of Erie Insurance Exchange (Exchange). The Exchange is a subscriber (policyholder) owned Pennsylvania-domiciled reciprocal insurer that writes property and casualty insurance.

Indemnity s primary function is to perform certain services for the Exchange relating to sales, underwriting and issuance of policies on behalf of the Exchange. This is done in accordance with a subscriber s agreement (a limited power of attorney) executed by each subscriber (policyholder), appointing Indemnity as their common attorney-in-fact to transact business on their behalf and to manage the affairs of the Exchange. Indemnity earns a management fee from the Exchange for these services, which is paid from the premiums collected from subscribers (policyholders).

Indemnity also operates as a property and casualty insurer through its wholly-owned subsidiaries, Erie Insurance Company (EIC), Erie Insurance Company of New York (ENY) and the Erie Insurance Property and Casualty Company (EPC).

The Property and Casualty Group refers to the Exchange and its wholly-owned subsidiary, Flagship City Insurance Company (Flagship) and Indemnity s wholly-owned subsidiaries. The Property and Casualty Group operates in 11 Midwestern, Mid-Atlantic and Southeastern states and the District of Columbia and primarily writes personal auto insurance, which comprised 48% of its 2009 direct premiums.

Erie Family Life Insurance Company (EFL) is an affiliated life insurance company that underwrites and sells nonparticipating individual and group life insurance policies and fixed annuities. Indemnity and Exchange own 21.6% and 78.4% of EFL, respectively.

Indemnity shareholder interest refers to the interest in Erie Indemnity Company owned by the Class A and Class B shareholders. In addition to referring to Erie Insurance Exchange, the term Exchange sometimes refers to the noncontrolling interest held for the benefit of the subscribers (policyholders) and includes its interests in Flagship and EFL.

The accompanying consolidated financial statements of Erie Indemnity Company reflect the consolidated results of Indemnity and its variable interest entity, the Exchange, which we refer to collectively as Erie Insurance Group .

Note 2. Significant Accounting Policies

Basis of presentation and principles of consolidation

The accompanying consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles (GAAP) and include the accounts of Indemnity together with its affiliate companies in which Indemnity holds a majority voting or economic interest. In addition, we consolidate the Exchange as a variable interest entity for which Indemnity is the primary beneficiary. All intercompany accounts and transactions have been eliminated in consolidation. The required presentation of noncontrolling interests is reflected in the consolidated financial statements. Noncontrolling interests represent the ownership interests of the Exchange, all of which is held by parties other than Indemnity (i.e. the Exchange s subscribers (policyholders)). Noncontrolling interests also include the Exchange subscribers 78.4% ownership interest in EFL. See the discussion Retrospective adoption of new accounting principle that follows for additional consolidation information.

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. 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 three month period ended September 30, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010. For further information, refer to the consolidated financial statements and footnotes for the year ended December 31, 2009 included in our Form 8-K as filed with the Securities and Exchange Commission on May 6, 2010.

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Presentation of assets and liabilities While the assets of the Exchange are presented separately in the Consolidated Statements of Financial Position, the Exchange s assets can only be used to satisfy the Exchange s liabilities or for other unrestricted activities. Accounting Standards Codification (ASC) 810, *Consolidation,* does not require separate presentation of the Exchange s assets. However, because the shareholders of Indemnity have no rights to the assets of the Exchange and, conversely, the Exchange has no rights to the assets of Indemnity, we have presented the invested assets of the Exchange separately on the Consolidated Statements of Financial Position along with the remaining consolidated assets reflecting the Exchange s portion parenthetically. Liabilities are required under ASC 810, *Consolidation,* to be presented separately for the Exchange on the Consolidated Statements of Financial Position as the Exchange s creditors do not have recourse to the general credit of Indemnity.

Rights of shareholders of Indemnity and subscribers (policyholders) of the Exchange The shareholders of Indemnity, through the management fee, have a controlling financial interest in the Exchange; however, they have no other rights to or obligations arising from assets and liabilities of the Exchange. The shareholders of Indemnity own its equity but have no rights or interest in the Exchange s (noncontrolling interest) income or equity. The noncontrolling interest equity represents the Exchange s equity held for the benefit of its subscribers (policyholders), who have no rights or interest in the Indemnity shareholder interest income or equity.

All intercompany assets, liabilities, revenues and expenses between Indemnity and the Exchange have been eliminated in the Consolidated Statements of Financial Position.

Retrospective adoption of new accounting principle

On June 12, 2009, the Financial Accounting Standards Board (FASB) updated ASC 810, *Consolidation*, which amended the existing guidance for determining whether an enterprise is the primary beneficiary of a variable interest entity (VIE). As of January 1, 2010, Indemnity adopted the new accounting principle on a retrospective basis since inception.

This guidance changed the methodology for assessing whether an enterprise is the primary beneficiary of a VIE by requiring a qualitative analysis to determine if an enterprise s variable interest gives it a controlling financial interest. The qualitative analysis looks at the power to direct activities of the VIE that most significantly impact economic performance and the right to receive benefits (or obligation to absorb losses) from the VIE that could potentially be significant.

In accordance with the new accounting guidance, Indemnity is deemed to be the primary beneficiary of the Exchange given the significance of the management fee to the Exchange and Indemnity s power to direct the Exchange s significant activities. Under the previously issued accounting guidance, Indemnity was not deemed the primary beneficiary of the Exchange and its financial position and operating results were not consolidated with Indemnity s. Following adoption of the new accounting guidance, as primary beneficiary of the Exchange, Erie Indemnity Company has consolidated Indemnity and the Exchange s financial position and operating results.

Furthermore, upon consolidation of the Exchange, 100% of the ownership of EFL resides within the consolidated entity and consequently EFL s financial results are also consolidated. The financial statements and notes to the financial statements presented herein have all been adjusted to reflect the retrospective adoption of the new accounting principle.

There was no cumulative effect to Indemnity s shareholders equity from consolidation of the Exchange and EFL. The noncontrolling interest in total equity represents the amount of the Exchange s subscribers (policyholders) equity.

Recent Accounting Updates

In January 2010, the FASB issued Accounting Standards Update (ASU) 2010-06, *Improving Disclosures about Fair Value Measurements.* This guidance updated the disclosures for FASB ASC 820, *Fair Value Measurements and Disclosures.* The additional disclosures include the amounts and reasons for significant transfers between the levels in the fair value hierarchy, the expansion of fair market disclosures by each class of assets, disclosure of the policy for recognition of level transfers, and disclosure of the valuation techniques used for all Level 2 and Level 3 assets. These disclosures are effective for periods beginning after December 15, 2009 and have been included in Note 6. An additional disclosure requirement to present purchases, sales, issuances, and settlements of Level 3 activity on a gross basis becomes effective with periods beginning after December 15, 2010.

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Note 3. Earnings Per Share

Basic earnings per share is 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 is 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 and awards not yet vested related to the outside directors stock compensation plan.

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

(dollars in millions, except share data)	Indemnity Earnings Per Share Calculation Three months ended September 30, 2010			2009		
	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount
Class A Basic EPS:						
Income available to Class A stockholders	$ 54	50,499,551	$ 1.05	$ 40	51,252,693	$ 0.77
Dilutive effect of stock awards	0	14,359		0	20,807	
Assumed conversion of Class B shares	0	6,110,400		0	6,110,400	
Class A Diluted EPS:						
Income available to Class A stockholders on Class A equivalent shares	$ 54	56,624,310	$ 0.94	$ 40	57,383,900	$ 0.69
Class B Basic and diluted EPS:						
Income available to Class B stockholders	$ 0	2,546	$ 150.87	$ 0	2,546	$ 112.06

(dollars in millions, except share data)	Indemnity Earnings Per Share Calculation Nine months ended September 30, 2010			2009		
	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount	Allocated net income (numerator)	Weighted Shares (denominator)	Per-share amount
Class A Basic EPS:						
Income available to Class A stockholders	$ 149	50,897,035	$ 2.92	$ 83	51,255,234	$ 1.62

Dilutive effect of stock awards	0	14,359		0	20,807	
Assumed conversion of Class B shares	1	6,110,400		1	6,117,600	
Class A Diluted EPS:						
Income available to Class A stockholders on Class A equivalent shares	$ 150	57,021,794	$ 2.62	$ 84	57,393,641	$ 1.46
Class B Basic and diluted EPS:						
Income available to Class B stockholders	$ 1	2,546	$ 421.91	$ 1	2,549	$ 239.96

Included in the diluted earnings per share calculations for the third quarters of 2010 and 2009, respectively, were 7,959 and 9,607 shares of awards not yet vested related to our outside directors stock compensation plan, and 6,400 and 11,200 shares of other stock-based awards not yet vested.

Note 4. Variable Interest Entity

Exchange

The Exchange is a reciprocal insurance exchange domiciled in Pennsylvania, for which Indemnity serves as attorney-in-fact. Indemnity holds a variable interest in the Exchange because of the absence of decision-making capabilities by the equity owners (i.e. subscribers (policyholders)) of the Exchange and because of the significance of the management fees the Exchange pays to Indemnity as the decision maker. The new accounting guidance, which we adopted on January 1, 2010, requires entities to perform a qualitative analysis to determine the primary beneficiary of variable interest entities. As a result of adopting the new guidance, Indemnity is deemed to have a controlling financial interest in the Exchange and is considered the primary beneficiary. The Exchange s results have been consolidated with those of Indemnity. We have retrospectively applied the new accounting guidance and have consolidated the Exchange for all periods presented in this report for comparability purposes. See Note 2.

Consolidation of the Exchange is required given the significance of the management fee to the Exchange and because Indemnity has the power to direct the activities of the Exchange that most significantly impact the Exchange s economic performance. Indemnity earns management fee revenues from the Exchange for services provided as attorney-in-fact for the Exchange. Indemnity s management fee revenues are based on the direct written premiums of the Exchange and the other members of the Property and Casualty Group. Indemnity s Board of Directors determines the management fee rate paid by the Exchange to Indemnity. This rate cannot exceed 25% of the direct and affiliated assumed written premiums of the Exchange, as defined by the subscriber agreement signed by each policyholder. The management fee revenues and management fee expenses are eliminated in consolidation.

Indemnity participates in the underwriting results of the Exchange through the pooling arrangement in which its insurance subsidiaries have a 5.5% participation. If the Exchange were to default, Indemnity s insurance subsidiaries would be liable for the policies that they wrote directly. Indemnity s property and casualty insurance subsidiaries wrote approximately 16% of the 2009 direct written premiums of the Property and Casualty Group. Indemnity s Board of Directors determines the continuation and participation percentage of Indemnity s property and casualty subsidiaries in the reinsurance pooling arrangement.

Indemnity has no obligation related to any underwriting and/or investment losses experienced by the Exchange. Indemnity would however be adversely impacted if the Exchange incurred significant underwriting and/or investment losses. If the surplus of the Exchange were to decline significantly from its current level, its financial strength ratings could be reduced and as a consequence the Exchange could find it more difficult to retain its existing business and attract new business. A decline in the business of the Exchange would have an adverse effect on the amount of the management fees Indemnity receives and the underwriting results of the Property and Casualty Group in which Indemnity has a 5.5% participation. In addition, a decline in the surplus of the Exchange from its current level may impact the management fee rate received by Indemnity. Indemnity also has an exposure to a concentration of credit risk related to the unsecured receivables due from the Exchange for its management fee, reinsurance recoverables from unpaid losses and loss expenses and unearned premium balances ceded under the pooling arrangement and cost reimbursements.

Indemnity has not provided financial or other support to the Exchange for the reporting periods presented. At September 30, 2010, there are no explicit or implicit arrangements that would require Indemnity to provide future financial support to the Exchange. Indemnity is not liable if the Exchange was to be in violation of its debt covenants or was unable to meet its obligation for unfunded commitments to limited partnerships.

Note 5. Segment Information

As a result of the changes in our reporting entity at January 1, 2010 (see Note 2), our reportable segments have increased from three to four. Our reportable segments include management operations, property and casualty insurance operations, life insurance operations and investment operations. The segment information presented below includes reclassification of all comparative prior period segment information. Accounting policies for segments are the same as those described in the summary of significant accounting policies. For further information, refer to the consolidated financial statements and footnotes for the year ended December 31, 2009 included in our Form 8-K as filed with the Securities and Exchange Commission on May 6, 2010. Assets are not allocated to the segments but rather are reviewed in total for purposes of decision-making. No single customer or agent provides 10% or more of revenues.

Our management operations segment reflects the results of serving as attorney-in-fact for the Exchange. Indemnity operates in this capacity solely for the Exchange. We evaluate profitability of our management operations segment principally on the gross margin from management operations.

Indemnity earns management fees from the Exchange for providing sales, underwriting and policy issuance services. The management fee revenue, which is eliminated in consolidation, is calculated as a percentage of the direct written premium of the Property and Casualty Group. The Exchange issues policies with annual terms only. Management fees are recorded upon policy issuance or renewal, as substantially all of the services required to be performed by Indemnity have been satisfied at that time. Certain activities are performed and related costs are incurred by Indemnity subsequent to policy issuance in connection with the services provided to the Exchange; however, these activities are inconsequential and perfunctory. Although these management fee revenues and expenses are eliminated in consolidation, the amount of the fee directly impacts allocations of our consolidated net income between noncontrolling interest, which bears the management fee expense and represents the interests of the Exchange subscribers, and Indemnity s interests, which earns the management fee revenue and represents Indemnity shareholder interest in net income.

Our property and casualty insurance operations segment includes personal and commercial lines of business. Personal lines consist primarily of personal auto and homeowners and are marketed to individuals. Commercial lines consist primarily of commercial multi-peril, commercial auto and workers compensation and are marketed to small and medium-sized businesses. Our property and casualty policies are sold by independent agents. Our property and casualty insurance underwriting operations are conducted through Indemnity subsidiaries and the Exchange and its subsidiaries, and include assumed voluntary reinsurance from nonaffiliated domestic and foreign sources, assumed involuntary and ceded reinsurance business. The Exchange exited the assumed voluntary reinsurance business effective December 31, 2003, and therefore unaffiliated reinsurance includes only run-off activity of the previously assumed voluntary reinsurance business. We evaluate profitability of the property and casualty operations principally based on net underwriting results represented by the combined ratio.

Our life insurance operations segment includes traditional and universal life insurance products and fixed annuities marketed to individuals using the same independent agency force utilized by our property and casualty operations. We evaluate profitability of the life insurance operations segment principally based on segment net income, including investments, which for segment purposes are reflected in the investment operations segment. At the same time, we recognize that investment-related income is integral to the evaluation of the life insurance segment because of the long duration of life products. For the third quarter 2010 and 2009, investment activities on life insurance-related assets generated revenues of $27 million and $19 million, respectively, resulting in EFL reporting income before income taxes of $16 million and $8 million, respectively, before intercompany eliminations. For the nine months ended September 30, 2010 and 2009, investment activities on life insurance and related assets generated revenues of $79 million and $45 million, respectively, resulting in EFL reporting income before taxes of $37 million and $8 million, respectively, before intercompany eliminations. See Note 15 for EFL supplemental information.

The investment operations segment performance is evaluated based on appreciation of assets, rate of return and overall return. Investment-related income for the life operations is included in the investment segment results.

The following tables summarize the components of the Consolidated Statements of Operations by reportable business segments:

	Erie Insurance Group For the three months ended September 30, 2010					
(in millions)	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations	Eliminations	Consolidated
Premiums earned/life policy revenue		$ 990	$ 16		$ (1)	$ 1,005
Net investment income				$ 113	(3)	110
Net realized investment gains				205		205
Net impairment losses recognized in earnings				0		0
Equity in earnings of limited partnerships				28		28

Management fee revenue	$ 266				(266)	
Service agreement and other revenue	9		0			9
Total revenues	275	990	16	346	(270)	1,357
Cost of management operations	217				(217)	
Insurance losses and loss expenses		690			(1)	689
Benefits and other changes in policy reserves			21			21
Policy acquisition and underwriting expense		288	6		(52)	242
Total benefits and expenses	217	978	27		(270)	952
Income (loss) before income taxes	58	12	(11)	346		405
Provision (benefit) for income taxes	22	4	(4)	108		130
Net income (loss)	$ 36	$ 8	$ (7)	$ 238	$	$ 275

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Erie Insurance Group
For the three months ended September 30, 2009

(in millions)	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations[1]	Eliminations	Consolidated
Premiums earned/life policy revenue		$ 964	$ 14		$ (1)	$ 977
Net investment income				$ 105	(3)	102
Net realized investment gains				251		251
Net impairment losses recognized in earnings				(16)		(16)
Equity in losses of limited partnerships				(37)		(37)
Management fee revenue	$ 253				(253)	
Service agreement and other revenue	9		0			9
Total revenues	262	964	14	303	(257)	1,286
Cost of management operations	214				(214)	
Insurance losses and loss expenses		613			(1)	612
Benefits and other changes in policy reserves			19			19
Policy acquisition and underwriting expense		335	6		(42)	299
Total benefits and expenses	214	948	25		(257)	930
Income (loss) before income taxes	48	16	(11)	303		356
Provision (benefit) for income taxes	24	6	(4)	78		104
Net income (loss)	$ 24	$ 10	$ (7)	$ 225	$	$ 252

Erie Insurance Group
For the nine months ended September 30, 2010

	Property and casualty	Life

(in millions)	Management operations	insurance operations	insurance operations	Investment operations	Eliminations	Consolidated
Premiums earned/life policy revenue		$ 2,926	$ 48		$ (2)	$ 2,972
Net investment income				$ 330	(8)	322
Net realized investment gains				117		117
Net impairment losses recognized in earnings				(6)		(6)
Equity in earnings of limited partnerships				58		58
Management fee revenue	$ 773				(773)	
Service agreement and other revenue	26		0			26
Total revenues	799	2,926	48	499	(783)	3,489
Cost of management operations	626				(626)	
Insurance losses and loss expenses		2,145			(4)	2,141
Benefits and other changes in policy reserves			67			67
Policy acquisition and underwriting expense		829	23		(153)	699
Total benefits and expenses	626	2,974	90		(783)	2,907
Income (loss) before income taxes	173	(48)	(42)	499		582
Provision (benefit) for income taxes	61	(17)	(15)	147		176
Net income (loss)	$ 112	$ (31)	$ (27)	$ 352	$	$ 406

	Erie Insurance Group For the nine months ended September 30, 2009					
(in millions)	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations[1]	Eliminations	Consolidated
Premiums earned/life policy revenue		$ 2,852	$ 48		$ (2)	$ 2,898
Net investment income				$ 332	(8)	324
Net realized investment gains				304		304
Net impairment losses recognized in earnings				(99)		(99)
Equity in losses of limited partnerships				(324)		(324)
Management fee revenue	$ 742				(742)	
Service agreement and other revenue	26		1			27
Total revenues	768	2,852	49	213	(752)	3,130
Cost of management operations	615				(615)	
Insurance losses and loss expenses		2,033			(4)	2,029
Benefits and other changes in policy reserves			65			65
Policy acquisition and underwriting expense		874	21		(133)	762
Total benefits and expenses	615	2,907	86		(752)	2,856
Income (loss) before income taxes	153	(55)	(37)	213		274
Provision (benefit) for income taxes	54	(19)	(13)	(20)		2
Net income (loss)	$ 99	$ (36)	$ (24)	$ 233	$	$ 272

(1) The significant realized losses, impairment charges and market value

adjustments on limited partnership investments were impacted by the significant disruption in the financial markets.

See the Results of the Erie Insurance Group s operations by interest table in the Management s Discussion and Analysis for the composition of income attributable to Indemnity and income attributable to the noncontrolling interest (Exchange).

Note 6. Fair Value

Our available-for-sale and trading securities are recorded at fair value, which is the price that would be received to sell the asset in an orderly transaction between willing market participants as of the measurement date.

Valuation techniques used to derive the 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 fair market value for these securities. Although the majority of our prices are obtained from third party sources, we also perform an internal pricing review for securities with low trading volumes in the current market conditions. Financial instruments are categorized based upon the following characteristics or inputs to the valuation techniques:

Level 1	Quoted prices for identical instruments in active markets not subject to adjustments or discounts.
Level 2	Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.
Level 3	Instruments whose significant value drivers are unobservable and reflect management s estimate of fair value based on assumptions used by market participants in an orderly transaction as of the valuation date.

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The following table represents the fair value measurements on a recurring basis for our consolidated available-for-sale and trading securities by asset class and level of input at September 30, 2010:

		Erie Insurance Group September 30, 2010 Fair value measurements using:		
(in millions)	Total	Quoted prices in active markets for identical assets Level 1	Significant observable inputs Level 2	Significant unobservable inputs Level 3
Indemnity				
Available for sale securities:				
Fixed maturities				
U.S. treasuries and government agencies	$ 6	$ 4	$ 2	$ 0
U.S. government sponsored enterprises	13	0	13	0
Municipal securities	263	0	263	0
U.S. corporate debt non-financial	180	0	180	0
U.S. corporate debt financial	149	0	147	2
Foreign corporate debt non-financial	29	0	29	0
Foreign corporate debt financial	25	0	25	0
Structured securities:				
Asset-backed securities auto loans	2	0	2	0
Collateralized debt obligations	10	0	3	7
Commercial mortgage-backed	4	0	4	0
Residential mortgage-backed:				
Government sponsored enterprises	11	0	11	0
Non-government sponsored enterprises	3	0	3	0
Total fixed maturities Indemnity	$ 695	$ 4	$ 682	$ 9
Equity securities				
U.S. nonredeemable preferred securities:				
Financial	$ 27	$ 7	$ 18	$ 2
Non-financial	14	6	8	0
Foreign nonredeemable preferred securities:				
Financial	4	0	4	0
Non-financial	1	0	1	0
Total equity securities Indemnity	$ 46	$ 13	$ 31	$ 2
Total available-for-sale securities Indemnity	$ 741	$ 17	$ 713	$ 11
Trading securities:				
Common stock	$ 26	$ 26	$ 0	$ 0

Total trading securities	$ 26	$ 26	$ 0	$ 0
Total Indemnity	$ 767	$ 43	$ 713	$ 11

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	Erie Insurance Group September 30, 2010 Fair value measurements using:			
(in millions)	Total	Quoted prices in active markets for identical assets Level 1	Significant observable inputs Level 2	Significant unobservable inputs Level 3
Exchange				
Available for sale securities:				
Fixed maturities				
U.S. treasuries and government agencies	$ 6	$ 5	$ 1	$ 0
U.S. government sponsored enterprises	62	0	62	0
Foreign government	21	0	21	0
Municipal securities	1,445	0	1,445	0
U.S. corporate debt non-financial	2,347	6	2,332	9
U.S. corporate debt financial	1,828	6	1,822	0
Foreign corporate debt non-financial	449	0	449	0
Foreign corporate debt financial	390	0	390	0
Structured securities:				
Asset-backed securities auto loans	39	0	39	0
Asset-backed securities other	29	0	24	5
Collateralized debt obligations	79	0	37	42
Commercial mortgage-backed	95	0	95	0
Residential mortgage-backed:				
Government sponsored enterprises	201	0	201	0
Non-government sponsored enterprises	28	0	28	0
Total fixed maturities Exchange	$ 7,019	$ 17	$ 6,946	$ 56
Equity securities				
U.S. nonredeemable preferred securities:				
Financial	$ 349	$ 97	$ 247	$ 5
Non-financial	132	47	85	0
Government sponsored enterprises	0	0	0	0
Foreign nonredeemable preferred securities:				
Financial	48	16	32	0
Non-financial	9	0	9	0
Total equity securities Exchange	$ 538	$ 160	$ 373	$ 5
Total available for sale securities Exchange	$ 7,557	$ 177	$ 7,319	$ 61
Trading securities:				
Common stock	$ 1,985	$ 1,974	$ 0	$ 11

Total trading securities	$ 1,985	$ 1,974	$ 0	$ 11
Total Exchange	$ 9,542	$ 2,151	$ 7,319	$ 72
Total Erie Insurance Group	$ 10,309	$ 2,194	$ 8,032	$ 83

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Level 3 Assets Quarterly Change:

	Erie Insurance Group					
(in millions)	Beginning balance at June 30, 2010	Included in earnings(1)	Included in other comprehensive income	Purchases, sales and adjustments	Transfers in and (out) of Level 3 (2)	Ending balance at September 30, 2010
Indemnity						
Available-for-sale securities:						
Fixed maturities:						
U.S. corporate debt financial	$ 2	$ 0	$ 0	$ 0	$ 0	$ 2
Collateralized debt obligations	8	0	0	0	(1)	7
Total fixed maturities	10	0	0	0	(1)	9
Preferred stock:						
U.S. nonredeemable financial	1	0	0	1	0	2
Total preferred stock	1	0	0	1	0	2
Total Level 3 assets Indemnity	$ 11	$ 0	$ 0	$ 1	$ (1)	$ 11
Exchange						
Available-for-sale securities:						
Fixed maturities:						
U.S. corporate debt non-financial	$ 9	$ 0	$ 0	$ 0	$ 0	$ 9
Asset backed securities other	5	0	0	0	0	5
Collateralized debt obligations	53	0	0	(1)	(10)	42
Total fixed maturities	67	0	0	(1)	(10)	56
Preferred stock:						
U.S. nonredeemable financial	4	0	0	1	0	5
Total preferred stock	4	0	0	1	0	5
Trading securities:						

Common stock	10	1	0	0	0	11
Total Level 3 assets Exchange	$ 81	$ 1	$ 0	$ 0	$ (10)	$ 72
Total Level 3 assets Erie Insurance Group	$ 92	$ 1	$ 0	$ 1	$ (11)	$ 83

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Level 3 Assets Year-to-Date Change:

	Erie Insurance Group					
(in millions)	Beginning balance at December 31, 2009	Included in earnings[1]	Included in other comprehensive income	Purchases, sales and adjustments	Transfers in and (out) of Level 3 [2]	Ending balance at September 30, 2010
Indemnity						
Available-for-sale securities:						
Fixed maturities:						
U.S. corporate debt financial	$ 2	$ 0	$ 0	$ 0	$ 0	$ 2
Collateralized debt obligations	8	0	0	0	(1)	7
Total fixed maturities	10	0	0	0	(1)	9
Preferred stock:						
U.S. nonredeemable financial	1	0	0	1	0	2
Total preferred stock	1	0	0	1	0	2
Total Level 3 assets Indemnity	$ 11	$ 0	$ 0	$ 1	$ (1)	$ 11
Exchange						
Available-for-sale securities:						
Fixed maturities:						
U.S. corporate debt non-financial	$ 17	$ 0	$ 0	$ 0	$ (8)	$ 9
Asset backed securities other	5	0	0	0	0	5
Collateralized debt obligations	49	2	4	0	(13)	42
Total fixed maturities	71	2	4	0	(21)	56
Preferred stock:						
U.S. nonredeemable financial	4	0	1	0	0	5
Total preferred stock	4	0	1	0	0	5
Trading securities:						
Common stock	9	2	0	0	0	11

Total Level 3 assets Exchange	$	84	$	4	$	5	$	0	$	(21)	$	72
Total Level 3 assets Erie Insurance Group	$	95	$	4	$	5	$	1	$	(22)	$	83

(1) Includes losses as a result of other-than-temporary impairments and accrual of discount and amortization of premium. These amounts are reported in the Consolidated Statement of Operations. There were no unrealized gains or losses included in earnings for the three or nine months ended September 30, 2010 on Level 3 securities.

(2) Transfers in and out of Level 3 are attributable to changes in the availability of market observable information for individual securities within the respective categories. There were no significant transfers in and out of Level 3. Transfers in and out of levels are recognized at the end of the period.

There were no significant transfers between Levels 1 and 2 during the nine months ended September 30, 2010.

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The following table represents the fair value measurements on a recurring basis for our consolidated available-for-sale and trading securities by asset class and level of input at December 31, 2009:

	Erie Insurance Group At December 31, 2009 Fair value measurements using:			
(in millions)	Total	Quoted prices in active markets for identical assets Level 1	Significant observable inputs Level 2	Significant unobservable inputs Level 3
Indemnity				
Available-for-sale securities:				
Fixed maturities	$ 664	$ 6	$ 648	$ 10
Preferred stock	38	9	28	1
Trading securities common stock	42	42	0	0
Total Indemnity	$ 744	$ 57	$ 676	$ 11
Exchange				
Available-for-sale securities:				
Fixed maturities	$ 6,517	$ 31	$ 6,415	$ 71
Preferred stock	472	157	311	4
Trading securities common stock	1,835	1,826		