

ERIE INDEMNITY CO  
Form 10-Q  
November 05, 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 September 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 October 22, 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 October 22, 2008.

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ERIE INDEMNITY COMPANY

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PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

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

	September 30, 2008 (Unaudited)	December 31, 2007
<b>Assets</b>		
Investments		
Available-for-sale securities, at fair value:		
Fixed maturities (amortized cost of \$617,244 and \$702,488, respectively)	\$ 596,728	\$ 703,406
Equity securities (cost of \$74,841 and \$204,005, respectively)	68,868	218,270
Trading securities, at fair value (cost of \$79,021)	74,506	0
Limited partnerships (cost of \$263,831 and \$235,886, respectively)	311,969	292,503
Real estate mortgage loans	1,237	4,556
<b>Total investments</b>	<b>1,053,308</b>	<b>1,218,735</b>
Cash and cash equivalents	18,158	31,070
Accrued investment income	9,831	9,713
Premiums receivable from policyholders	261,020	243,612
Federal income taxes recoverable	0	1,451
Deferred income taxes	14,594	0
Reinsurance recoverable from Erie Insurance Exchange on unpaid losses and loss adjustment expenses	802,315	833,554
Ceded unearned premiums to Erie Insurance Exchange	118,455	110,524
Note receivable from Erie Family Life Insurance	25,000	25,000
Other receivables due from Erie Insurance Exchange and affiliates	240,205	208,752
Reinsurance recoverable from non-affiliates	2,277	2,323
Deferred policy acquisition costs	17,113	16,129
Equity in Erie Family Life Insurance	42,264	59,046
Securities lending collateral	14,890	30,370
Pension plan asset	43,968	32,460
Other assets	71,528	55,884
<b>Total assets</b>	<b>\$ 2,734,926</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)

	September 30, 2008 (Unaudited)	December 31, 2007
<b>Liabilities and shareholders equity</b>		
<b>Liabilities</b>		
Unpaid losses and loss adjustment expenses	\$ 995,603	\$ 1,026,531
Unearned premiums	445,831	421,263
Commissions payable	135,267	122,473
Agent bonuses	58,821	94,458
Securities lending collateral	14,890	30,370
Bank line of credit	30,000	0
Accounts payable and accrued expenses	54,971	41,057
Deferred executive compensation	16,718	23,499
Deferred income taxes	0	14,598
Federal income taxes payable	452	0
Dividends payable	22,774	23,637
Employee benefit obligations	25,816	29,458
<b>Total liabilities</b>	<b>1,801,143</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; 51,376,513 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	(26,856)	10,048
Retained earnings, before cumulative effect adjustment	1,747,050	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	1,758,241	1,740,174
Total contributed capital and retained earnings	1,741,385	1,760,222
Treasury stock, at cost, 16,901,087 and 14,938,663 shares, respectively	(807,602)	(708,943)
<b>Total shareholders equity</b>	<b>933,783</b>	<b>1,051,279</b>

<b>Total liabilities and shareholders equity</b>	<b>\$ 2,734,926</b>	<b>\$ 2,878,623</b>
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See accompanying notes to Consolidated Financial Statements.

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## ERIE INDEMNITY COMPANY

## CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(dollars in thousands, except per share data)

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
<b>OPERATING REVENUE</b>				
Management fee revenue, net	\$ 234,120	\$ 232,089	\$ 692,737	\$ 690,432
Premiums earned	52,057	51,892	155,719	155,988
Service agreement revenue	8,340	7,470	23,480	22,186
<b>Total operating revenue</b>	<b>294,517</b>	<b>291,451</b>	<b>871,936</b>	<b>868,606</b>
<b>OPERATING EXPENSES</b>				
Cost of management operations	195,297	200,913	577,754	576,768
Losses and loss adjustment expenses incurred	37,185	30,766	104,768	92,789
Policy acquisition and other underwriting expenses	12,311	13,090	36,592	36,779
<b>Total operating expenses</b>	<b>244,793</b>	<b>244,769</b>	<b>719,114</b>	<b>706,336</b>
<b>INVESTMENT (LOSS) INCOME</b>				
<b>UNAFFILIATED</b>				
Investment income, net of expenses	10,218	12,233	33,357	40,350
Net realized (losses) gains on investments	(41,356)	3,438	(80,202)	7,550
Equity in earnings of limited partnerships	1,057	14,169	20,310	46,867
<b>Total investment (loss) income unaffiliated</b>	<b>(30,081)</b>	<b>29,840</b>	<b>(26,535)</b>	<b>94,767</b>
Income before income taxes and equity in (losses) earnings of Erie Family Life Insurance				
Provision for income taxes	6,011	23,669	40,550	79,767
Equity in (losses) earnings of Erie Family Life Insurance, net of tax	(9,384)	643	(10,197)	3,074
<b>Net income</b>	<b>\$ 4,248</b>	<b>\$ 53,496</b>	<b>\$ 75,540</b>	<b>\$ 180,344</b>
<b>Net income per share:</b>				
Class A common stock basic	\$ 0.08	\$ 0.97	\$ 1.45	\$ 3.17
<b>Class A common stock diluted</b>	<b>0.07</b>	<b>0.87</b>	<b>1.30</b>	<b>2.87</b>
Class B common stock basic and diluted	15.92	145.92	216.59	482.27

**Weighted average shares outstanding****basic:**

Class A common stock	51,376,513	55,183,547	51,984,203	56,727,315
Class B common stock	2,551	2,559	2,551	2,568

**Weighted average shares outstanding****diluted:**

Class A common stock	57,533,591	61,370,219	58,141,281	62,935,587
Class B common stock	2,551	2,559	2,551	2,568

**Dividends declared per share:**

Class A common stock	\$ 0.44	\$ 0.40	\$ 1.32	\$ 1.20
Class B common stock	66.00	60.00	198.00	180.00

See accompanying notes to Consolidated Financial Statements.

## ERIE INDEMNITY COMPANY

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

(dollars in thousands)

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
<b>Accumulated other comprehensive income</b>				
Balance, beginning of period	\$ (8,543)	\$ (1,359)	\$ 10,048	\$ 5,422
Adjustment to opening balance, net of tax*	0	0	(11,191)	0
Adjusted balance, beginning of period	(8,543)	(1,359)	(1,143)	5,422
Gross unrealized (losses) gains arising during period	(66,105)	1,049	(98,040)	(5,272)
Less: reclassification adjustment for gross realized losses (gains) included in net income	37,932	(3,438)	58,482	(7,550)
Change in comprehensive loss, before tax	(28,173)	(2,389)	(39,558)	(12,822)
Income tax benefit related to items of other comprehensive loss	9,860	836	13,845	4,488
Change in other comprehensive (loss) income, net of tax	(18,313)	(1,553)	(25,713)	(8,334)
<b>Balance, end of period</b>	<b>\$ (26,856)</b>	<b>\$ (2,912)</b>	<b>\$ (26,856)</b>	<b>\$ (2,912)</b>
<b>Comprehensive (loss) income</b>				
Net income	\$ 4,248	\$ 53,496	\$ 75,540	\$ 180,344
Net change in accumulated other comprehensive (loss) income	(18,313)	(1,553)	(25,713)	(8,334)
<b>Total comprehensive (loss) income</b>	<b>\$ (14,065)</b>	<b>\$ 51,943</b>	<b>\$ 49,827</b>	<b>\$ 172,010</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.

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## ERIE INDEMNITY COMPANY

## CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(dollars in thousands)

	Nine months ended September 30,	
	2008	2007
<b>Cash flows from operating activities</b>		
Management fee received	\$ 660,047	\$ 682,700
Service agreement fee received	23,880	22,686
Premiums collected	157,813	157,214
Settlement of commutation received from Exchange	0	6,782
Net investment income received	38,318	40,811
Limited partnership distributions	21,738	66,149
Salaries and wages paid	(81,030)	(80,986)
Pension contribution and employee benefits paid	(36,972)	(30,639)
Commissions paid to agents	(326,940)	(325,963)
Agent bonuses paid	(94,855)	(91,758)
General operating expenses paid	(77,859)	(64,586)
Interest paid on bank line of credit	(953)	
Losses paid	(88,748)	(85,735)
Loss adjustment expenses paid	(15,765)	(16,002)
Other underwriting and acquisition costs paid	(42,474)	(39,673)
Income taxes paid	(56,360)	(61,552)
<b>Net cash provided by operating activities</b>	<b>79,840</b>	<b>179,448</b>
<b>Cash flows from investing activities</b>		
Purchase of investments:		
Fixed maturities	(141,641)	(129,098)
Preferred stock	(31,343)	(41,840)
Common stock	(55,894)	(64,424)
Limited partnerships	(44,702)	(68,319)
Sales/maturities of investments:		
Fixed maturity sales	121,966	177,363
Fixed maturity calls/maturities	80,088	71,427
Preferred stock	35,560	66,038
Common stock	72,508	68,406
Sale and return of limited partnerships	20,368	7,723
(Purchase) disposal of property and equipment	(8,551)	100
Net distributions on agent loans	(2,924)	(5,643)
<b>Net cash provided by investing activities</b>	<b>45,435</b>	<b>81,733</b>
<b>Cash flows from financing activities</b>		
Proceeds from bank line of credit	75,000	

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Payments on bank line of credit	(45,000)	
Purchase of treasury stock	(98,659)	(219,827)
Dividends paid to shareholders	(69,528)	(69,438)
(Decrease) increase in collateral from securities lending	(15,480)	6,336
Redemption (acquisition) of securities lending collateral	15,480	(6,336)
<b>Net cash used in financing activities</b>	<b>(138,187)</b>	<b>(289,265)</b>
Net decrease in cash and cash equivalents	(12,912)	(28,084)
Cash and cash equivalents at beginning of period	31,070	60,241
<b>Cash and cash equivalents at end of period</b>	<b>\$ 18,158</b>	<b>\$ 32,157</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 nine-month period ended September 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 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.

Perpetual preferred securities and hybrid preferred securities are evaluated without considering any bond like characteristics. We believe this approach to be more conservative since the lack of a final maturity and unlikelihood of a call means recovery is uncertain and would occur over a multiyear period. If we believe we have the intent and ability to hold these types of securities until recovery we would not record an other-than-temporary impairment.

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 reclassified 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 Consolidated 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.

## 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 September 30,					
	2008			2007		
	Allocated Net Income	Weighted Shares	Per-Share Amount	Allocated Net Income	Weighted Shares	Per-Share Amount
<i>(dollars in thousands except per share data)</i>	(Numerator)	(Denominator)		(Numerator)	(Denominator)	
<b>Class A Basic EPS:</b>						
Income available to Class A stockholders	\$ 4,208	51,376,513	\$ 0.08	\$ 53,123	55,183,547	\$ 0.97
Dilutive effect of stock awards		34,678			45,072	
Assumed conversion of Class B shares	40	6,122,400		373	6,141,600	
<b>Class A Diluted EPS:</b>						
Income available to Class A stockholders on Class A equivalent shares	\$ 4,248	57,533,591	\$ 0.07	\$ 53,496	61,370,219	\$ 0.87
<b>Class B Basic and Diluted EPS:</b>						
Income available to Class B stockholders	\$ 40	2,551	\$ 15.92	\$ 373	2,559	\$ 145.92
	Nine Months Ended September 30,					
	2008			2007		
	Allocated Net Income	Weighted Shares	Per-Share Amount	Allocated Net Income	Weighted Shares	Per-Share Amount
<i>(dollars in thousands except per share data)</i>	(Numerator)	(Denominator)		(Numerator)	(Denominator)	
<b>Class A Basic EPS:</b>						
Income available to Class A stockholders	\$ 74,988	51,984,203	\$ 1.45	\$ 179,106	56,727,315	\$ 3.17
Dilutive effect of stock awards		34,678			45,072	
Assumed conversion of Class B shares	552	6,122,400		1,238	6,163,200	
<b>Class A Diluted EPS:</b>						
Income available to Class A stockholders on Class A equivalent shares	\$ 75,540	58,141,281	\$ 1.30	\$ 180,344	62,935,587	\$ 2.87
<b>Class B Basic and Diluted EPS:</b>						
Income available to Class B stockholders	\$ 552	2,551	\$ 216.59	\$ 1,238	2,568	\$ 482.27

Included in the restricted stock awards not yet vested are awards of 12,535 and 37,716 for the third quarters 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 6,143 and 7,356 for the third 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.

On October 10, 2008 the FASB issued Financial Staff Position (FSP) SFAS 157-3, Determining the Fair Value of a Financial Asset When the Market for that Asset Is Not Active. This FSP provides clarification regarding the application of SFAS 157 in a market that is not active and provides illustrations to consider in determining prices in such an environment. This FSP was effective upon issuance. We have considered the guidance provided in this FSP for securities held at September 30, 2008 that were not actively traded. The adoption of FSP SFAS 157-3 during the third quarter did not have a material effect on our results of operating financial position or liquidity.

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. Although the majority of our prices are obtained from third party sources, we performed an internal review of securities due to the current unstable market conditions to determine that inputs were observable given low trading volume on certain securities. Certain securities were downgraded to Level 3 as a result. 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 that 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:

		September 30, 2008		
		Fair value measurements using:		
		Quoted prices in active markets for identical assets	Significant observable inputs	Significant unobservable inputs
<i>(dollars in thousands)</i>	Total	Level 1	Level 2	Level 3

Available-for-sale securities:



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Fixed maturities	\$596,728	\$ 6,779	\$ 561,886	\$28,063
Preferred stock	68,868	42,594	13,096	13,178
Trading securities:				
Common stock	74,506	74,484	0	22
Total	\$740,102	\$123,857	\$ 574,982	\$41,263

## 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 for the three and nine months ended September 30, 2008:

Quarterly Change:	Net Realized/Unrealized Gains and Losses					Ending balance at September 30, 2008
	Beginning balance at June 30, 2008	Included in earnings <sup>(1)</sup>	Included in other comprehensive income	Purchases and sales, net	Transfers in and (out) of Level 3 <sup>(2)</sup>	
<i>(dollars in thousands)</i>						
Available-for-sale securities:						
Fixed maturities	\$ 9,139	\$ (651)	\$ (623)	\$ 0	\$20,198	\$28,063
Preferred stock	12,973	(1,236)	(404)	0	1,845	13,178
Trading securities:						
Common stock	21	0	1	0	0	22
Total Level 3 assets	\$22,133	\$(1,887)	\$(1,026)	\$ 0	\$22,043	\$41,263

The fixed maturities in Level 3 are primarily made up of securities in the financial services industry affected by the recent turmoil in the credit markets. The fair value of these securities breaks down as follows:

<i>(dollars in thousands)</i>	Fair Value
Corporate Debt	
Financial Services Industry	\$ 12,544
Others	5,551
Asset Backed Securities	6,137
Collateralized Mortgage Obligations	3,831
Total	\$ 28,063

Year-to-Date Change:	Net Realized/Unrealized Gains and Losses					Ending balance at September 30, 2008
	Beginning balance at December 31, 2007	Included in earnings <sup>(1)</sup>	Included in other comprehensive income	Purchases and sales, net	Transfers in and (out) of Level 3 <sup>(2)</sup>	
<i>(dollars in thousands)</i>						
Available-for-sale securities:						
Fixed maturities	\$10,941	\$(1,250)	\$ (253)	\$1,446	\$17,179	\$28,063
Preferred stock	5,858	(1,836)	(1,201)	2,000	8,357	13,178

Trading securities:						
Common stock	21	0	1	0	0	22
Total Level 3 assets	\$16,820	\$(3,086)	\$(1,453)	\$3,446	\$25,536	\$41,263

(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 September 30, 2008 on Level 3 securities.

(2) Transfers in to Level 3 would be attributable to changes in the availability of market observable information for individual securities within the respective categories.

We have no assets that were measured at fair value on a nonrecurring basis during the nine months ended September 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 31, 2007 (carrying value prior to adoption)	Cumulative effect adjustment to January 1, 2008 retained earnings	January 1, 2008 fair value (carrying value after adoption)
Common stock	\$ 108,090	\$ 17,216	\$ 108,090
Deferred tax adjustment		(6,025)	
Carrying value, net of deferred tax adjustment		\$ 11,191	

## 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 September 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>	Amortized cost	September 30, 2008 Gross unrealized gains	Gross unrealized losses	Estimated fair value
<b>Available-for-sale securities</b>				
<b>Fixed maturities</b>				
U.S. treasuries and government agencies	\$ 3,469	\$ 251	\$ 1	\$ 3,719
Foreign government	1,998	0	11	1,987
Municipal securities	212,470	206	5,511	207,165
U.S. corporate debt	296,296	1,815	15,200	282,911
Foreign corporate debt	66,782	441	2,205	65,018
Mortgage-backed securities	13,647	601	537	13,711
Asset-backed securities	12,082	24	626	11,480
Total bonds	606,744	3,338	24,091	585,991
Redeemable preferred stock	10,500	285	48	10,737
Total fixed maturities	\$ 617,244	\$ 3,623	\$ 24,139	\$ 596,728
<b>Equity securities</b>				
U.S. nonredeemable preferred stock	\$ 70,375	\$ 1,250	\$ 6,766	\$ 64,859

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Foreign nonredeemable preferred stock	4,466	0	457	4,009
Total equity securities	\$ 74,841	\$ 1,250	\$ 7,223	\$ 68,868
<b>Total available-for-sale securities</b>	<b>\$ 692,085</b>	<b>\$ 4,873</b>	<b>\$ 31,362</b>	<b>\$ 665,596</b>

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 7 INVESTMENTS (Continued)

<i>(dollars in thousands)</i>	December 31, 2007			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
<b>Available-for-sale securities</b>				
<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
<b>Total available-for-sale securities</b>	<b>\$ 906,493</b>	<b>\$ 30,739</b>	<b>\$ 15,556</b>	<b>\$ 921,676</b>

Trading securities

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

<i>(dollars in thousands)</i>	September 30, 2008			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
<b>Trading securities</b>				
U.S. common stock	\$ 54,381	\$ 5,065	\$ 7,657	\$ 51,789
Foreign common stock	24,640	1,222	3,145	22,717
Total trading securities	\$ 79,021	\$ 6,287	\$ 10,802	\$ 74,506

## 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 third quarter of 2008.

<i>(dollars in thousands)</i>	Three months ended		Nine months ended	
	September 30,		September 30,	
	2008	2007	2008	2007
<b>Available-for-sale securities:</b>				
<b>Fixed maturities</b>				
Gross realized gains	\$ 137	\$ 1,890	\$ 2,311	\$ 2,305
Gross realized losses	(775)	(523)	(1,115)	(745)
Impairment charges	(15,747)	0	(29,717)	(1,635)
Net realized (losses) gains	(16,385)	1,367	(28,521)	(75)
<b>Equity securities</b>				
Gross realized gains	2,377	7,156	5,061	15,787
Gross realized losses	(1,572)	(2,095)	(5,993)	(4,140)
Impairment charges	(21,683)	(2,990)	(32,117)	(4,022)
Net realized (losses) gains	(20,878)	2,071	(33,049)	7,625
<b>Trading securities:</b>				
<b>Common stock</b>				
Gross realized gains	3,579	0	10,275	0
Gross realized losses	(4,247)	0	(8,814)	0
Valuation adjustments	(3,425)	0	(21,721)	0
Net realized losses	(4,093)	0	(20,260)	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	\$ (41,356)	\$ 3,438	\$ (80,202)	\$ 7,550

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 7 INVESTMENTS (Continued)

Limited partnerships

For the nine months ended September 30, 2008 our equity in earnings from these partnerships as reported in the Consolidated Statements of Operations totaled 16.1% 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 September 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.

Investment percentage of partnership for Erie Insurance Group	Number of partnerships	Asset recorded	Recorded by Erie Indemnity Company as of and for the nine months ended September 30, 2008	
			(Loss) Income recognized due to valuation adjustments by the partnerships	Net income (loss) recorded
<i>(dollars in thousands)</i>				
<b>Private equity:</b>				
Less than 10%	27	\$ 89,571	(\$1,209)	\$ 8,219
Greater than or equal to 10% but less than 50%	5	6,363	(954)	1,544
Greater than or equal to 50%	1	3,984	0	(434)
Total private equity	33	99,918	(2,163)	9,329
<b>Mezzanine debt:</b>				
Less than 10%	13	36,216	1,235	1,822
Greater than or equal to 10% but less than 50%	3	14,142	835	545
Greater than or equal to 50%	1	3,678	(197)	353
Total mezzanine debt	17	54,036	1,873	2,720
<b>Real estate:</b>				
Less than 10%	19	103,749	(5,059)	8,833
Greater than or equal to 10% but less than 50%	5	30,914	225	1,067
Greater than or equal to 50%	5	23,352	1,406	2,079
Total real estate	29	158,015	(3,428)	11,979
Total limited partnerships	79	\$311,969	(\$3,718)	\$24,028





## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 7 INVESTMENTS (Continued)

Investment percentage of partnership for Erie Insurance Group	Total assets	Total liabilities	Recorded by Partnerships as of and for the nine months ended September 30, 2008	
			Income (loss) recognized due to valuation adjustments by the partnerships	Net income (loss)
			<i>(dollars in thousands)</i>	
<b>Private equity:</b>				
Less than 10%	\$22,739,440	\$ 464,542	\$ 237,477	\$ 879,315
Greater than or equal to 10% but less than 50%	516,945	1,676	30,712	9,793
Greater than or equal to 50%	10,019	29	0	(147)
Total private equity	23,266,404	466,247	268,189	888,961
<b>Mezzanine debt:</b>				
Less than 10%	5,542,704	450,403	(80,230)	168,967
Greater than or equal to 10% but less than 50%	587,674	198,595	(679)	20,303
Greater than or equal to 50%	26,693	7,056	(89)	747
Total mezzanine debt	6,157,071	656,054	(80,998)	190,017
<b>Real estate:</b>				
Less than 10%	18,888,874	7,618,453	(524,149)	427,656
Greater than or equal to 10% but less than 50%	1,462,654	768,814	(12,993)	38,550
Greater than or equal to 50%	246,289	123,705	13,625	26,067
Total real estate	20,597,817	8,510,972	(523,517)	492,273
Total limited partnerships	\$50,021,292	\$9,633,273	\$(336,326)	\$1,571,251

## 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 for Erie Insurance Group	Number of partnerships	Asset recorded	Income (loss) recognized due to valuation adjustments by the partnerships	Net income (loss) recorded
<i>(dollars in thousands)</i>				
<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 for Erie Insurance Group	Total assets	Total liabilities	Recorded by Partnerships as of and for the year ended December 31, 2007	
			Income (loss) recognized due to valuation adjustments by the partnerships	Net income (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 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 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 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 nine months of 2008, we sold our interests in 10 private equity limited partnerships in the secondary market and completed our commitment to six 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 our sales will help to fund the remaining commitments of existing limited partnerships that total \$101 million at September 30, 2008 (See also Note 15).

Securities lending program

To generate additional investment income 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 \$14.1 million and \$29.4 million at September 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 INCOME TAXES

We account for income taxes in accordance with SFAS 109, Accounting for Income Taxes. SFAS 109 requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statement or tax returns. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized. At September 30, 2008 we recorded a net deferred tax asset of \$14.6 million on our Consolidated Statements of Financial Position. We evaluated the need for an offsetting valuation allowance and management determined that sufficient tax planning strategies were available to the Company that would allow it to recover the deferred tax asset in future periods, and thus, an allowance was not recorded at September 30, 2008.

## NOTE 9 BANK LINE OF CREDIT

We have available a \$100 million line of credit with a bank that expires on December 31, 2008. Borrowings outstanding on the line of credit were \$30 million at September 30, 2008. We repaid \$45 million of borrowings during the third quarter of 2008. Interest is currently being charged on the line at the Federal Funds Rate (currently at 2.0%) plus 50 basis points and totaled \$0.5 million and \$1.0 million for the quarter and nine months ended September 30, 2008, respectively. Bonds with a value of \$127.5 million are pledged as collateral on the loan at September 30, 2008. These securities have no restrictions and are reported as available-for-sale fixed maturities in the Consolidated Statement of Financial Position as of September 30, 2008. The bank requires compliance with certain covenants which include minimum net worth and leverage ratios. We are in compliance with all bank covenants at September 30, 2008.

## NOTE 10 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 September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Revenues	\$ (7,183)	\$ 36,819	\$ 39,756	\$ 118,155
Benefits and expenses	29,296	31,824	83,115	96,038
(Loss) income before income taxes	(36,479)	4,995	(43,359)	22,117
Net (loss) income	(46,650)	3,198	(51,081)	15,278
Comprehensive (loss) income	(66,006)	6,156	(77,980)	9,062

In the third quarter of 2008 and 2007, EFL recognized pre-tax impairment charges of \$40.1 million and \$2.1 million, respectively, primarily related to its bonds and preferred stock in the financial

services industry sector. Impairment charges for the nine months ended September 30, 2008 were \$75.5 million compared to \$2.1 million for the same period in 2007. A deferred tax valuation allowance of \$22.7 million was also recorded at September 30, 2008 related to these impairments and remaining unrealized losses on its securities where the deferred tax asset is not expected to be realized.

<i>(in thousands)</i>	September 30, 2008	As of December 31, 2007
Investments	\$1,393,769	\$1,511,319
Total assets	1,694,966	1,744,704
Liabilities	1,499,559	1,471,317
Accumulated other comprehensive loss	(28,363)	(1,465)
Total shareholders' equity	195,407	273,387

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 11 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:

<i>(dollars in thousands)</i>	Three months ended		Nine months ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Service cost	\$ 3,136	\$ 3,531	\$ 9,408	\$ 10,591
Interest cost	4,447	4,191	13,342	12,574
Expected return on plan assets	(6,043)	(5,257)	(18,128)	(15,771)
Amortization of prior service cost	33	123	100	370
Amortization of actuarial loss	78	352	233	1,057
Settlement	97		170	
Net periodic benefit cost	\$ 1,748	\$ 2,940	\$ 5,125	\$ 8,821

Defined benefit pension plan

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.

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 the then 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 third quarter of 2008, \$0.9 million was recorded as an estimate of future compensation expense for our new chief executive officer whose employment began on July 29, 2008. Our share of these expenses totaled \$0.6 million at September 30, 2008.

## NOTE 12 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 accrued interest, payable semi-annually to us, of \$0.4 million in each of the third quarters ended September 30, 2008 and 2007.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 13 STATUTORY INFORMATION

Cash and securities with carrying values of \$6.6 million and \$6.3 million were deposited by our property/casualty insurance subsidiaries with regulatory authorities under statutory requirements at September 30, 2008 and December 31, 2007, respectively.

## NOTE 14 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>	Nine months ended September	
	2008	2007
<b>Net income</b>	<b>\$ 75,540</b>	<b>\$ 180,344</b>
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	27,528	22,399
Deferred income tax (benefit) expense	(18,480)	7,334
Realized loss (gain) on investments	80,202	(7,550)
Equity in earnings of limited partnerships	(20,310)	(46,867)
Net amortization of bond premium	1,153	1,543
Undistributed losses (earnings) of Erie Family Life Insurance	10,965	(3,305)
Decrease in deferred compensation	(6,781)	(8,224)
Limited partnership distributions	21,738	66,149
(Increase) decrease in receivables and reinsurance recoverable from the Exchange and affiliates	(24,174)	45,073
Increase in prepaid expenses and other assets	(44,188)	(32,841)
Increase in accounts payable and accrued expenses	18,643	16,104
Decrease in accrued agent bonuses	(35,637)	(22,117)
Decrease in loss reserves	(30,928)	(58,487)
Increase in unearned premiums	24,569	19,893
<b>Net cash provided by operating activities</b>	<b>\$ 79,840</b>	<b>\$ 179,448</b>

## NOTE 15 COMMITMENTS AND CONTINGENCIES

We have contractual commitments to invest up to \$101.0 million of additional funds in limited partnership investments at September 30, 2008. These commitments will be funded as required by the partnerships' agreements through 2012. At September 30, 2008, the total commitment to fund limited partnerships that invest in private equity securities is \$45.5 million, real estate activities is \$34.7 million and mezzanine debt securities is \$20.8 million. We expect to have sufficient cash flows from operations and 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 16 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 September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Premiums earned	\$ 902,260	\$ 899,455	\$ 2,694,802	\$ 2,702,322
Losses, loss adjustment expenses and other underwriting expenses*	892,731	786,908	2,558,171	2,347,799
<b>Net underwriting income</b>	<b>9,529</b>	<b>112,547</b>	<b>136,631</b>	<b>354,523</b>
Total investment (loss) income	(269,878)	109,933	(294,141)	459,514
Net (loss) income before federal income tax	(260,349)	222,480	(157,510)	814,037
Federal income tax expense	15,800	101,778	129,164	284,297
<b>Net (loss) income</b>	<b>\$ (276,149)</b>	<b>\$ 120,702</b>	<b>\$ (286,674)</b>	<b>\$ 529,740</b>

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

As with our investments, the Exchange's investment portfolio was impacted by declines in the value of securities that resulted from the recent significant disruption in the securities markets. During the Exchange's third quarter 2008 investment losses were impairment charges of \$103.5 million on fixed maturities, \$94.8 million on common stock and \$126.5 million on preferred securities. For the nine months ended September 30, 2008, impairment charges were \$194.8 million on fixed maturities, \$201.1 million on common stock and \$189.6 million on preferred securities. Impairment charges for the nine months ended September 30, 2007 were \$52.3 million. Under statutory accounting, deferred tax assets on realized capital losses from impairments of investments are reflected as a change in surplus rather than in deferred income taxes on the statement of operations. For the three and nine months ended September 30, 2008, deferred taxes on impairment charges totaled \$113.6 million and \$204.9 million, respectively.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 16 VARIABLE INTEREST ENTITY (Continued)

**Erie Insurance Exchange****Condensed statutory statements of financial position**

	As of	
	September 30, 2008	December 31, 2007
<i>(dollars in thousands)</i>		
Fixed maturities	\$ 4,176,488	\$ 4,353,977
Equity securities	2,317,572	3,016,607
Alternative investments	1,417,940	1,389,224
Other invested assets	386,134	168,189
<b>Total invested assets</b>	<b>8,298,134</b>	<b>8,927,997</b>
Other assets	1,469,154	1,033,852
<b>Total assets</b>	<b>\$ 9,767,288</b>	<b>\$ 9,961,849</b>
Loss and loss adjustment expense reserves	\$ 3,425,560	\$ 3,418,221
Unearned premium reserves	1,515,975	1,430,328
Accrued liabilities	405,337	345,776
<b>Total liabilities</b>	<b>5,346,872</b>	<b>5,194,325</b>
Total policyholders' surplus	4,420,416	4,767,524
<b>Total liabilities and policyholders' surplus</b>	<b>\$ 9,767,288</b>	<b>\$ 9,961,849</b>

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

	Nine months ended September 30,	
	2008	2007
<i>(dollars in thousands)</i>		
<b>Cash flows from operating activities</b>		
Premiums collected net of reinsurance	\$ 2,711,789	\$ 2,713,105
Losses and loss adjustment expenses paid	(1,528,555)	(1,475,428)
Management fee and expenses paid	(986,404)	(1,000,567)
Net investment income received	350,177	375,590
Federal income taxes and other expenses paid	(150,125)	(322,920)
<b>Net cash provided by operating activities</b>	<b>396,882</b>	<b>289,780</b>
<b>Net cash used in investing activities</b>	<b>(252,413)</b>	<b>(269,794)</b>
<b>Net cash (used in) provided by financing activities</b>	<b>(735)</b>	<b>2,805</b>
Net increase in cash and cash equivalents	143,734	22,791
Cash and cash equivalents-beginning of period	98,712	85,784

<b>Cash and cash equivalents-end of period</b>	<b>\$ 242,446</b>	<b>\$ 108,575</b>
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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 17 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:

<i>(in thousands)</i>	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
<b>Management Operations</b>				
<i>Operating revenue</i>				
Management fee revenue	\$ 247,723	\$ 245,585	\$ 733,131	\$ 730,691
Service agreement revenue	8,340	7,470	23,480	22,186
Total operating revenue	256,063	253,055	756,611	752,877
Cost of management operations	206,652	212,601	611,426	610,377
Income before income taxes	\$ 49,411	\$ 40,454	\$ 145,185	\$ 142,500
Net income from management operations	\$ 34,291	\$ 27,144	\$ 98,567	\$ 95,618
<b>Insurance Underwriting Operations</b>				
<i>Operating revenue</i>				
Premiums earned:				
Personal lines	\$ 36,826	\$ 36,740	\$ 109,874	\$ 108,740
Commercial lines	15,341	15,266	46,143	47,255
Reinsurance nonaffiliates	(110)	(114)	(298)	(7)
Total premiums earned	52,057	51,892	155,719	155,988
<i>Operating expenses</i>				
Losses and expenses:				
Personal lines	36,554	32,501	102,387	95,141
Commercial lines	16,343	12,687	45,758	40,354
Reinsurance nonaffiliates	(1,153)	476	(64)	723
Total losses and expenses	51,744	45,664	148,081	136,218
Income before income taxes	\$ 313	\$ 6,228	\$ 7,638	\$ 19,770
Net income from insurance underwriting operations	\$ 217	\$ 4,179	\$ 5,185	\$ 13,266

**Investment Operations**

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Investment income, net of expenses	\$ 10,218	\$ 12,233	\$ 33,357	\$ 40,350
Net realized (losses) gains on investments	(41,356)	3,438	(80,202)	7,550
Equity in earnings of limited partnerships	1,057	14,169	20,310	46,867
Total investment (loss) income-unaffiliated	\$ (30,081)	\$ 29,840	\$ (26,535)	\$ 94,767
Net (loss) income from investment operations	\$ (20,876)	\$ 20,023	\$ (18,015)	\$ 63,588
Equity in (losses) earnings of EFL, net of tax	\$ (9,384)	\$ 643	\$ (10,197)	\$ 3,074

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 17 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		Nine months ended September	
	2008	2007	2008	2007
Segment revenues, excluding investment operations	\$ 308,120	\$ 304,947	\$ 912,330	\$ 908,865
Elimination of intersegment management fee revenue	(13,603)	(13,496)	(40,394)	(40,259)
Total operating revenue	\$ 294,517	\$ 291,451	\$ 871,936	\$ 868,606
Segment operating expenses	\$ 258,396	\$ 258,265	\$ 759,508	\$ 746,595
Elimination of intersegment management fee revenue	(13,603)	(13,496)	(40,394)	(40,259)
Total operating expenses	\$ 244,793	\$ 244,769	\$ 719,114	\$ 706,336

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 17 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
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
09/30/2008	1,677,151	1.7	1,446,779	2.7	340,566	7.5	3,464,496	2.7

  

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
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
09/30/2008	124,418	1.9	236,994	4.7	56,381	3.8	98,786	2.7	516,579	3.5

  

Date	Total All Lines	12-mth. growth rate
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
09/30/2008	3,981,075	2.8

\* CML =  
Commercial

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## NOTE 17 SEGMENT INFORMATION (Continued)

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

Date	Private	CML*	Homeowners	CML*	Workers	All Other	Total
	Passenger Auto	Auto		Multi-Peril	Comp.	Lines	All Lines
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
09/30/2008	91.7	87.8	91.0	86.0	87.2	88.2	90.5

\* 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 Auto	percent change		percent change	Other Personal Lines	percent change	Personal Lines	percent change
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)
09/30/2008	1,086	(0.6)	511	(1.5)	354	0.6	774	(1.1)

Date	CML*	12-mth.	Workers Comp.	12-mth.	All	12-mth.	Total	12-mth.	Total	12-mth.
	Auto	percent change		percent change	Other CML* Lines	percent change	CML* Lines	percent change	All Lines	percent change
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)
09/30/2008	2,514	(3.3)	5,067	(12.3)	1,536	(3.5)	2,157	(6.0)	953	(2.6)

\* 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 segments: management operations, insurance underwriting operations and investment operations, consistent with the presentation in Item 1, Note 17 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**

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

We serve as the attorney-in-fact for the 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 8,700 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 property/casualty insurance industry is well capitalized, however, the turmoil in the securities markets, the volatile economic environment, and the return of severe tropical storm losses have all taken a toll on projected 2008 industry results. As a result, industry forecasts project continued increases in the combined ratio, decreases in return on equity and reductions in policyholder surplus in 2008. According to A.M. Best, for the first six months of 2008 industry premiums declined 0.7%, policyholder surplus declined 4.5%, and the industry combined ratio deteriorated to 102.1% from 93.2% in the first six months of 2007. While favorable loss reserve development benefited industry underwriting results, continued price softening, high catastrophe losses and significant underwriting losses contributed to the deterioration. These market conditions for insurers may be a precursor to increases in pricing on property and casualty policies. 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 reflected minimal growth of 0.9%, as direct written premiums of the Property and Casualty Group increased only 0.8% in the third quarter of 2008 compared to the third quarter of 2007.

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 17 in the Notes to Consolidated Financial Statements.

**Segment Results**

	Three months ended September 30,			Nine months ended September 30,		
	2008	2007	% Change	2008	2007	% Change
<i>(dollars in thousands, except per share data)</i>						
	(Unaudited)			(Unaudited)		
Income from management operations	\$ 49,411	\$ 40,454	22.1%	\$ 145,185	\$ 142,500	1.9%
Underwriting income	313	6,228	(95.0)	7,638	19,770	(61.4)
Net (loss) revenue from investment operations	(40,171)	30,532	NM	(37,500)	98,071	NM
Income before income taxes	9,553	77,214	(87.6)	115,323	260,341	(55.7)
Provision for income taxes	5,305	23,718	(77.6)	39,783	79,997	(50.3)
Net income	\$ 4,248	\$ 53,496	(92.1)%	\$ 75,540	\$ 180,344	(58.1)%
Net income per share diluted	\$ 0.07	\$ 0.87	(91.5)%	\$ 1.30	\$ 2.87	(54.7)%

NM = not  
meaningful

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

KEY POINTS

Decrease in net income per share-diluted in the third quarter of 2008 was driven by net realized losses on investments due to \$37.4 million of impairment charges and a drop in our equity in earnings of limited partnerships of \$13.1 million.

Gross margins from management operations increased to 19.3% in the third quarter of 2008 from 16.0% in the third quarter of 2007. The third quarter of 2007 included \$3.7 million in severance compensation for our former chief executive officer and a \$4.3 million charge for a judgment against us.

GAAP combined ratios of the insurance underwriting operations were 99.4% in the third quarter of 2008 compared to 88.0% in the third quarter of 2007 driven by higher catastrophe losses primarily related to remnants of Hurricane Ike in Ohio and Pennsylvania offset somewhat by favorable development of prior accident year loss reserves.

Annualized effective tax rate of 32.9% in the third quarter of 2008 was benefited by a \$0.5 million reduction to adjust our estimated current tax provision to actual 2007 returns filed in September 2008.

Our cost of management operations decreased 2.8% to \$206.7 million in the third quarter. The third quarter of 2007 included two charges: 1) an estimate of \$4.3 million for a judgment against us and 2) an estimate of \$3.7 million for our share of additional compensation due our former president and chief executive officer. Excluding these 2007 charges, cost of management operations increased 1.0% in the third quarter of 2008. Our current estimate for growth in non-commission operating costs is about 9% for 2008 as we plan to increase investments in information technology during the remainder of the year.

The insurance underwriting operations experienced higher catastrophe losses of \$2.9 million in the third quarter of 2008 compared to \$1.8 million in the third quarter of 2007 primarily due to the impact of Hurricane Ike. Favorable development of prior accident year loss and loss adjustment expense reserves continued, however not to the same extent as the third quarter of 2007.

Concerns persist surrounding the credit markets and more broadly the financial services industry. We actively evaluate our bond and preferred stock portfolios for impairments. The impairment charges we recognized in the third quarter of 2008 of \$37.4 million were the result of continued declines in fair value and credit deterioration on certain of our bonds and preferred stocks predominately 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.

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

<i>(dollars in thousands)</i>	Three months ended September 30,			Nine months ended September 30,		
	2008 (Unaudited)	2007	% Change	2008 (Unaudited)	2007	% Change
Management fee revenue	\$ 247,723	\$ 245,585	0.9%	\$ 733,131	\$ 730,691	0.3%
Service agreement revenue	8,340	7,470	11.6	23,480	22,186	5.8
Total revenue from management operations	256,063	253,055	1.2	756,611	752,877	0.5
Cost of management operations	206,652	212,601	(2.8)	611,426	610,377	0.2
Income from management operations	\$ 49,411	\$ 40,454	22.1%	\$ 145,185	\$ 142,500	1.9%
Gross margin	19.3%	16.0%		19.2%	18.9%	

**KEY POINTS**

The management fee rate was 25% in 2008 and 2007.

Direct written premiums of the Property and Casualty Group increased 0.8% in the third quarter of 2008 compared to the third quarter of 2007.

Year-over-year policies in force grew 2.8%, or 107,410 policies, to 3,981,075 at September 30, 2008 compared to year-over-year growth of 80,210 policies in the third quarter of 2007.

Year-over-year average premium per policy was \$953 and \$978 at September 30, 2008 and 2007, respectively, a decrease of 2.6%.

During the third quarter of 2008, premium rate changes resulted in a net \$8.2 million reduction in written premiums.

Commission costs decreased 1.1% while costs other than commissions decreased 6.5% in the third quarter of 2008.

Estimates for agent bonuses decreased \$5.2 million, offset by a \$1.2 million increase in scheduled rate commissions and a \$1.4 million increase in the private passenger auto bonus compared to the third quarter of 2007.

Personnel costs decreased \$1.8 million primarily as a result of decreases in salaries and wages due to the third quarter of 2007 including additional severance pay for our former chief executive officer partially offset by higher average pay rates for employees in 2008.

All other operating costs decreased \$4.4 million due to the recording of a \$4.3 million charge in September 2007 as mentioned above.





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

<i>(dollars in thousands)</i>	Three months ended September 30,			Nine months ended September 30,		
	2008 (Unaudited)	2007	% Change	2008 (Unaudited)	2007	% Change
Private passenger auto	\$ 488,043	\$ 480,967	1.5%	\$ 1,408,259	\$ 1,390,442	1.3%
Homeowners	209,065	206,355	1.3	567,224	560,992	1.1
Commercial multi-peril	103,507	101,965	1.5	338,282	337,484	0.2
Commercial auto	73,404	74,185	(1.1)	242,827	245,851	(1.2)
Workers compensation	63,325	69,847	(9.3)	226,142	247,035	(8.5)
All other lines of business	51,947	48,220	7.7	154,990	146,161	6.0
Property and Casualty Group direct written premiums	989,291	981,539	0.8	2,937,724	2,927,965	0.3
Management fee rate	25.00%	25.00%		25.00%	25.00%	
Management fee revenue, gross	247,323	245,385	0.8	734,431	731,991	0.3
Change in allowance for management fee returned on cancelled policies*	400	200	NM	(1,300)	(1,300)	0.0
Management fee revenue, net of allowance	\$ 247,723	\$ 245,585	0.9%	\$ 733,131	\$ 730,691	0.3%

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.

Direct written premiums of the Property and Casualty Group increased 0.8% to \$989.3 million in the third quarter of 2008 reflecting an increase in policies in force offset by reductions in average premium. Total year-over-year policies in force increased by 2.8% to 3,981,075 at September 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 2.6% to \$953 at September 30, 2008 from \$978 at September 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 \$31.0 million during 2008, of which approximately \$25.5 million occurred in the first nine months of 2008. The most significant rate reductions effective in 2008 are in workers compensation in Pennsylvania and homeowners in Maryland.

Premiums generated from new business increased 2.7% to \$108.7 million from \$105.9 million in the third quarter of 2008 as compared to 2007. Underlying the trend in new business premiums is an increase in new business policies in force of 3.3% to 475,731 for the twelve months ended September 30, 2008 from 460,685 at September 30, 2007, while the year-over-year average premium per policy on new business remained flat at \$858 at September 30, 2008 from September 30, 2007.

Premiums generated from renewal business increased 0.6% to \$880.6 million at September 30, 2008 from \$875.7 million at September 30, 2007. Renewal policies in force increased 2.7% to 3,505,344 from 3,412,980, offset by a decrease in the year-over-year average premium per policy on renewal business of 2.8% to \$966, from \$994, for the same respective periods in 2008 and 2007.

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

**Personal lines** - The Property and Casualty Group's personal lines new business premiums written increased 3.5% to \$73.7 million in the third quarter of 2008 compared to \$71.3 million in the third quarter of 2007. Personal lines new policies in force increased 2.5% to 385,190 for the twelve months ended September 30, 2008 compared to September 30, 2007, while the year-over-year average premium per policy on personal lines new business declined 0.8% to \$682 at September 30, 2008 from \$687 at September 30, 2007.

Private passenger auto new premiums written increased to \$46.3 million, or 5.2%, during the third quarter of 2008 driven by a 5.8% increase in new business policies in force to 164,808. The private passenger auto new business year-over-year average premium per policy decreased 1.4% to \$1,010 at September 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 based 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 \$21.6 million in the third quarter of 2008 from \$22.2 million in the third quarter of 2007. Homeowners new policies in force decreased 2.4% to 165,977, while the year-over-year average premium per policy on homeowners new business decreased 3.2% to \$457. The decline in homeowners new business policies is partly impacted by the slowdown in the housing market in our operating region.

Renewal premiums written on personal lines policies increased during the third quarter of 2008 to \$656.4 million from \$646.1 million, or 1.6%. 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 \$785 at September 30, 2008 from \$795 at September 30, 2007. The policy retention ratio for private passenger auto improved to 91.7% at September 30, 2008, from 91.5% at December 31, 2007 and 91.3% at September 30, 2007, while the policy retention for homeowners improved to 91.0% at September 30, 2008, from 90.3% at December 31, 2007 and 90.1% at September 30, 2007.

**Commercial lines** - The commercial lines new business premiums written increased 1.0% to \$34.9 million in the third quarter of 2008 from \$34.5 million in the third quarter of 2007. Commercial lines new policies in force increased 6.9% to 90,541 for the twelve months ended September 30, 2008, while the average premium per policy on commercial lines decreased 0.7%. 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 decrease in the average premium per policy on commercial lines new business was primarily driven by pricing actions that decreased workers compensation rates.

Renewal premiums for commercial lines decreased 2.4% to \$224.2 million from \$229.6 million in the third quarters of 2008 and 2007, respectively. While renewal policies in force increased 2.9% to 426,038 for the twelve months ended September 30, 2008, the year-over-year average premium per policy on commercial lines renewal business declined 6.6% due primarily to the workers compensation line of business trends.

**Future trends premium revenue** We are continuing our efforts to grow premiums and improve our competitive position in the marketplace. The continued expansion of our agency force will contribute to current and future growth as new agents build up their books of business with the Property and Casualty Group. We appointed 113 new agencies in the first nine months of 2008, for a total of 2,030 agencies at September 30, 2008. We expect to meet our goal of appointing 140 new agencies in 2008. In 2007, we appointed 214 new agencies. In the third quarter of 2008, we decided not to pursue our planned 2009 expansion effort into the state of Minnesota in order to refocus our growth strategy to our current markets where we expect to realize a higher return more quickly than by expanding into another state.

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

<i>(in thousands)</i>	Three months ended September 30,			Nine months ended September 30,		
	2008 (Unaudited)	2007	% Change	2008 (Unaudited)	2007	% Change
Commissions	\$ 143,306	\$ 144,850	(1.1)%	\$ 421,881	\$ 424,554	(0.6)%
Personnel costs	36,907	38,753	(4.8)	110,189	107,262	2.7
Survey and underwriting costs	6,047	6,046	0.0	18,250	18,219	0.2
Sales and policy issuance costs	6,146	6,170	(0.4)	19,323	17,136	12.8
All other operating costs	14,246	16,782	(15.1)	41,783	43,206	(3.3)
Non-commission expense	63,346	67,751	(6.5)	189,545	185,823	2.0
Total cost of management operations	\$ 206,652	\$ 212,601	(2.8)%	\$ 611,426	\$ 610,377	0.2%

**KEY POINTS**

Commissions in the third quarter of 2008 include:

a decrease in the estimate for agent bonuses of \$5.2 million,

an increase in normal and accelerated rate commissions of \$1.6 million in the third quarter of 2008 driven by an increase in certain commercial commission rates and higher accelerated commissions due to more newly appointed agents, and

an increase in promotional incentives and the private passenger auto bonus of \$2.0 million.

Personnel costs decreased 4.8% in the third quarter of 2008. Salaries and wages increased \$1.6 million in the third quarter of 2008 due to higher average pay rates and staffing levels. In the third quarter of 2007, \$3.7 million of severance compensation was recorded related to our former president and chief executive officer who voluntarily resigned in August 2007.

All other operating costs in the third quarter of 2008 included a \$2.2 million increase in consulting fees, primarily contract labor costs related to various technology initiatives. The third quarter of 2007 included a \$4.3 million accrual for a judgment against us.

**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:

<i>(in thousands)</i>	Three months ended September 30,			Nine months ended September 30,		
	2008	2007	% Change	2008	2007	% Change

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	(Unaudited)			(Unaudited)		
Scheduled rate commissions	\$ 119,229	\$ 117,994	1.0%	\$ 352,561	\$ 349,121	1.0%
Accelerated rate commissions	1,132	805	40.6	3,237	1,970	64.3
Agent bonuses	19,075	24,316	(21.6)	58,430	69,507	(15.9)
Promotional incentives	755	93	NM	2,262	121	NM
Private passenger auto bonus	2,915	1,542	89.0	6,191	4,535	36.5
Change in commissions allowance for mid-term policy cancellations	200	100	NM	(800)	(700)	NM
Total commissions	\$ 143,306	\$ 144,850	(1.1)%	\$ 421,881	\$ 424,554	(0.6)%

NM = not meaningful

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

*Scheduled and accelerated rate commissions* - Scheduled rate commissions were impacted by the 0.8% increase in the direct written premiums of the Property and Casualty Group in the third quarter of 2008 compared to the third quarter of 2007. Also, effective July 1, 2008, commission rates were increased for certain commercial lines new business premiums which added \$0.5 million to the third quarter of 2008 scheduled rate commissions. For the nine months ended September 2008, \$1.0 million of additional commissions were related to these increased commission rates as \$0.5 million was recognized in the second quarter for those commercial premiums written but not yet collected as of June 2008. The higher commercial commission rates are expected to increase commission expense by approximately \$0.5 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 third 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 nine months of 2008 we appointed 113 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 third quarter of 2008 reflects a reduction in our estimate of the profitability component of the bonus. The agent bonus award is estimated at \$76.9 million for 2008. Of this estimate, \$73.5 million represents the profitability component and \$3.4 million represents the growth component. At September 30, 2007, the agent bonus award was estimated at an annualized \$90.6 million.

*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. The total cost of this program is expected to approximate \$9.0 million for 2008 and, assuming current policy levels, \$9.7 million for 2009. Additional commission expense of \$1.5 million was recorded as a result of the new tiered bonus structure in the nine months ended September 30, 2008.

**Other costs of management operations** - The cost of management operations excluding commission costs decreased \$4.4 million, or 6.5%, for the third quarter of 2008 compared to the third quarter of 2007. Personnel costs decreased \$1.8 million, or 4.8% in the third quarter of 2008. Salaries and wages increased by \$1.6 million in the third quarter of 2008 from higher average pay rates coupled with higher staffing levels, and \$0.6 million in compensation expense recognized for our new chief executive officer, whose employment began on July 29, 2008. Offsetting this was a decrease of \$0.9 million in management incentive plan expense resulting from market value adjustments and a lowering of target projections for the 2008 performance year. In the third quarter of 2007 there was a charge of \$3.7 million for severance pay due our former president and chief executive officer. All other operating expenses decreased \$2.5 million, or 15.1%. Third quarter of 2008 consulting fees increased \$2.2 million primarily due to contract labor costs related to various technology initiatives. The third quarter of 2007 included a charge of \$4.3 million for a judgment against us in a lawsuit arising from our termination of an agency.

For the nine months ended September 30, 2008, personnel costs increased 2.7%, or \$2.9 million. Salaries and wages increased \$2.4 million in 2008 due to higher average pay rates and higher staffing levels. Executive severance costs and the recognition of certain compensation expense for our new chief executive officer contributed an additional \$2.7 million in the nine months ended September 2008. The 2007 personnel costs included \$3.7 million of additional severance for our former president and chief executive officer.

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

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 as well as investments in new technologies are being incurred. We incurred \$3.5 million of additional expense in the third quarter of 2008, including consulting fees, hardware and software costs incurred in conjunction with the planning and design for the development of a new policy administration platform. For the nine months ended September 30, 2008, we incurred \$5.4 million of additional expense related to these same technology initiatives. 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 9%. In the remainder of 2008 we will continue to develop the detailed planning and design of our various technology initiatives aimed at improving our competitiveness and as a result expect to incur additional external expenses of approximately \$8 million.

***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.

<i>(in thousands)</i>	Three months ended September 30,			Nine months ended September 30,		
	2008 (Unaudited)	2007	% Change	2008 (Unaudited)	2007	% Change
Premiums earned	\$ 52,057	\$ 51,892	0.3%	\$ 155,719	\$ 155,988	(0.2)%
Losses and loss adjustment expenses incurred	37,185	30,766	20.9	104,768	92,789	12.9
Policy acquisition and other underwriting expenses	14,559	14,898	(2.3)	43,313	43,429	(0.3)
Total losses and expenses	51,744	45,664	13.3	148,081	136,218	8.7
Underwriting income	\$ 313	\$ 6,228	(95.0)%	\$ 7,638	\$ 19,770	(61.4)%

**KEY POINTS**

Catastrophe losses, a majority of which were from Hurricane Ike in 2008, contributed 5.7 points and 3.4 points to the GAAP combined ratio in the third quarters of 2008 and 2007, respectively.

Development of prior accident year loss reserves improved the loss ratio by 0.4 points, or \$0.2 million, in the third quarter of 2008, compared to an improvement of 7.8 points for the third quarter of 2007.

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

	Three months ended September 30,		Nine months ended September 30,	
	2008	2007	2008	2007
Erie Indemnity Company GAAP loss and LAE ratio <sup>(1)</sup>	71.4%	59.3%	67.3%	59.5%
Erie Indemnity Company GAAP combined ratio <sup>(1)</sup>	99.4	88.0	95.1	87.3
P&C Group statutory combined ratio	97.7	86.1	94.0	86.0
P&C Group adjusted statutory combined ratio <sup>(2)</sup>	93.6	82.3	89.8	81.8
Direct business:				
Personal lines adjusted statutory combined ratio	91.6	81.3	87.5	81.3
Commercial lines adjusted statutory combined ratio <sup>(3)</sup>	109.4	83.6	97.0	82.8
Prior accident year reserve development redundancy	(0.4)	(7.8)	(3.2)	(7.5)
Prior year salvage and subrogation recoveries collected	(1.0)	(1.0)	(2.0)	(2.0)
Total loss ratio points from prior accident years	(1.4)%	(8.8)%	(5.2)%	(9.5)%

(1) 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 from the results of the Property and Casualty Group due to certain GAAP



adjustments.

- (2) The adjusted statutory combined ratio removes the profit margin on the management fee we earn from the Property and Casualty Group.
- (3) The commercial lines adjusted statutory combined ratio increase in the third quarter 2008 over the third quarter 2007 is primarily due to one large fire claim in Pennsylvania and losses related to Hurricane Ike in Ohio and Pennsylvania.

**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 \$0.2 million and \$4.0 million, and improved the loss ratio by 0.4 points and 7.8 points in the third quarters of 2008 and 2007, respectively. The favorable development in 2008 resulted from improvements in frequency trends and slight improvements in severity trends on automobile bodily injury and uninsured/underinsured motorist bodily injury. In the third quarter of 2007, the 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, our private passenger auto loss trends have remained favorable, which is consistent with industry trends in this line of business.

**Catastrophe losses**

Our share of catastrophe losses, as defined by the Property and Casualty Group, amounted to \$2.9 million and \$1.8 million in the third quarters of 2008 and 2007, respectively. The third quarter of 2008 included flooding, tornado and wind storms related to Hurricane Ike primarily in Ohio and Pennsylvania. During the third quarter of 2008, the Property and Casualty Group recorded an increase in the incurred but not reported reserves related to catastrophe losses of \$22.7 million, of which our share was \$1.2 million. This reserve is not included in the quarterly catastrophe loss totals. Catastrophe losses incurred for the first nine months of 2008 and 2007 were \$5.3 million and \$3.2 million, respectively, and contributed 3.4 points and 2.0 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 third quarter of 2008, our share of the increase to incurred but not reported reserves related to seasonality adjustments was \$0.2 million, compared to \$1.7 million in the third quarter of 2007. Seasonality adjustments increased our share of incurred but not reported reserves by \$0.9 million in the second quarter of 2008, and reduced these reserves by \$3.5 million in the first quarter of 2008.



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

<i>(in thousands)</i>	Three months ended September 30,			Nine months ended September 30,		
	2008 (Unaudited)	2007	% Change	2008 (Unaudited)	2007	% Change
Net investment income	\$ 10,218	\$ 12,233	(16.5)%	\$ 33,357	\$ 40,350	(17.3)%
Net realized (losses) gains on investments	(41,356)	3,438	NM	(80,202)	7,550	NM
Equity in earnings of limited partnerships	1,057	14,169	(92.5)	20,310	46,867	(56.7)
Equity in (losses) earnings of EFL	(10,090)	692	NM	(10,965)	3,304	NM
Net revenue from investment operations	\$ (40,171)	\$ 30,532	NM	\$ (37,500)	\$ 98,071	NM

NM = not  
meaningful

**KEY POINTS**

Net investment income decreased 16.5% for the quarter due to lower invested asset balances as a result of our continued share repurchase activity.

Net realized (losses) gains on investments in the third quarter of 2008 include \$37.4 million of impairment charges in the third quarter of 2008, and \$3.4 million of unrealized losses on common stock recognized as a result of adopting SFAS 159. Impairment charges were \$1.8 million in the third quarter of 2007.

Equity in earnings of limited partnerships decreased \$13.1 million in the third quarter of 2008 due to the general slowdown and recent economic downturn in the real estate markets.

Equity in (losses) earnings of EFL declined \$10.8 million primarily due to our share of impairment charges recognized by EFL in the third quarter of 2008.

Impairment charges of \$37.4 million included \$15.7 million on fixed maturities and \$21.7 million on preferred stock for the three months ended September 30, 2008. Impairment charges in the third quarter increased significantly due to the significant disruption in the securities markets experienced in September 2008. Securities in an unrealized loss position at September 30, 2008 are stratified below based on time in a loss position and magnitude of the loss as a percentage of book value of the security. The majority of the declines in investment value have not been to the severity depicted in the table for longer than one month.

<i>(in thousands)</i>	Fair Value	Total Gross Unrealized Losses	Decline of Investment Value				
			<=15%	>15%	>25%	>35%	>45%
Fixed Maturities:							

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Unrealized loss for less than 1 quarter	\$ 214,774	\$ 4,174	\$ 4,174	\$ 0	\$ 0	\$ 0	\$ 0
Unrealized loss for 1 quarter	97,215	5,637	5,059	578	293	293	0
Unrealized loss for 2 quarters	95,700	6,692	5,132	1,560	1,021	745	0
Unrealized loss for 3 quarters	12,437	1,380	987	393	0	0	0
Unrealized loss for 1 year or longer	49,437	6,256	3,166	3,090	726	0	0
Total	\$ 469,563	\$ 24,139	\$ 18,518	\$ 5,621	\$ 2,040	\$ 1,038	\$ 0

Preferred Stock:

Unrealized loss for less than 1 quarter	\$ 6,386	\$ 1,208	\$ 288	\$ 919	\$ 0	\$ 0	\$ 0
Unrealized loss for 1 quarter	14,111	3,973	574	3,399	2,284	1,332	1,332
Unrealized loss for 2 quarters	6,290	501	354	147	0	0	0
Unrealized loss for 3 quarters	7,377	1,156	116	1,040	0	0	0
Unrealized loss for 1 year or longer	2,801	386	7	379	0	0	0
Total	\$ 36,965	\$ 7,224	\$ 1,339	\$ 5,884	\$ 2,284	\$ 1,332	\$ 1,332

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

We determined that none of the securities represented in the table above met the criteria for other-than-temporary impairment write-downs as of September 30, 2008. We completed a thorough review of the securities based upon our impairment and valuation review process. We continue to have the intent and ability to hold these investments for the periods of time that we anticipate is needed to recover while continuing to collect the interest and dividend obligations on them.

For the nine months ended September 30, 2008, impairment charges on fixed maturities were \$29.7 million while impairment charges on preferred stock were \$32.1 million. In the third quarter of 2008, valuation losses on common stock that were reported in earnings were \$3.4 million, and \$21.7 million for the nine months ended September 30, 2008. 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 losses of \$0.7 million and earnings of \$8.5 million for the quarters ended September 30, 2008 and 2007, respectively. Real estate limited partnerships generated earnings of \$1.8 million and \$5.7 million in the third quarters of 2008 and 2007, respectively. The reduced valuation adjustments recorded by our real estate limited partnerships are the result of the general slow-down and recent economic downturn in the real estate markets.

Our equity in losses of EFL totaling \$10.1 million in the third quarter of 2008 resulted from EFL recognizing pre-tax impairment charges of \$40.1 million, of which our share was \$8.7 million before tax. While EFL recognized a deferred tax asset related to these impairments, it was limited to the amount of assets that management believed to be recoverable under SFAS 109, Accounting for Income Taxes. As such, a valuation allowance related to these impairments was recorded on the books of EFL at September 30, 2008, further reducing its net income for the quarter.

**FINANCIAL CONDITION**

**Investments**

Our investment strategy continues to take 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 September 30, 2008, our investment portfolio of investment-grade bonds and preferred stock, common stock and cash and cash equivalents represents \$729.4 million, or 26.7%, of total assets.

Our investments are subject to certain risks, including interest rate, credit and price risk. Our exposure to interest rate risk is concentrated in our fixed maturities portfolio. This portfolio comprises 56.7% and 57.7% of invested assets at September 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 potentially have incurred other-than-temporary declines in value. 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. In addition to specific factors, other factors considered in our review of investment valuation are the length of time and extent to which the fair value is below cost and whether we have the intent to hold the security, which is affected by our desire to generate capital losses for federal income tax reasons. 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.



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

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 6.2% of our available-for-sale and trading securities at September 30, 2008. The amount of securities classified as unobservable increased from less than 3% at June 30, 2008 due to the recent illiquid market conditions.

Income Taxes

As reported on our Consolidated Statements of Financial Position, we recognized a net deferred asset of \$14.6 million at September 30, 2008 that is expected to be realized in a future tax return. This compares to a net deferred tax liability of \$8.2 million at June 30, 2008. The movement to a net deferred tax asset position during the quarter is due primarily to an increase in our net unrealized losses on securities. We believe we have sufficient tax planning strategies in place to recover these deferred tax assets in future tax returns, thus no deferred tax valuation allowance was established at September 30, 2008.

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 nine 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>	September 30, 2008	As of December 31, 2007
Gross reserve liability:		
Private passenger auto	\$291,890	\$ 321,320
Pre-1986 automobile catastrophic injury	176,726	192,764
Homeowners	31,719	28,506
Workers compensation	164,496	146,402
Workers compensation catastrophic injury	99,752	108,589
Commercial auto	75,146	79,848
Commercial multi-peril	81,998	75,169
All other lines of business	73,876	73,933
Gross reserves	995,603	1,026,531
Reinsurance recoverable	803,052	834,453
Net reserve liability	\$192,551	\$ 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 \$524.4 million at September 30, 2008, which is net of \$174.0 million of anticipated reinsurance



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

recoverable. Our property/casualty subsidiaries' share of the net catastrophic injury liability reserves is \$28.9 million at September 30, 2008 compared to \$29.7 million at December 31, 2007. The decrease in the pre-1986 automobile catastrophe injury reserve at September 2008 compared to December 2007 was primarily due to lower cost expectations of future attendant care services.

**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 15 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. In the third quarter 2008, our investment portfolio was impacted by declines in the value of securities that resulted from the recent significant disruption in the securities markets. To the extent the market instability continues, our investment portfolio may continue to be impacted.

We expect to meet our future funding requirements through various alternatives available to us. 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 \$30 million at September 30, 2008 thus providing an additional \$70 million if needed, (2) dividend payments from our wholly-owned property/casualty insurance subsidiaries, EIC, EIPC 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 \$93 million at September 30, 2008 and (4) the ability to curtail or modify discretionary outlays such as those related to 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.

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. Payments on the line of credit totaled \$45.0 million in the third quarter of 2008. This line of credit expires on December 31, 2008. Also during the first quarter of 2008, we borrowed \$30.0 million from EIC, our 100% owned 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 nine months of 2008, compared to the first nine months of 2007, were primarily related to a decrease in cash flow from 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 third quarter of 2008, we repurchased 20,000 shares of our outstanding Class A common stock at a cost of \$0.9 million in conjunction with our stock repurchase plan. Through the first nine months of 2008, 2.0 million shares were repurchased at a total cost of \$98.7 million. For the first nine months of 2007, we repurchased 4.2 million shares at a total cost of \$219.8 million. The third quarter of 2007 included a repurchase of 1.9 million shares of our Class A nonvoting common stock from the F. William Hirt Estate separate from the stock repurchase program for a total purchase price of \$99.0 million. At September 30, 2008, approximately \$93.3 million of repurchase authority remains under this plan. (See Item 2. of Part II. Unregistered Sales of Equity Securities and Use of Proceeds).



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

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 September 30, 2008 total \$101 million and are required to be funded through 2012.

**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. During the third quarter of 2008, the Exchange recognized impairment charges on its investment portfolio of \$324.8 million due to the recent downturn experienced in the securities markets. To the extent the market downturn continues, the Exchange's investment portfolio may continue to be impacted. For the nine months ended September 30, 2008, the Exchange recognized impairments of \$585.5 million. Despite recent market events, at September 30, 2008, the Exchange had \$4.4 billion in statutory surplus and a premium to surplus ratio of less than 1 to 1.

The Exchange has strong underlying operating cash flows and sufficient liquidity to meet its needs, including the ability to pay the management fees owed to us. Through the nine months ended September 30, 2008, the Exchange generated \$397 million in cash flow from operating activities. At September 30, 2008 the Exchange had \$242 million in cash and cash equivalents. The Exchange also has a \$75 million untapped bank line of credit with a bank at September 30, 2008.

Additional information, including condensed statutory financial statements of the Exchange, is presented in Note 16 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 \$5.5 million through the remainder of the year for a total of \$31.0 million in 2008. Rate actions are expected to increase premiums by about 1% in 2009.

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

**Market volatility**

Our portfolio of fixed income, preferred and common stocks are subject to significant market value changes especially in the current market environment of instability in the worldwide financial markets. Uncertainty remains surrounding the general market conditions. The current volatility in the financial markets could have an adverse impact on our financial condition, operations and cash flows.

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 and design our policy administration platform replacement which we initiated in 2007. In the remainder of 2008 we will continue to develop the detailed planning and design of the policy administration platform replacement and expect to incur approximately \$8 million of external consulting and contract labor fees, hardware costs and software costs as a result. The 2009 phase of the project and the related expenses are expected to be approved before the end of this initial phase of the project in December of 2008.

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

There were no material changes in our identified market risk components as described in Item 7A of the December 31, 2007 annual report on Form 10-K. However, during the quarter ended September 30, 2008, there were significant disruptions in the financial markets that have affected prices for many securities due to the lack of trading and distressed selling. This market disruption has resulted in a lack of liquidity in the credit markets and a widening of credit spreads. As a result of these effects, we recorded net unrealized losses of \$20.5 million in our fixed maturities portfolio at September 30, 2008, compared with net unrealized gains of \$0.9 million at December 31, 2007.

**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 September 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 Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plan
July 1 31, 2008	20,000	\$ 45.58	20,000	
August 1 31, 2008	0		0	
September 1 30, 2008	0		0	
Total	20,000		20,000	\$ 93,300,000

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.



PART II. OTHER INFORMATION (Continued)

ITEM 6. EXHIBITS

Exhibit Number	Description of Exhibit
10.1*	Employment Agreement dated July 14, 2008, between Erie Indemnity Company and Terrence W. Cavanaugh
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 July 18, 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: November 5, 2008

/s/ Terrence W. Cavanaugh  
Terrence W. Cavanaugh, President & CEO

/s/ Philip A. Garcia  
Philip A. Garcia, Executive Vice President  
& CFO