

ERIE INDEMNITY CO
Form 10-Q
July 31, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2014

Commission file number 0-24000

ERIE INDEMNITY COMPANY
(Exact name of registrant as specified in its charter)

PENNSYLVANIA (State or other jurisdiction of incorporation or organization)	25-0466020 (I.R.S. Employer Identification No.)
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100 Erie Insurance Place, Erie, Pennsylvania (Address of principal executive offices)	16530 (Zip Code)
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(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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
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

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(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 X

The number of shares outstanding of the registrant's Class A Common Stock as of the latest practicable date, with no par value and a stated value of \$0.0292 per share, was 46,189,068 at July 18, 2014.

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 2,542 at July 18, 2014.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ERIE INDEMNITY COMPANY

CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(dollars in millions, except per share data)

	Three months ended		Six months ended	
	June 30,	2013	June 30,	2013
	2014		2014	
Revenues				
Premiums earned	\$1,319	\$1,215	\$2,607	\$2,390
Net investment income	111	104	220	207
Net realized investment gains	133	61	189	310
Net impairment losses recognized in earnings	0	(1	) 0	(1
Equity in earnings of limited partnerships	27	39	77	75
Other income	8	8	16	16
Total revenues	1,598	1,426	3,109	2,997
Benefits and expenses				
Insurance losses and loss expenses	1,126	861	2,160	1,703
Policy acquisition and underwriting expenses	325	302	646	595
Total benefits and expenses	1,451	1,163	2,806	2,298
Income from operations before income taxes and noncontrolling interest	147	263	303	699
Provision for income taxes	44	86	91	232
Net income	\$103	\$177	\$212	\$467
Less: Net income attributable to noncontrolling interest in consolidated entity – Exchange	54	133	117	386
Net income attributable to Indemnity	\$49	\$44	\$95	\$81
Earnings Per Share				
Net income attributable to Indemnity per share				
Class A common stock – basic	\$1.05	\$0.95	\$2.04	\$1.73
Class A common stock – diluted	\$0.94	\$0.84	\$1.82	\$1.54
Class B common stock – basic and diluted	\$158	\$142	\$307	\$259
Weighted average shares outstanding attributable to Indemnity – Basic				
Class A common stock	46,214,153	46,693,333	46,307,659	46,733,925
Class B common stock	2,542	2,542	2,542	2,542
Weighted average shares outstanding attributable to Indemnity – Diluted				
Class A common stock	52,411,414	52,886,259	52,504,920	52,926,851
Class B common stock	2,542	2,542	2,542	2,542

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Dividends declared per share				
Class A common stock	\$0.6350	\$0.5925	\$1.2700	\$1.1850
Class B common stock	\$95.2500	\$88.8750	\$190.5000	\$177.7500

See accompanying notes to Consolidated Financial Statements. See Note 12. "Indemnity Accumulated Other Comprehensive Loss," for amounts reclassified out of accumulated other comprehensive income (loss) into the Consolidated Statements of Operations. See Note 15. "Indemnity Supplemental Information," for supplemental statements of operations information.

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

	Three months ended June 30,		Six months ended June 30,		
	2014	2013	2014	2013	
Net income	\$103	\$177	\$212	\$467	
Other comprehensive income (loss)					
Change in unrealized holding gains (losses) on available-for-sale securities, net of tax (expense) benefit of \$(37), \$105, \$(80), and \$111 respectively	68	(194	) 148	(206)
Reclassification adjustment for gross gains included in net income, net of tax benefit of \$2, \$2, \$7, and \$7, respectively	(3	) (3	) (11	) (13)
Other comprehensive income (loss)	65	(197	) 137	(219)
Comprehensive income (loss)	\$168	\$(20	) \$349	\$248	
Less: Comprehensive income (loss) attributable to noncontrolling interest in consolidated entity – Exchange	118	(60	) 250	172	
Total comprehensive income – Indemnity	\$50	\$40	\$99	\$76	

See accompanying notes to Consolidated Financial Statements. See Note 12. "Indemnity Accumulated Other Comprehensive Loss," for supplemental statements of comprehensive income (loss) information.

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

	June 30, 2014 (Unaudited)	December 31, 2013
Assets		
Investments – Indemnity		
Available-for-sale securities, at fair value:		
Fixed maturities (amortized cost of \$484 and \$518, respectively)	\$497	\$526
Equity securities (cost of \$25 and \$50, respectively)	26	50
Limited partnerships (cost of \$114 and \$123, respectively)	141	146
Other invested assets	1	1
Investments – Exchange		
Available-for-sale securities, at fair value:		
Fixed maturities (amortized cost of \$8,149 and \$7,801, respectively)	8,701	8,162
Equity securities (cost of \$842 and \$778, respectively)	914	819
Trading securities, at fair value (cost of \$2,314 and \$2,198, respectively)	3,377	3,202
Limited partnerships (cost of \$754 and \$790, respectively)	931	940
Other invested assets	20	20
Total investments	14,608	13,866
Cash and cash equivalents (Exchange portion of \$237 and \$403, respectively)	300	452
Premiums receivable from policyholders – Exchange	1,287	1,167
Reinsurance recoverable – Exchange	168	172
Deferred income taxes – Indemnity	1	2
Deferred acquisition costs – Exchange	579	566
Other assets (Exchange portion of \$405 and \$337, respectively)	517	451
Total assets	\$17,460	\$16,676
Liabilities and shareholders' equity		
Liabilities		
Indemnity liabilities		
Other liabilities	\$451	\$476
Exchange liabilities		
Losses and loss expense reserves	3,964	3,747
Life policy and deposit contract reserves	1,789	1,758
Unearned premiums	2,788	2,598
Deferred income taxes	557	450
Other liabilities	90	97
Total liabilities	9,639	9,126
Indemnity shareholders' equity		
Class A common stock, stated value \$0.0292 per share; 74,996,930 shares authorized; 68,299,200 shares issued; 46,189,068 and 46,461,125 shares outstanding, respectively	2	2
Class B common stock, convertible at a rate of 2,400 Class A shares for one Class B share, stated value \$70 per share; 3,070 shares authorized; 2,542 shares issued and outstanding	0	0
Additional paid-in-capital	16	16

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Accumulated other comprehensive loss	(55) (59)
Retained earnings	1,938	1,902	
Total contributed capital and retained earnings	1,901	1,861	
Treasury stock, at cost, 22,110,132 and 21,838,075 shares, respectively	(1,146	) (1,127)
Total Indemnity shareholders' equity	755	734	
Noncontrolling interest in consolidated entity – Exchange	7,066	6,816	
Total equity	7,821	7,550	
Total liabilities, shareholders' equity, and noncontrolling interest	\$17,460	\$16,676	

See accompanying notes to Consolidated Financial Statements. See Note 15. "Indemnity Supplemental Information," for supplemental consolidating statements of financial position information.

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

	Six months ended		
	June 30,		
	2014	2013	
Cash flows from operating activities			
Premiums collected	\$2,679	\$2,450	
Net investment income received	235	222	
Limited partnership distributions	64	79	
Service agreement fee received	15	15	
Commissions and bonuses paid to agents	(397)	(356))
Losses paid	(1,630)	(1,359))
Loss expenses paid	(251)	(227))
Other underwriting and acquisition costs paid	(372)	(345))
Income taxes paid	(98)	(149))
Net cash provided by operating activities	245	330	
Cash flows from investing activities			
Purchase of investments:			
Fixed maturities	(1,090)	(1,240))
Preferred stock	(168)	(54))
Common stock	(550)	(700))
Limited partnerships	(46)	(52))
Sales/maturities of investments:			
Fixed maturity sales	371	330	
Fixed maturity calls/maturities	413	617	
Preferred stock	119	42	
Common stock	565	654	
Sale of and returns on limited partnerships	70	86	
Net purchase of property and equipment	(17)	(19))
Net collections on agent loans	1	1	
Net cash used in investing activities	(332)	(335))
Cash flows from financing activities			
Annuity deposits and interest	45	47	
Annuity surrenders and withdrawals	(39)	(39))
Universal life deposits and interest	14	12	
Universal life surrenders	(6)	(5))
Purchase of treasury stock	(20)	(17))
Dividends paid to shareholders	(59)	(28))
Net cash used in financing activities	(65)	(30))
Net decrease in cash and cash equivalents	(152)	(35))
Cash and cash equivalents at beginning of period	452	400	
Cash and cash equivalents at end of period	\$300	\$365	

See accompanying notes to Consolidated Financial Statements. See Note 15. "Indemnity Supplemental Information," for supplemental cash flow information.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1. Nature of Operations

Erie Indemnity Company (“Indemnity”) is a publicly held Pennsylvania business corporation that has been the managing attorney-in-fact for the subscribers (policyholders) at the Erie Insurance Exchange (“Exchange”) since 1925. The Exchange is a subscriber-owned, Pennsylvania-domiciled reciprocal insurer that writes property and casualty insurance.

Indemnity’s primary function is to perform certain services for the Exchange relating to the sales, underwriting and issuance of policies on behalf of the Exchange. This is done in accordance with a subscriber’s agreement (a limited power of attorney) executed by each subscriber (policyholder), which appoints Indemnity as their common attorney-in-fact to transact business on their behalf and to manage the affairs of the Exchange. Pursuant to the subscriber’s agreement and for its services as attorney-in-fact, Indemnity earns a management fee calculated as a percentage of the direct premiums written by the Exchange and the other members of the Property and Casualty Group (defined below), which are assumed by the Exchange under an intercompany pooling arrangement.

Indemnity has the power to direct the activities of the Exchange that most significantly impact the Exchange’s economic performance by acting as the common attorney-in-fact and decision maker for the subscribers (policyholders) at the Exchange.

The Exchange, together with its wholly owned subsidiaries, Erie Insurance Company (“EIC”), Erie Insurance Company of New York (“ENY”), Erie Insurance Property and Casualty Company (“EPC”), and Flagship City Insurance Company (“Flagship”), operate as a property and casualty insurer and are collectively referred to as the “Property and Casualty Group”. The Property and Casualty Group operates in 11 Midwestern, Mid-Atlantic and Southeastern states and the District of Columbia.

Erie Family Life Insurance Company (“EFL”), a wholly owned subsidiary of the Exchange, operates as a life insurer that underwrites and sells individual and group life insurance policies and fixed annuities.

Indemnity plans to expand the property and casualty and life insurance operations of the Erie Insurance Group into the Commonwealth of Kentucky by the first quarter of 2015 or earlier if possible.

All property and casualty and life insurance operations are owned by the Exchange and Indemnity functions solely as the management company.

The consolidated financial statements of Erie Indemnity Company reflect the results of Indemnity and its variable interest entity, the Exchange, which we refer to collectively as the “Erie Insurance Group” (“we,” “us,” “our”).

“Indemnity shareholder interest” refers to the interest in Erie Indemnity Company owned by the Class A and Class B shareholders. “Noncontrolling interest” refers to the interest in the Erie Insurance Exchange held for the subscribers (policyholders).

Note 2. Significant Accounting Policies

Basis of presentation

The accompanying consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles (“GAAP”) and include the accounts of Indemnity together with its affiliate companies in which

Indemnity holds a majority voting or economic interest.

Use of estimates

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of our financial position, results of operations, and cash flows for the interim periods have been included. Operating results for the six months ended June 30, 2014 are not necessarily indicative of the results that may be expected for the year ended December 31, 2014. The accompanying consolidated financial statements and notes should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013 as filed with the Securities and Exchange Commission on February 27, 2014.

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Principles of consolidation

We consolidate the Exchange as a variable interest entity for which Indemnity is the primary beneficiary. All intercompany accounts and transactions have been eliminated in consolidation. The required presentation of noncontrolling interests is reflected in the consolidated financial statements. Noncontrolling interests represent the ownership interests of the Exchange, all of which are held by parties other than Indemnity (i.e. the Exchange's subscribers (policyholders)). Noncontrolling interests also include the Exchange subscribers' ownership interest in EFL.

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

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

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

Pending accounting pronouncements

In January 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-01, Accounting for Investments in Qualified Affordable Housing Projects. This guidance permits reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Generally, investors in qualified affordable housing project investments expect to receive substantially all of their return through the receipt of tax credits and other tax benefits. ASU No. 2014-01 allows for the recording of the investment performance net of taxes as a component of income tax expense to more fairly represent the economics of the investments and provide users with a better understanding of the returns from such investments. The qualifications to make this accounting election were also made less restrictive. ASU No. 2014-01 is effective for annual and interim periods beginning after December 15, 2014, with early adoption permitted. While we are currently evaluating whether to make the accounting election and whether the election would be made for early adoption, such election is not expected to have a material impact on our consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers. ASU No. 2014-09 clarifies the principles for recognizing revenue and provides a common revenue standard for GAAP. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Insurance contracts are not within the scope of this guidance. ASU No. 2014-09 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016. Early application is not permitted. We do not expect the adoption of ASU No. 2014-09 related to the management fee and service agreement

revenue to have a material impact on our consolidated financial statements.

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Note 3. Indemnity Earnings Per Share

Class A and Class B basic earnings per share and Class B diluted earnings per share are calculated under the two-class method. The two-class method allocates earnings to each class of stock based upon its dividend rights. Class B shares are convertible into Class A shares at a conversion ratio of 2,400 to 1. See Note 11. "Indemnity Capital Stock".

Class A diluted earnings per share are calculated under the if-converted method, which reflects the conversion of Class B shares to Class A shares. Diluted earnings per share calculations include the effect of any potential common shares. Potential common shares include outstanding vested and not yet vested awards related to our outside directors' stock compensation plan and any employee stock based awards.

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

(dollars in millions, except per share data)	Indemnity Shareholder Interest					
	Three months ended June 30,					
	2014			2013		
	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount	Allocated net income (numerator)	Weighted shares (denominator)	Per- share amount
Class A – Basic EPS:						
Income available to Class A stockholders	\$49	46,214,153	\$ 1.05	\$44	46,693,333	\$0.95
Dilutive effect of stock-based awards	0	96,461	—	0	92,126	—
Assumed conversion of Class B shares	0	6,100,800	—	0	6,100,800	—
Class A – Diluted EPS:						
Income available to Class A stockholders on Class A equivalent shares	\$49	52,411,414	\$0.94	\$44	52,886,259	\$0.84
Class B – Basic and diluted EPS:						
Income available to Class B stockholders	\$0	2,542	\$ 158	\$0	2,542	\$ 142

(dollars in millions, except per share data)	Indemnity Shareholder Interest					
	Six months ended June 30,					
	2014			2013		
	Allocated net income (numerator)	Weighted shares (denominator)	Per-share amount	Allocated net income (numerator)	Weighted shares (denominator)	Per- share amount
Class A – Basic EPS:						
Income available to Class A stockholders	\$94	46,307,659	\$2.04	\$80	46,733,925	\$ 1.73
Dilutive effect of stock-based awards	0	96,461	—	0	92,126	—
	1	6,100,800	—	1	6,100,800	—

Assumed conversion of Class B
shares

Class A – Diluted EPS:

Income available to Class A
stockholders on Class A
equivalent shares

\$95	52,504,920	\$1.82	\$81	52,926,851	\$1.54
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Class B – Basic and diluted EPS:

Income available to Class B
stockholders

\$1	2,542	\$307	\$1	2,542	\$259
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Note 4. Variable Interest Entity

Erie Insurance Exchange

The Exchange is a reciprocal insurance exchange domiciled in Pennsylvania, for which Indemnity serves as attorney-in-fact. Indemnity holds a variable interest in the Exchange due to the absence of decision-making capabilities by the equity owners (subscribers/policyholders) of the Exchange and due to the significance of the management fee the Exchange pays to Indemnity as its decision maker. As a result, Indemnity is deemed to have a controlling financial interest in the Exchange and is considered to be its primary beneficiary.

Consolidation of the Exchange's financial results is required given the significance of the management fee to the Exchange and because Indemnity has the power to direct the activities of the Exchange that most significantly impact the Exchange's economic performance. The Exchange's anticipated economic performance is the product of its underwriting results combined with its investment results. The fees paid to Indemnity under the subscriber's agreement impact the anticipated economic performance attributable to the Exchange's results. Indemnity earns a management fee from the Exchange for the services it provides as attorney-in-fact. Indemnity's management fee revenues are based upon all premiums written or assumed by the Exchange. Indemnity's Board of Directors determines the management fee rate to be paid by the Exchange to Indemnity. This rate cannot exceed 25% of the direct and assumed written premiums of the Exchange, as defined by the subscriber's agreement signed by each policyholder. Management fee revenues and management fee expenses are eliminated upon consolidation.

The shareholders of Indemnity have no rights to the assets of the Exchange and no obligations arising from the liabilities of the Exchange. Indemnity has no obligation related to any underwriting and/or investment losses experienced by the Exchange. Indemnity would, however, be adversely impacted if the Exchange incurred significant underwriting and/or investment losses. If the surplus of the Exchange were to decline significantly from its current level, its financial strength ratings could be reduced and, as a consequence, the Exchange could find it more difficult to retain its existing business and attract new business. A decline in the business of the Exchange would have an adverse effect on the amount of the management fees Indemnity receives. In addition, a decline in the surplus of the Exchange from its current level may impact the management fee rate received by Indemnity. Indemnity also has an exposure to a concentration of credit risk related to the unsecured receivables due from the Exchange for its management fee. If any of these events occurred, Indemnity's financial position, financial performance, and/or cash flows could be adversely impacted.

All property and casualty and life insurance operations are owned by the Exchange, and Indemnity functions solely as the management company.

Indemnity has not provided financial or other support to the Exchange for any of the reporting periods presented. At June 30, 2014, there are no explicit or implicit arrangements that would require Indemnity to provide future financial support to the Exchange. Indemnity is not liable if the Exchange was to be in violation of its debt covenants or was unable to meet its obligation for unfunded commitments to limited partnerships.

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Note 5. Segment Information

Our reportable segments include management operations, property and casualty insurance operations, life insurance operations, and investment operations. Accounting policies for segments are the same as those described in the summary of significant accounting policies. See Item 8. “Financial Statements and Supplementary Data, Note 2. Significant Accounting Policies,” in our Annual Report on Form 10-K for the year ended December 31, 2013 as filed with the Securities and Exchange Commission on February 27, 2014. Assets are not allocated to the segments, but rather, are reviewed in total for purposes of decision-making. No single customer or agent provides 10% or more of revenues.

Management operations

Our management operations segment consists of Indemnity serving as attorney-in-fact for the Exchange. Indemnity operates in this capacity solely for the Exchange. We evaluate profitability of our management operations segment principally on the gross margin from management operations. Indemnity earns a management fee from the Exchange for providing sales, underwriting, and policy issuance services. Management fee revenue, which is eliminated upon consolidation, is calculated as a percentage not to exceed 25% of all the direct premiums written by the Exchange and the other members of the Property and Casualty Group, which are assumed by the Exchange under an intercompany pooling arrangement. The Property and Casualty Group issues policies with annual terms only. Management fees are recorded upon policy issuance or renewal, as substantially all of the services required to be performed by Indemnity have been satisfied at that time. Certain activities are performed and related costs are incurred by us subsequent to policy issuance in connection with the services provided to the Exchange; however, these activities are inconsequential and perfunctory. Although these management fee revenues and expenses are eliminated upon consolidation, the amount of the fee directly impacts the allocation of our consolidated net income between the noncontrolling interest, which bears the management fee expense and represents the interests of the Exchange subscribers (policyholders), and Indemnity’s interest, which earns the management fee revenue and represents the Indemnity shareholder interest in net income.

Property and casualty insurance operations

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

Life insurance operations

Our life insurance operations segment includes traditional and universal life insurance products and fixed annuities marketed to individuals using the same independent agency force utilized by our property and casualty insurance operations. We evaluate profitability of the life insurance segment principally based upon segment net income, including investments, which for segment purposes are reflected in the investment operations segment. At the same time, we recognize that investment-related income is integral to the evaluation of the life insurance segment because of the long duration of life products. For the second quarters of 2014 and 2013, investment activities on life insurance related assets generated revenues of \$24 million and \$26 million, respectively, resulting in EFL reporting income before income taxes of \$10 million and \$13 million, respectively, before intercompany eliminations. For the six months ended June 30, 2014 and June 30, 2013, investment activities on life insurance related assets generated

revenues of \$53 million and \$52 million, respectively, resulting in EFL reporting income before income taxes of \$23 million and \$24 million, respectively, before intercompany eliminations.

Investment operations

The investment operations segment includes returns from our fixed maturity, equity security and limited partnership investment portfolios to support our underwriting business. The Indemnity and Exchange portfolios are managed with the objective of maximizing after-tax returns on a risk-adjusted basis, while the EFL portfolio is managed to be closely aligned to its liabilities and to maintain a sufficient yield to meet profitability targets. Management actively evaluates the portfolios for impairments. We record impairment writedowns on investments in instances where the fair value of the investment is substantially below cost, and we conclude that the decline in fair value is other-than-temporary. Investment related income for the life operations is included in the investment segment results.

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

(in millions)	Erie Insurance Group Three months ended June 30, 2014					Eliminations	Consolidated
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations			
Premiums earned/life policy revenue		\$1,298	\$22			\$(1)	\$ 1,319
Net investment income				\$116		(5)	111
Net realized investment gains				133			133
Net impairment losses recognized in earnings				0			0
Equity in earnings of limited partnerships				27			27
Management fee revenue	\$366					(366)	—
Service agreement and other revenue	8		0				8
Total revenues	374	1,298	22	276		(372)	1,598
Cost of management operations	306					(306)	—
Insurance losses and loss expenses		1,101	27			(2)	1,126
Policy acquisition and underwriting expenses		380	9			(64)	325
Total benefits and expenses	306	1,481	36	—		(372)	1,451
Income (loss) before income taxes	68	(183)	(14)	276		—	147
Provision for income taxes	24	(64)	(5)	89		—	44
Net income (loss)	\$44	\$(119)	\$(9)	\$187		—	\$ 103

(in millions)	Erie Insurance Group Three months ended June 30, 2013					Eliminations	Consolidated
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations			
Premiums earned/life policy revenue		\$1,196	\$20			\$(1)	\$ 1,215
Net investment income				\$107		(3)	104
Net realized investment gains				61			61
Net impairment losses recognized in earnings				(1)			(1)
Equity in earnings of limited partnerships				39			39
Management fee revenue	\$336					(336)	—
Service agreement and other revenue	8		0				8
Total revenues	344	1,196	20	206		(340)	1,426
Cost of management operations	285					(285)	—
Insurance losses and loss expenses		837	26			(2)	861

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Policy acquisition and underwriting expenses		348	7		(53) 302
Total benefits and expenses	285	1,185	33	—	(340) 1,163
Income (loss) before income taxes	59	11	(13) 206	—	263
Provision for income taxes	21	4	(5) 66	—	86
Net income (loss)	\$38	\$7	\$(8) \$140	\$—	\$ 177

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(in millions)	Erie Insurance Group Six months ended June 30, 2014					Eliminations	Consolidated
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations			
Premiums earned/life policy revenue		\$2,566	\$42			\$ (1)	\$ 2,607
Net investment income				\$228		(8)	220
Net realized investment gains				189			189
Net impairment losses recognized in earnings				0			0
Equity in earnings of limited partnerships				77			77
Management fee revenue	\$685					(685)	—
Service agreement and other revenue	15		1				16
Total revenues	700	2,566	43	494		(694)	3,109
Cost of management operations	574					(574)	—
Insurance losses and loss expenses		2,108	55			(3)	2,160
Policy acquisition and underwriting expenses		745	18			(117)	646
Total benefits and expenses	574	2,853	73	—		(694)	2,806
Income (loss) before income taxes	126	(287)	(30)	494		—	303
Provision for income taxes	44	(100)	(11)	158		—	91
Net income (loss)	\$82	\$(187)	\$(19)	\$336		\$—	\$ 212

(in millions)	Erie Insurance Group Six months ended June 30, 2013					Eliminations	Consolidated
	Management operations	Property and casualty insurance operations	Life insurance operations	Investment operations			
Premiums earned/life policy revenue		\$2,352	\$39			\$ (1)	\$ 2,390
Net investment income				\$213		(6)	207
Net realized investment gains				310			310
Net impairment losses recognized in earnings				(1)			(1)
Equity in earnings of limited partnerships				75			75
Management fee revenue	\$632					(632)	—
Service agreement and other revenue	15		1				16
Total revenues	647	2,352	40	597		(639)	2,997
Cost of management operations	539					(539)	—
Insurance losses and loss expenses		1,654	52			(3)	1,703
Policy acquisition and underwriting expenses		676	16			(97)	595
Total benefits and expenses	539	2,330	68	—		(639)	2,298
Income (loss) before income taxes	108	22	(28)	597		—	699

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Provision for income taxes	38	8	(10) 196	—	232
Net income (loss)	\$70	\$14	\$(18) \$401	\$—	\$ 467

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Note 6. Fair Value

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

Valuation techniques used to derive the fair value of our available-for-sale and trading securities are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources. Unobservable inputs reflect our own assumptions regarding fair market value for these securities. Although the majority of our prices are obtained from third party sources, we also perform an internal pricing review for securities with low trading volumes under current market conditions. Financial instruments are categorized based upon the following characteristics or inputs to the valuation techniques:

• Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity can access at the measurement date.

• Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly.

• Level 3 – Unobservable inputs for the asset or liability.

Estimates of fair values for our investment portfolio are obtained primarily from a nationally recognized pricing service. Our Level 1 category includes those securities valued using an exchange traded price provided by the pricing service. The methodologies used by the pricing service that support a Level 2 classification of a financial instrument include multiple verifiable, observable inputs including benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, and reference data. Pricing service valuations for Level 3 securities are based upon proprietary models and are used when observable inputs are not available or in illiquid markets.

In limited circumstances we adjust the price received from the pricing service when, in our judgment, a better reflection of fair value is available based upon corroborating information and our knowledge and monitoring of market conditions such as a disparity in price of comparable securities and/or non-binding broker quotes. In other circumstances, certain securities are internally priced because prices are not provided by the pricing service.

We perform continuous reviews of the prices obtained from the pricing service. This includes evaluating the methodology and inputs used by the pricing service to ensure that we determine the proper classification level of the financial instrument. Price variances, including large periodic changes, are investigated and corroborated by market data. We have reviewed the pricing methodologies of our pricing service as well as other observable inputs, such as data, and transaction volumes and believe that their prices adequately consider market activity in determining fair value. Our review process continues to evolve based upon accounting guidance and requirements.

When a price from the pricing service is not available, values are determined by obtaining broker/dealer quotes and/or market comparables. When available, we obtain multiple quotes for the same security. The ultimate value for these securities is determined based upon our best estimate of fair value using corroborating market information. Our evaluation includes the consideration of benchmark yields, reported trades, issuer spreads, two-sided markets, benchmark securities, bids, offers, and reference data.

For certain securities in an illiquid market, there may be no prices available from a pricing service and no comparable market quotes available. In these situations, we value the security using an internally-developed, risk-adjusted discounted cash flow model.

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The following table represents our consolidated fair value measurements on a recurring basis by asset class and level of input at June 30, 2014:

(in millions)	Erie Insurance Group June 30, 2014 Fair value measurements using:			
	Total	Quoted prices in active markets for identical assets Level 1	Observable inputs Level 2	Unobservable inputs Level 3
Indemnity				
Available-for-sale securities:				
States & political subdivisions	\$241	\$0	\$241	\$0
Corporate debt securities	256	0	255	1
Collateralized debt obligations	0	0	0	0
Total fixed maturities	497	0	496	1
Nonredeemable preferred stock	14	2	12	0
Common stock	12	12	0	0
Total available-for-sale securities	523	14	508	1
Other investments ⁽¹⁾	18	0	0	18
Total – Indemnity	\$541	\$14	\$508	\$19
Exchange				
Available-for-sale securities:				
U.S. treasury	\$31	\$0	\$31	\$0
Government sponsored enterprises	4	0	4	0
States & political subdivisions	1,519	0	1,519	0
Foreign government securities	15	0	15	0
Corporate debt securities	6,866	0	6,841	25
Residential mortgage-backed securities	146	0	146	0
Commercial mortgage-backed securities	34	0	34	0
Collateralized debt obligations	14	0	14	0
Other debt securities	72	0	72	0
Total fixed maturities	8,701	0	8,676	25
Nonredeemable preferred stock	717	303	413	1
Common stock	197	197	0	0
Total available-for-sale securities	9,615	500	9,089	26
Trading securities:				
Common stock	3,377	3,362	0	15
Total trading securities	3,377	3,362	0	15
Other investments ⁽¹⁾	102	0	0	102
Total – Exchange	\$13,094	\$3,862	\$9,089	\$143
Total – Erie Insurance Group	\$13,635	\$3,876	\$9,597	\$162

(1) Other investments measured at fair value represent four real estate funds included on the balance sheet as limited partnership investments that are reported under the fair value option. These investments can never be redeemed with the funds. Instead, distributions are received when liquidation of the underlying assets of the funds occur. It is estimated that the underlying assets will generally be liquidated between 5 and 10 years from the inception

of the funds. The fair value of these investments is based on the net asset value (NAV) information provided by the general partner. Fair value is based on our proportionate share of the NAV based on the most recent partners' capital statements received from the general partners, which is generally one quarter prior to our balance sheet date. These values are then analyzed to determine if they represent the NAV at our balance sheet date, with adjustment being made where appropriate. We consider observable market data and perform a review validating the appropriateness of the NAV at each balance sheet date. It is likely that all of the investments will be redeemed at a future date for an amount different than the NAV of our ownership interest in partners' capital as of June 30, 2014. During the six months ended June 30, 2014, Indemnity made no contributions and received distributions totaling \$1.8 million, and the Exchange made no contributions and received distributions totaling \$6.9 million for these investments. As of June 30, 2014, the amount of unfunded commitments related to the investments was \$1.5 million for Indemnity and \$4.5 million for the Exchange.

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Level 3 Assets – Quarterly Change:

(in millions)	Erie Insurance Group						Ending balance at June 30, 2014
	Beginning balance at March 31, 2014	Included in earnings ⁽¹⁾	Included in other comprehensive income	Purchases	Sales	Transfers in and (out) of Level 3 ⁽²⁾	
Indemnity							
Available-for-sale securities:							
Corporate debt securities	\$1	\$0	\$ 0	\$ 0	\$0	\$0	\$1
Collateralized debt obligations	0	0	0	0	0	0	0
Total fixed maturities	1	0	0	0	0	0	1
Total available-for-sale securities	1	0	0	0	0	0	1
Other investments	18	1	0	0	(1)	0	18
Total Level 3 assets – Indemnity	\$19	\$1	\$ 0	\$ 0	\$(1)	\$0	\$19
Exchange							
Available-for-sale securities:							
Corporate debt securities	\$26	\$0	\$ 0	\$ 0	\$(1)	\$0	\$25
Collateralized debt obligations	0	0	0	0	0	0	0
Total fixed maturities	26	0	0	0	(1)	0	25
Nonredeemable preferred stock	1	0	0	0	0	0	1
Total available-for-sale securities	27	0	0	0	(1)	0	26
Trading securities:							
Common stock	15	0	0	0	0	0	15
Total trading securities	15	0	0	0	0	0	15
Other investments	98	6	0	0	(2)	0	102
Total Level 3 assets – Exchange	\$140	\$6	\$ 0	\$ 0	\$(3)	\$0	\$143
Total Level 3 assets – Erie Insurance Group	\$159	\$7	\$ 0	\$ 0	\$(4)	\$0	\$162

(1) These amounts are reported in the Consolidated Statement of Operations. There is \$7 million included in equity in earnings of limited partnerships for the three months ended June 30, 2014 on Level 3 securities.

(2) Transfers in and out of Level 3 are attributable to changes in the availability of market observable information for individual securities within the respective categories. Transfers in and out of levels are recognized at the start of the period.

We review the fair value hierarchy classifications each reporting period. Transfers between hierarchy levels may occur due to changes in the available market observable inputs. Transfers in and out of level classifications are reported as having occurred at the beginning of the quarter in which the transfers occurred.

For Indemnity, there were no transfers between Level 1 and Level 2 or between Level 2 and Level 3 for the three months ended June 30, 2014.

For the Exchange, Level 1 to Level 2 transfers totaled \$11 million due to trading activity levels for one preferred stock holding, and there were no transfers from Level 2 to Level 1 or between Level 2 and Level 3 for the three months ended June 30, 2014.

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Level 3 Assets – Year-to-Date Change:

(in millions)	Erie Insurance Group					Transfers in and (out) of Level 3 ⁽²⁾	Ending balance at June 30, 2014
	Beginning balance at December 31, 2013	Included in earnings (¹)	Included in other comprehensive income	Purchases	Sales		
Indemnity							
Available-for-sale securities:							
Corporate debt securities	\$1	\$0	\$ 0	\$ 0	\$0	\$0	\$1
Collateralized debt obligations	1	0	0	0	(1)	0	0
Total fixed maturities	2	0	0	0	(1)	0	1
Total available-for-sale securities	2	0	0	0	(1)	0	1
Other investments	18	2	0	0	(2)	0	18
Total Level 3 assets – Indemnity	\$20	\$2	\$ 0	\$ 0	\$(3)	\$0	\$19
Exchange							
Available-for-sale securities:							
Corporate debt securities	\$26	\$0	\$ 0	\$ 0	\$(1)	\$0	\$25
Collateralized debt obligations	5	1	(1)	0	(3)	(2)	0
Total fixed maturities	31	1	(1)	0	(4)	(2)	25
Nonredeemable preferred stock	0	0	0	1	0	0	1
Total available-for-sale securities	31	1	(1)	1	(4)	(2)	26
Trading securities:							
Common stock	15	0	0	0	0	0	15
Total trading securities	15	0	0	0	0	0	15
Other investments	98	11	0	0	(7)	0	102
Total Level 3 assets – Exchange	\$144	\$12	\$ (1)	\$ 1	\$(11)	\$(2)	\$143
Total Level 3 assets – Erie Insurance Group	\$164	\$14	\$ (1)	\$ 1	\$(14)	\$(2)	\$162

These amounts are reported in the Consolidated Statement of Operations. There is \$1 million included in net (1) realized investment gains (losses) and \$13 million included in equity in earnings of limited partnerships for the six months ended June 30, 2014 on Level 3 securities.

Transfers in and out of Level 3 are attributable to changes in the availability of market observable information for (2) individual securities within the respective categories. Transfers in and out of levels are recognized at the start of the period.

For Indemnity, there were no transfers between Level 1 and Level 2 or between Level 2 and Level 3 for the six months ended June 30, 2014.

For the Exchange, Level 1 to Level 2 transfers totaled \$14 million due to trading activity levels for two preferred stock holdings, and there were no transfers from Level 2 to Level 1 for the six months ended June 30, 2014. There were no Level 2 to Level 3 transfers, and Level 3 to Level 2 transfers totaled \$2 million for one fixed maturity holding as a result of using observable market data to determine the fair value at June 30, 2014.

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Quantitative and Qualitative Disclosures about Unobservable Inputs

(dollars in millions)	Erie Insurance Group June 30, 2014		Valuation techniques	Unobservable input	Range	Weighted average
	Fair value	No. of holdings				
Indemnity						
Corporate debt securities ⁽¹⁾	\$1	1	Market approach	Non-binding broker quote	114	
Collateralized debt obligations ⁽²⁾	0	1	Income approach	Projected maturity date	Dec 2014	
				Repayment at maturity	1%	
				Discount rate	15%	
Other investments ⁽⁴⁾	18	2				
Total Level 3 assets – Indemnity	\$19	4				
Exchange						
Corporate debt securities ⁽¹⁾⁽³⁾	\$25	7	Market approach	Non-binding broker quote	109-117	111
				Comparable transaction EBITDA multiples	8.0 - 12.1x	8.0x
				Comparable security yield	6%	
Collateralized debt obligations ⁽²⁾	0	2	Income approach	Projected maturity date	Dec 2014 - Oct 2035	
				Repayment at maturity	1 - 100%	64%
				Discount rate	15 - 18%	17%
Nonredeemable preferred stock ⁽⁵⁾	1	1	Market approach	Comparable company price-to-sales ratio	12.0 - 22.0x	19.0x
Common stock ⁽³⁾	15	4	Market approach	Comparable transaction EBITDA multiples	8.0 - 12.1x	8.0x
				Discount for lack of marketability	5 - 30%	10%
Other investments ⁽⁴⁾	102	4				
Total Level 3 assets – Exchange	\$143	18				
Total Level 3 assets – Erie Insurance Group	\$162	22				

Corporate debt securities – The unobservable input used in the fair value measurement of certain corporate debt securities is the likelihood of repayment by the underlying entity when there is no market for trading these securities. When available, we obtain non-binding broker quotes to value such securities. When a non-binding broker quote was the only input available, it was considered unobservable.

(2)

Collateralized-debt-obligation securities – The unobservable inputs used in the fair value measurement of certain collateralized-debt-obligation securities are the repayment at maturity of underlying collateral available to pay note holders, the projected maturity of the underlying security, and a discount rate appropriate for the security. Significant changes in any of those inputs in isolation would result in a significantly higher or lower fair value measurement. Generally, a change in the assumption used for the performance of the underlying collateral is accompanied by an opposite change in the maturity and a directionally opposite change in the discount rate used to value the security.

(3) Common stock investments and Corporate debt securities – The unobservable inputs used in the fair value measurement of direct private equity common stock investments and certain corporate debt securities are comparable private transaction earnings before interest, taxes, depreciation, and amortization (“EBITDA”) multiples, the average EBITDA multiple for comparable publicly traded companies and the amount of discount applied to the price due to the illiquidity of the securities being valued. Significant changes in any of those inputs in isolation could result in a significantly higher or lower fair value measurement.

(4) Other investments – Other investments represent certain limited partnerships that are recorded at fair value and are based upon net asset value (NAV) provided by the general partner where the unobservable inputs are not reasonably available to us.

(5) Nonredeemable preferred stock - The unobservable input used in the fair value measurement of a private nonredeemable preferred stock security is the price to sales ratio for comparable publicly traded companies.

Securities valued using unobservable inputs shown above totaled \$162 million at June 30, 2014. In total, Level 3 assets represent less than 1.2% of the total assets measured at fair value on a recurring basis for the Erie Insurance Group.

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The following table represents our consolidated fair value measurements on a recurring basis by asset class and level of input at December 31, 2013:

(in millions)	Erie Insurance Group December 31, 2013 Fair value measurements using:			
	Total	Quoted prices in active markets for identical assets Level 1	Observable inputs Level 2	Unobservable inputs Level 3
Indemnity				
Available-for-sale securities:				
States & political subdivisions	\$243	\$ 0	\$243	\$ 0
Corporate debt securities	282	0	281	1
Collateralized debt obligations	1	0	0	1
Total fixed maturities	526	0	524	2
Nonredeemable preferred stock	25	2	23	0
Common stock	25	25	0	0
Total available-for-sale securities	576	27	547	2
Other investments ⁽¹⁾	18	0	0	18
Total – Indemnity	\$594	\$ 27	\$547	\$ 20
Exchange				
Available-for-sale securities:				
U.S. government & agencies	\$172	\$ 0	\$172	\$ 0
States & political subdivisions	1,470	0	1,470	0
Foreign government securities	15	0	15	0
Corporate debt securities	6,211	0	6,185	26
Residential mortgage-backed securities	156	0	156	0
Commercial mortgage-backed securities	47	0	47	0
Collateralized debt obligations	16	0	11	5
Other debt securities	75	0	75	0
Total fixed maturities	8,162	0	8,131	31
Nonredeemable preferred stock	621	242	379	0
Common stock	198	198	0	0
Total available-for-sale securities	8,981	440	8,510	31
Trading securities:				
Common stock	3,202	3,187	0	15
Total trading securities	3,202	3,187	0	15
Other investments ⁽¹⁾	98	0	0	98
Total – Exchange	\$12,281	\$ 3,627	\$8,510	\$ 144
Total – Erie Insurance Group	\$12,875	\$ 3,654	\$9,057	\$ 164

(1) Other investments measured at fair value represent four real estate funds included on the balance sheet as limited partnership investments that are reported under the fair value option. These investments can never be redeemed with the funds. Instead, distributions are received when liquidation of the underlying assets of the funds occur. It is estimated that the underlying assets will generally be liquidated between 5 and 10 years from the inception of the funds. The fair value of these investments is based on the net asset value (NAV) information provided by the general partner. Fair value is based on our proportionate share of the NAV based on the most recent partners' capital statements received from the general partners, which is generally one quarter prior to our balance sheet date. These

values are then analyzed to determine if they represent the NAV at our balance sheet date, with adjustment being made where appropriate. We consider observable market data and perform a review validating the appropriateness of the NAV at each balance sheet date. It is likely that all of the investments will be redeemed at a future date for an amount different than the NAV of our ownership interest in partners' capital as of December 31, 2013. During the year ended December 31, 2013, Indemnity made no contributions and received distributions totaling \$2.4 million, and the Exchange made no contributions and received distributions totaling \$21.7 million for these investments. As of December 31, 2013, the amount of unfunded commitments related to the investments was \$1.5 million for Indemnity and \$4.5 million for the Exchange.

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Level 3 Assets – Quarterly Change:

(in millions)	Erie Insurance Group						Ending balance at June 30, 2013
	Beginning balance at March 31, 2013	Included in earnings ⁽¹⁾	Included in other comprehensive income	Purchases	Sales	Transfers in and (out) of Level 3 ⁽²⁾	
Indemnity							
Available-for-sale securities:							
Corporate debt securities	\$1	\$0	\$0	\$0	\$0	\$0	\$1
Collateralized debt obligations	2	0	0	0	(1)	0	1
Total fixed maturities	3	0	0	0	(1)	0	2
Total available-for-sale securities	3	0	0	0	(1)	0	2
Other investments	20	0	0	0	0	0	20
Total Level 3 assets – Indemnity	\$23	\$0	\$0	\$0	\$(1)	\$0	\$22
Exchange							
Available-for-sale securities:							
Corporate debt securities	58	0	(1)	1	(2)	(23)	33
Commercial mortgage-backed securities	5	0	0	0	(1)	0	4
Collateralized debt obligations	14	1	(1)	0	(2)	0	12
Total fixed maturities	77	1	(2)	1	(5)	(23)	49
Nonredeemable preferred stock	12	2	(1)	0	(6)	0	7
Total available-for-sale securities	89	3	(3)	1	(11)	(23)	56
Trading securities:							
Common stock	7	0	0	0	0	0	7
Total trading securities	7	0	0	0	0	0	7
Other investments	112	2	0	0	(1)	0	113
Total Level 3 assets – Exchange	\$208	\$5	\$(3)	\$1	\$(12)	\$(23)	\$176
Total Level 3 assets – Erie Insurance Group	\$231	\$5	\$(3)	\$1	\$(13)	\$(23)	\$198

These amounts are reported in the Consolidated Statement of Operations. There is \$3 million included in net (1) realized investment gains (losses) and \$2 million included in equity in earnings of limited partnerships for the three months ended June 30, 2013 on Level 3 securities.

Transfers in and out of Level 3 are attributable to changes in the availability of market observable information for (2) individual securities within the respective categories. Transfers in and out of levels are recognized at the start of the period.

We review the fair value hierarchy classifications each reporting period. Transfers between hierarchy levels may occur due to changes in the available market observable inputs. Transfers in and out of level classifications are reported as having occurred at the beginning of the quarter in which the transfers occurred.

For Indemnity, there were no transfers between Level 1 and Level 2 or between Level 2 and Level 3 for the three months ended June 30, 2013.

For the Exchange, there were no transfers between Level 1 and Level 2 or from Level 2 to Level 3 for the three months ended June 30, 2013. Level 3 to Level 2 transfers totaled \$23 million for three fixed maturity holdings. These transfers out of Level 3 were primarily the result of using observable market data to determine the fair value at June 30, 2013.

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Level 3 Assets – Year-to-Date Change:

(in millions)	Erie Insurance Group					Transfers in and (out) of Level 3 ⁽²⁾	Ending balance at June 30, 2013
	Beginning balance at December 31, 2012	Included in earnings (¹)	Included in other comprehensive income	Purchases	Sales		
Indemnity							
Available-for-sale securities:							
Corporate debt securities	\$1	\$0	\$ 0	\$ 0	\$0	\$0	\$1
Collateralized debt obligations	3	0	0	0	(2)	0	1
Total fixed maturities	4	0	0	0	(2)	0	2
Total available-for-sale securities	4	0	0	0	(2)	0	2
Other investments	19	1	0	0	0	0	20
Total Level 3 assets – Indemnity	\$23	\$1	\$ 0	\$ 0	\$(2)	\$0	\$22
Exchange							
Available-for-sale securities:							
Corporate debt securities	\$43	\$0	\$ (1)	\$ 1	\$(2)	\$(8)	\$33
Commercial mortgage-backed securities	0	0	(1)	0	(1)	6	4
Collateralized debt obligations	16	1	0	0	(7)	2	12
Total fixed maturities	59	1	(2)	1	(10)	0	49
Nonredeemable preferred stock	0	0	3	4	0	0	7
Total available-for-sale securities	59	1	1	5	(10)	0	56
Trading securities:							
Common stock	15	(3)	0	0	(5)	0	7
Total trading securities	15	(3)	0	0	(5)	0	7
Other investments	109	7	0	0	(3)	0	113
Total Level 3 assets – Exchange	\$183	\$5	\$ 1	\$ 5	\$(18)	\$0	\$176
Total Level 3 assets – Erie Insurance Group	\$206	\$6	\$ 1	\$ 5	\$(20)	\$0	\$198

These amounts are reported in the Consolidated Statement of Operations. There is \$(2) million of losses included (1) in net realized investment (losses) and \$8 million included in equity in earnings of limited partnerships for the six months ended June 30, 2013 on Level 3 securities.

Transfers in and out of Level 3 are attributable to changes in the availability of market observable information for (2) individual securities within the respective categories. Transfers in and out of levels are recognized at the start of the period.

For Indemnity, there were no Level 1 to Level 2 transfers for the six months ended June 30, 2013. Level 2 to Level 1 transfers totaled \$1 million, due to trading activity levels related to one preferred stock holding, and there were no transfers between Levels 2 and 3.

For the Exchange, Level 1 to Level 2 transfers totaled \$5 million and Level 2 to Level 1 transfers totaled \$44 million due to trading activity levels related to one preferred stock holding and five preferred stock holdings, respectively, for the six months ended June 30, 2013. Level 2 to Level 3 transfers totaled \$18 million for five fixed maturity holdings

and Level 3 to Level 2 transfers totaled \$18 million for two fixed maturity holdings. These transfers in and out of Level 3 were primarily the result of using non-binding and binding broker quotes, respectively, to determine the fair value at June 30, 2013.

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The following table presents our consolidated fair value measurements on a recurring basis by pricing source at June 30, 2014:

(in millions)	Erie Insurance Group			
	June 30, 2014			
	Total	Level 1	Level 2	Level 3
Indemnity				
Fixed maturities:				
Priced via pricing services	\$496	\$0	\$496	\$0
Priced via market comparables/broker quotes ⁽¹⁾	1	0	0	1
Priced via internal modeling	0	0	0	0
Total fixed maturities	497	0	496	1
Nonredeemable preferred stock:				
Priced via pricing services	12	2	10	0
Priced via market comparables/broker quotes ⁽¹⁾	2	0	2	0
Total nonredeemable preferred stock	14	2	12	0
Common stock:				
Priced via pricing services	12	12	0	0
Total common stock	12	12	0	0
Other investments:				
Priced via unobservable inputs ⁽²⁾	18	0	0	18
Total other investments	18	0	0	18
Total – Indemnity	\$541	\$14	\$508	\$19
Exchange				
Fixed maturities:				
Priced via pricing services	\$8,646	\$0	\$8,646	\$0
Priced via market comparables/broker quotes ⁽¹⁾	48	0	30	18
Priced via internal modeling	7	0	0	7
Total fixed maturities	8,701	0	8,676	25
Nonredeemable preferred stock:				
Priced via pricing services	679	303	376	0
Priced via market comparables/broker quotes ⁽¹⁾	37	0	37	0
Priced via internal modeling	1	0	0	1
Total nonredeemable preferred stock	717	303	413	1
Common stock:				
Priced via pricing services	3,559	3,559	0	0
Priced via internal modeling	15	0	0	15
Total common stock	3,574	3,559	0	15
Other investments:				
Priced via unobservable inputs ⁽²⁾	102	0	0	102
Total other investments	102	0	0	102
Total – Exchange	\$13,094	\$3,862	\$9,089	\$143
Total – Erie Insurance Group	\$13,635	\$3,876	\$9,597	\$162

(1) When a non-binding broker quote was the only price available, the security was classified as Level 3.

Other investments measured at fair value represent real estate funds included on the balance sheet as limited (2) partnership investments that are reported under the fair value option. The fair value of these investments is based on the net asset value (NAV) information provided by the general partner.

There were no assets measured at fair value on a nonrecurring basis during the six months ended June 30, 2014.

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Note 7. Investments

Available-for-sale securities

The following table summarizes the cost and fair value of our available-for-sale securities at June 30, 2014:

(in millions)	Erie Insurance Group June 30, 2014			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Indemnity				
Available-for-sale securities:				
States & political subdivisions	\$230	\$ 11	\$ 0	\$241
Corporate debt securities	254	2	0	256
Collateralized debt obligations	0	0	0	0
Total fixed maturities	484	13	0	497
Nonredeemable preferred stock	12	2	0	14
Common stock	13	0	1	12
Total available-for-sale securities – Indemnity	\$509	\$ 15	\$ 1	\$523
Exchange				
Available-for-sale securities:				
U.S. treasury	\$31	\$ 0	\$ 0	\$31
Government sponsored enterprises	3	1	0	4
States & political subdivisions	1,438	83	2	1,519
Foreign government securities	15	0	0	15
Corporate debt securities	6,409	465	8	6,866
Residential mortgage-backed securities	145	3	2	146
Commercial mortgage-backed securities	32	2	0	34
Collateralized debt obligations	7	7	0	14
Other debt securities	69	3	0	72
Total fixed maturities	8,149	564	12	8,701
Nonredeemable preferred stock	646	73	2	717
Common stock	196	2	1	197
Total available-for-sale securities – Exchange	\$8,991	\$ 639	\$ 15	\$9,615
Total available-for-sale securities – Erie Insurance Group	\$9,500	\$ 654	\$ 16	\$10,138

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The following table summarizes the cost and fair value of our available-for-sale securities at December 31, 2013:

(in millions)	Erie Insurance Group December 31, 2013			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Indemnity				
Available-for-sale securities:				
States & political subdivisions	\$237	\$ 7	\$ 1	\$243
Corporate debt securities	280	2	0	282
Collateralized debt obligations	1	0	0	1
Total fixed maturities	518	9	1	526
Nonredeemable preferred stock	24	2	1	25
Common stock	26	0	1	25
Total available-for-sale securities – Indemnity	\$568	\$ 11	\$ 3	\$576
Exchange				
Available-for-sale securities:				
U.S. government & agencies	\$171	\$ 1	\$ 0	\$172
States & political subdivisions	1,430	55	15	1,470
Foreign government securities	15	0	0	15
Corporate debt securities	5,902	354	45	6,211
Residential mortgage-backed securities	157	3	4	156
Commercial mortgage-backed securities	45	2	0	47
Collateralized debt obligations	8	8	0	16
Other debt securities	73	3	1	75
Total fixed maturities	7,801	426	65	8,162
Nonredeemable preferred stock	577	55	11	621
Common stock	201	0	3	198
Total available-for-sale securities – Exchange	\$8,579	\$ 481	\$ 79	\$8,981
Total available-for-sale securities – Erie Insurance Group	\$9,147	\$ 492	\$ 82	\$9,557

The amortized cost and estimated fair value of fixed maturities at June 30, 2014 are shown below by remaining contractual term to maturity. Mortgage-backed securities are allocated based upon their stated maturity dates. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(in millions)	Erie Insurance Group June 30, 2014	
	Amortized cost	Estimated fair value
Indemnity		
Due in one year or less	\$69	\$69
Due after one year through five years	229	232
Due after five years through ten years	113	118
Due after ten years	73	78
Total fixed maturities – Indemnity	\$484	\$497
Exchange		

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Due in one year or less	377	384
Due after one year through five years	3,155	3,365
Due after five years through ten years	3,094	3,303
Due after ten years	1,523	1,649
Total fixed maturities – Exchange	\$8,149	\$8,701
Total fixed maturities – Erie Insurance Group	\$8,633	\$9,198

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Available-for-sale securities in a gross unrealized loss position at June 30, 2014 are as follows. Data is provided by length of time for securities in a gross unrealized loss position.

(dollars in millions)	Erie Insurance Group						
	June 30, 2014						
	Less than 12 months		12 months or longer		Total		No. of holdings
Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses		
Indemnity							
Available-for-sale securities:							
States & political subdivisions	\$3	\$0	\$7	\$0	\$10	\$0	4
Corporate debt securities	49	0	6	0	55	0	172
Total fixed maturities	52	0	13	0	65	0	176
Nonredeemable preferred stock	0	0	2	0	2	0	2
Common stock	0	0	12	1	12	1	1
Total available-for-sale securities – Indemnity	\$52	\$0	\$27	\$1	\$79	\$1	179
Quality breakdown of fixed maturities:							
Investment grade	\$11	\$0	\$13	\$0	\$24	\$0	7
Non-investment grade	41	0	0	0	41	0	169
Total fixed maturities – Indemnity	\$52	\$0	\$13	\$0	\$65	\$0	176
Exchange							
Available-for-sale securities:							
U.S. treasury	\$0	\$0	\$0	\$0	\$0	\$0	1
States & political subdivisions	38	0	111	2	149	2	36
Foreign government securities	0	0	5	0	5	0	1
Corporate debt securities	312	2	279	6	591	8	376
Residential mortgage-backed securities	15	0	51	2	66	2	12
Commercial mortgage-backed securities	1	0	0	0	1	0	1
Other debt securities	4	0	7	0	11	0	3
Total fixed maturities	370	2	453	10	823	12	430
Nonredeemable preferred stock	42	0	40	2	82	2	14
Common stock	0	0	131	1	131	1	2
Total available-for-sale securities – Exchange	\$412	\$2	\$624	\$13	\$1,036	\$15	446
Quality breakdown of fixed maturities:							
Investment grade	\$203	\$1	\$429	\$9	\$632	\$10	131
Non-investment grade	167	1	24	1	191	2	299
Total fixed maturities – Exchange	\$370	\$2	\$453	\$10	\$823	\$12	430

The above securities for Indemnity and the Exchange have been evaluated and determined to be temporary impairments for which we expect to recover our entire principal plus interest. The primary components of this analysis include a general review of market conditions and financial performance of the issuer along with the extent and duration at which fair value is less than cost. Any securities that we intend to sell or will more likely than not be required to sell before recovery are included in other-than-temporary impairments with the impairment charges recognized in earnings.

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Available-for-sale securities in a gross unrealized loss position at December 31, 2013 are as follows. Data is provided by length of time for securities in a gross unrealized loss position.

(dollars in millions)	Erie Insurance Group December 31, 2013						
	Less than 12 months		12 months or longer		Total		No. of holdings
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses	
Indemnity							
Available-for-sale securities:							
States & political subdivisions	\$58	\$1	\$0	\$0	\$58	\$1	21
Corporate debt securities	54	0	10	0	64	0	11
Total fixed maturities	112	1	10	0	122	1	32
Nonredeemable preferred stock	5	1	3	0	8	1	4
Common stock	12	1	13	0	25	1	2
Total available-for-sale securities – Indemnity	\$129	\$3	\$26	\$0	\$155	\$3	38
Quality breakdown of fixed maturities:							
Investment grade	\$112	\$1	\$10	\$0	\$122	\$1	32
Non-investment grade	0	0	0	0	0	0	0
Total fixed maturities – Indemnity	\$112	\$1	\$10	\$0	\$122	\$1	32
Exchange							
Available-for-sale securities:							
U.S. government & agencies	\$1	\$0	\$0	\$0	\$1	\$0	2
States & political subdivisions	408	13	18	2	426	15	100
Foreign government securities	5	0	0	0	5	0	1
Corporate debt securities	1,251	43	36	2	1,287	45	237
Residential mortgage-backed securities	71	4	8	0	79	4	12
Commercial mortgage-backed securities	5	0	0	0	5	0	1
Other debt securities	30	1	0	0	30	1	5
Total fixed maturities	1,771	61	62	4	1,833	65	358
Nonredeemable preferred stock	182	10	13	1	195	11	27
Common stock	97	3	101	0	198	3	3
Total available-for-sale securities – Exchange	\$2,050	\$74	\$176	\$5	\$2,226	\$79	388
Quality breakdown of fixed maturities:							
Investment grade	\$1,707	\$57	\$62	\$4	\$1,769	\$61	344
Non-investment grade	64	4	0	0	64	4	14
Total fixed maturities – Exchange	\$1,771	\$61	\$62	\$4	\$1,833	\$65	358

The above securities for Indemnity and the Exchange have been evaluated and determined to be temporary impairments for which we expect to recover our entire principal plus interest. The primary components of this analysis include a general review of market conditions and financial performance of the issuer along with the extent and duration at which fair value is less than cost. Any securities that we intend to sell or will more likely than not be required to sell before recovery are included in other-than-temporary impairments with the impairment charges recognized in earnings.

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Net investment income

Interest and dividend income are recognized as earned and recorded to net investment income. Investment income, net of expenses, was generated from the following portfolios:

(in millions)	Erie Insurance Group			
	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Indemnity				
Fixed maturities	\$3	\$3	\$6	\$6
Equity securities	0	0	1	1
Cash equivalents and other	1	1	1	1
Total investment income	4	4	8	8
Less: investment expenses	0	1	0	1
Investment income, net of expenses – Indemnity	\$4	\$3	\$8	\$7
Exchange				
Fixed maturities	\$85	\$83	\$171	\$166
Equity securities	30	27	59	51
Cash equivalents and other	1	0	1	0
Total investment income	116	110	231	217
Less: investment expenses	9	9	19	17
Investment income, net of expenses – Exchange	\$107	\$101	\$212	\$200
Investment income, net of expenses – Erie Insurance Group	\$111	\$104	\$220	\$207

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Realized investment gains (losses)

Realized gains and losses on sales of securities are recognized in income based upon the specific identification method. Realized gains (losses) on investments were as follows:

(in millions)	Erie Insurance Group			
	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Indemnity				
Available-for-sale securities:				
Fixed maturities:				
Gross realized gains	\$0	\$0	\$0	\$0
Gross realized losses	0	0	0	0
Net realized gains	0	0	0	0
Equity securities:				
Gross realized gains	0	0	1	0
Gross realized losses	0	0	0	0
Net realized gains	0	0	1	0
Net realized investment gains – Indemnity	\$0	\$0	\$1	\$0
Exchange				
Available-for-sale securities:				
Fixed maturities:				
Gross realized gains	\$4	\$7	\$10	\$22
Gross realized losses	0	(3	) (1	) (5
Net realized gains	4	4	9	17
Equity securities:				
Gross realized gains	2	2	10	4
Gross realized losses	(1	) 0	(2	) 0
Net realized gains	1	2	8	4
Trading securities:				
Common stock:				
Gross realized gains	52	54	122	156
Gross realized losses	(7	) (3	) (10	) (15
Increases in fair value ⁽¹⁾	83	4	59	148
Net realized gains	128	55	171	289
Net realized investment gains – Exchange	\$133	\$61	\$188	\$310
Net realized investment gains – Erie Insurance Group	\$133	\$61	\$189	\$310

(1) The fair value on our common stock portfolio is based upon exchange traded prices provided by a nationally recognized pricing service.

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Net impairment losses

Net impairment losses recorded in earnings for Indemnity were \$0.1 million for the second quarter and six months ended June 30, 2014 and June 30, 2013. Net impairment losses recorded in earnings for the Exchange were \$0.1 million for the second quarter and \$0.3 million for the six months ended June 30, 2014, compared to net impairment losses of \$1 million for the second quarter and the six months ended June 30, 2013.

In considering if fixed maturity securities were credit-impaired, some of the factors considered include: potential for the default of interest and/or principal, level of subordination, collateral of the issue, compliance with financial covenants, credit ratings and industry conditions. We have the intent to sell all credit-impaired fixed maturity securities, therefore the entire amount of the impairment charges were included in earnings and no non-credit impairments were recognized in other comprehensive income.

Limited partnerships

Limited partnership investments, excluding certain real estate limited partnerships recorded at fair value, are generally reported on a one-quarter lag, therefore our year-to-date limited partnership results through June 30, 2014 are comprised of partnership financial results for the fourth quarter of 2013 and first quarter of 2014. Given the lag in reporting, our limited partnership results do not reflect the market conditions of the second quarter of 2014. Cash contributions made to and distributions received from the partnerships are recorded in the period in which the transaction occurs.

Amounts included in equity in earnings of limited partnerships by method of accounting are included below:

(in millions)	Erie Insurance Group			
	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Indemnity				
Equity in earnings of limited partnerships accounted for under the equity method	\$2	\$5	\$7	\$7
Change in fair value of limited partnerships accounted for under the fair value option	1	0	2	1
Equity in earnings of limited partnerships – Indemnity	\$3	\$5	\$9	\$8
Exchange				
Equity in earnings of limited partnerships accounted for under the equity method	\$18	\$31	\$57	\$60
Change in fair value of limited partnerships accounted for under the fair value option	6	3	11	7
Equity in earnings of limited partnerships – Exchange	\$24	\$34	\$68	\$67
Equity in earnings of limited partnerships – Erie Insurance Group	\$27	\$39	\$77	\$75

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We have provided summarized financial information in the following tables for the six months ended June 30, 2014 and for the year ended December 31, 2013. Amounts provided in the tables are presented using the latest available financial statements received from the partnerships for the respective periods. Limited partnership financial information has been presented based upon the investment percentage in the partnerships for the Erie Insurance Group consistent with how management evaluates the investments.

As these investments are generally reported on a one-quarter lag, our limited partnership results through June 30, 2014 include partnership financial results for the fourth quarter of 2013 and the first quarter of 2014.

(dollars in millions)	Erie Insurance Group			
	As of and for the six months ended June 30, 2014			
Investment percentage in limited partnerships	Number of partnerships	Asset recorded	Income (loss) recognized due to valuation adjustments by the partnerships	Income (loss) recorded
Indemnity				
Private equity:				
Less than 10%	24	\$39	\$(3)	\$4
Greater than or equal to 10% but less than 50%	3	19	3	0
Greater than 50%	0	0	0	0
Total private equity	27	58	0	4
Mezzanine debt:				
Less than 10%	11	12	0	1
Greater than or equal to 10% but less than 50%	3	6	0	0
Greater than 50%	1	0	0	0
Total mezzanine debt	15	18	0	1
Real estate:				
Less than 10%	11	44	2	1
Greater than or equal to 10% but less than 50%	3	15	1	0
Greater than 50%	2	6	0	0
Total real estate	16	65	3	1
Total limited partnerships – Indemnity	58	\$141	\$3	\$6
Exchange				
Private equity:				
Less than 10%	42	\$368	\$(7)	\$24
Greater than or equal to 10% but less than 50%	3	80	15	1
Greater than 50%	0	0	0	0
Total private equity	45	448	8	25
Mezzanine debt:				
Less than 10%	20	113	1	9
Greater than or equal to 10% but less than 50%	4	23	(2)	2
Greater than 50%	3	31	0	1
Total mezzanine debt	27	167	(1)	12
Real estate:				
Less than 10%	20	215	8	10

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Greater than or equal to 10% but less than 50%	6	77	3	1
Greater than 50%	2	24	(14) 16
Total real estate	28	316	(3) 27
Total limited partnerships – Exchange	100	\$931	\$4	\$64
Total limited partnerships – Erie Insurance Group		\$1,072	\$7	\$70

Per the limited partnership financial statements, total partnership assets were \$47 billion and total partnership liabilities were \$4 billion at June 30, 2014 (as recorded in the March 31, 2014 limited partnership financial statements). For the six months period comparable to that presented in the preceding table (fourth quarter of 2013 and first quarter of 2014), total partnership valuation adjustment gains were \$0.5 billion and total partnership net income was \$3 billion.

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As these investments are generally reported on a one-quarter lag, our limited partnership results through December 31, 2013 include partnership financial results for the fourth quarter of 2012 and the first three quarters of 2013.

(dollars in millions)	Erie Insurance Group			
	As of and for the year ended December 31, 2013			
Investment percentage in limited partnerships	Number of partnerships	Asset recorded	Income (loss) recognized due to valuation adjustments by the partnerships	Income (loss) recorded
Indemnity				
Private equity:				
Less than 10%	26	\$46	\$(6)	\$9
Greater than or equal to 10% but less than 50%	3	16	3	0
Greater than 50%	0	0	0	0
Total private equity	29	62	(3)	9
Mezzanine debt:				
Less than 10%	11	14	0	1
Greater than or equal to 10% but less than 50%	3	6	0	2
Greater than 50%	1	0	0	0
Total mezzanine debt	15	20	0	3
Real estate:				
Less than 10%	12	44	0	5
Greater than or equal to 10% but less than 50%	3	14	(1)	4
Greater than 50%	2	6	1	4
Total real estate	17	64	0	13
Total limited partnerships – Indemnity	61	\$146	\$(3)	\$25
Exchange				
Private equity:				
Less than 10%	44	\$396	\$(24)	\$79
Greater than or equal to 10% but less than 50%	3	67	13	2
Greater than 50%	0	0	0	0
Total private equity	47	463	(11)	81
Mezzanine debt:				
Less than 10%	19	117	1	13
Greater than or equal to 10% but less than 50%	4	23	(3)	7
Greater than 50%	3	32	1	3
Total mezzanine debt	26	172	(1)	23
Real estate:				
Less than 10%	22	211	(10)	34
Greater than or equal to 10% but less than 50%	6	71	(2)	10
Greater than 50%	2	23	(1)	16
Total real estate	30	305	(13)	60
Total limited partnerships – Exchange	103	\$940	\$(25)	\$164
Total limited partnerships – Erie Insurance Group		\$1,086	\$(28)	\$189

Per the limited partnership financial statements, total partnership assets were \$50 billion and total partnership liabilities were \$5 billion at December 31, 2013 (as recorded in the September 30, 2013 limited partnership financial statements). For the twelve month period comparable to that presented in the preceding table (fourth quarter of 2012 and first three quarters of 2013), total partnership valuation adjustment gains were \$2 billion and total partnership net income was \$7 billion.

See also Note 14. "Commitments and Contingencies," for investment commitments related to limited partnerships.

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Note 8. Bank Line of Credit

As of June 30, 2014, Indemnity has access to a \$100 million bank revolving line of credit with a \$25 million letter of credit sublimit that expires on November 3, 2018. As of June 30, 2014, a total of \$98.2 million remains available under the facility due to \$1.8 million outstanding letters of credit, which reduce the availability for letters of credit to \$23.2 million. Indemnity had no borrowings outstanding on its line of credit as of June 30, 2014. Bonds with a fair value of \$113 million were pledged as collateral on the line at June 30, 2014.

As of June 30, 2014, the Exchange has access to a \$300 million bank revolving line of credit with a \$25 million letter of credit sublimit that expires on October 25, 2018. As of June 30, 2014, a total of \$298.9 million remains available under the facility due to \$1.1 million outstanding letters of credit, which reduce the availability for letters of credit to \$23.9 million. The Exchange had no borrowings outstanding on its line of credit as of June 30, 2014. Bonds with a fair value of \$331 million were pledged as collateral on the line at June 30, 2014.

Both lines have securities pledged as collateral that have no trading restrictions and are reported as available-for-sale fixed maturities in the Consolidated Statements of Financial Position as of June 30, 2014. The banks require compliance with certain covenants, which include leverage ratios for Indemnity's line of credit and statutory surplus and risk based capital ratios for the Exchange's line of credit. We are in compliance with all covenants at June 30, 2014.

Note 9. Income Taxes

Deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been included in the financial statements or tax returns. Valuation allowances are established, when necessary, to reduce deferred tax assets to the amount expected to be realized.

At June 30, 2014, we recorded a net deferred tax liability of \$556 million on our Consolidated Statements of Financial Position. Of this amount, \$1 million is a net deferred tax asset attributable to Indemnity and \$557 million is a net deferred tax liability attributable to the Exchange. There was no deferred tax valuation allowance recorded at June 30, 2014. Our effective tax rate is calculated after consideration of permanent differences related to our investment revenues. Given that these amounts represent over 98% of the total permanent differences, the effective tax rate is approximately 35% for both Indemnity and the Exchange when the investment related permanent differences are excluded.

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Note 10. Postretirement Benefits

Pension plans

Our pension plans consist of a noncontributory defined benefit pension plan covering substantially all employees and an unfunded supplemental employee retirement plan for certain members of executive and senior management of the Erie Insurance Group. The gross liability for postretirement benefits is presented in the Consolidated Statements of Financial Position as part of other liabilities. A portion of annual expenses related to our postretirement benefit plans is allocated to related entities within the Erie Insurance Group. Although Indemnity is the sponsor of these postretirement plans and records the funded status of these plans, the Exchange and EFL reimburse Indemnity for approximately 55% of the annual benefit expense of these plans, which represents pension benefits for Indemnity employees performing claims and EFL functions.

Prior to 2003, the employee pension plan purchased annuities from EFL for certain plan participants that were receiving benefit payments under the pension plan. These are nonparticipating annuity contracts under which EFL has unconditionally contracted to provide specified benefits to beneficiaries; however, the pension plan remains the primary obligor to the beneficiaries and a contingent liability, \$26 million at June 30, 2014, exists in the event EFL does not honor the annuity contracts.

The cost of our pension plans are as follows:

(in millions)	Erie Insurance Group			
	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Service cost for benefits earned	\$5	\$6	\$11	\$13
Interest cost on benefits obligation	7	7	14	13
Expected return on plan assets	(8	) (7	) (16	) (15
Prior service cost amortization	1	1	1	1
Net actuarial loss amortization	1	3	3	7
Pension plan cost ⁽¹⁾	\$6	\$10	\$13	\$19

⁽¹⁾ Pension plan costs represent the total cost for the Erie Insurance Group before reimbursements to Indemnity from the Exchange and EFL.

Note 11. Indemnity Capital Stock

Class A and B common stock

Holder of Class B shares may, at their option, convert their shares into Class A shares at the rate of 2,400 Class A shares per Class B share. There were no conversions of Class B shares to Class A shares during the six months ended June 30, 2014 and the year ended December 31, 2013. There is no provision for conversion of Class A shares to Class B shares, and, Class B shares surrendered for conversion cannot be reissued.

Stock repurchase program

In October 2011, our Board of Directors approved a continuation of the current stock repurchase program for a total of \$150 million, with no time limitation. Indemnity had approximately \$18 million of repurchase authority remaining under this program at June 30, 2014.

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Note 12. Indemnity Accumulated Other Comprehensive Loss

Changes in Indemnity's accumulated other comprehensive loss by component attributable to the Indemnity shareholder interest is presented as follows for the six months ended June 30, 2014:

(in millions)	Indemnity Shareholder Interest		
	Unrealized holding gains (losses) on available-for-sale securities	Postretirement plans ⁽²⁾	Total
Balance at December 31, 2013	\$6	\$(65)	\$(59)
Other comprehensive income before reclassifications, net of tax	5	0	5
Amounts reclassified from accumulated other comprehensive income (loss), net of tax ⁽¹⁾	(1)	0	(1)
Net current period other comprehensive income, net of tax	4	0	4
Balance at June 30, 2014	\$10	\$(65)	\$(55)

(1) See the following table for details about these reclassifications.

(2) There are no amounts reclassified out of accumulated other comprehensive loss related to postretirement plan items during interim periods.

Amounts reclassified out of accumulated other comprehensive income (loss) and the related affected line item in the Consolidated Statements of Operations where net income is presented are as follows for the three and six months ended June 30, 2014:

(in millions)	Erie Insurance Group	
	Three months ended June 30, 2014	Six months ended June 30, 2014
Amounts reclassified from accumulated other comprehensive income (loss) ⁽¹⁾		
Unrealized holding gains (losses) on available-for-sale securities:		
Net realized investment gains	\$5	\$18
Net impairment losses recognized in earnings	0	0
Income from operations before income taxes and noncontrolling interest	5	18
Provision for income taxes	2	7
Net income	3	11
Less: Net income attributable to noncontrolling interest in consolidated entity – Exchange	3	10
Net income attributable to Indemnity	\$0	\$1
Amortization of postretirement plan items ⁽²⁾ :		
Net income attributable to Indemnity	\$0	\$0
Net income attributable to Indemnity	\$0	\$1

(1) Positive amounts indicate net income, while negative amounts indicate net loss.

(2)

There are no amounts reclassified out of accumulated other comprehensive loss related to postretirement plan items during interim periods.

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Note 13. Indemnity Shareholders' Equity and Noncontrolling Interest

A reconciliation of the beginning and ending balances of Indemnity's shareholders' equity and the noncontrolling interest is presented as follows for the year ended December 31, 2013 and for the six months ended June 30, 2014:

(in millions, except per share data)	Erie Insurance Group		
	Indemnity shareholder interest	Exchange noncontrolling interest	Erie Insurance Group
Balance at December 31, 2012	\$642	\$6,149	\$6,791
Net income	163	885	1,048
Change in other comprehensive income (loss), net of tax	74	(218)	(144)
Net purchase of treasury stock	(32)	—	(32)
Dividends declared:			
Class A \$2.4125 per share	(112)	—	(112)
Class B \$361.875 per share	(1)	—	(1)
Balance at December 31, 2013	\$734	\$6,816	\$7,550
Net income	95	117	212
Change in other comprehensive income, net of tax	4	133	137
Net purchase of treasury stock	(19)	—	(19)
Dividends declared:			
Class A \$1.27 per share	(59)	—	(59)
Class B \$190.50 per share	0	—	0
Balance at June 30, 2014	\$755	\$7,066	\$7,821

Note 14. Commitments and Contingencies

Indemnity has contractual commitments to invest up to \$26 million related to its limited partnership investments at June 30, 2014. These commitments are split among private equity securities of \$11 million, mezzanine debt securities of \$9 million, and real estate activities of \$6 million. These commitments will be funded as required by the partnership agreements.

The Exchange, including EFL, has contractual commitments to invest up to \$445 million related to its limited partnership investments at June 30, 2014. These commitments are split among private equity securities of \$146 million, mezzanine debt securities of \$173 million, and real estate activities of \$126 million. These commitments will be funded as required by the partnership agreements.

We are involved in litigation arising in the ordinary course of conducting business. In accordance with current accounting standards for loss contingencies and based upon information currently known to us, we establish reserves for litigation when it is probable that a loss associated with a claim or proceeding has been incurred and the amount of the loss or range of loss can be reasonably estimated. When no amount within the range of loss is a better estimate than any other amount, we accrue the minimum amount of the estimable loss. To the extent that such litigation against us may have an exposure to a loss in excess of the amount we have accrued, we believe that such excess would not be material to our consolidated financial condition, results of operations, or cash flows. Legal fees are expensed as incurred. We believe that our accruals for legal proceedings are appropriate and, individually and in the aggregate, are not expected to be material to our consolidated financial condition, operations, or cash flows.

We review all litigation on an ongoing basis when making accrual and disclosure decisions. For certain legal proceedings, we cannot reasonably estimate losses or a range of loss, if any, particularly for proceedings that are in their early stages of development or where the plaintiffs seek indeterminate damages. Various factors, including, but not limited to, the outcome of potentially lengthy discovery and the resolution of important factual questions, may need to be determined before probability can be established or before a loss or range of loss can be reasonably estimated. If the loss contingency in question is not both probable and reasonably estimable, we do not establish an accrual and the matter will continue to be monitored for any developments that would make the loss contingency both probable and reasonably estimable. In the event that a legal proceeding results in a substantial judgment against, or settlement by, us, there can be no assurance that any resulting liability or financial commitment would not have a material adverse effect on the financial condition, results of operations, or cash flows of the Indemnity shareholder interest or the consolidated financial statements of Erie Indemnity Company.

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We are subject to escheatment laws and regulations requiring the identification, reporting and payment to the state of unclaimed or abandoned funds of our policyholders, annuitants, claimants and shareholders. We are also subject to audit and examination for compliance with these requirements.

In August 2012, we were notified that we would be subject to an audit of our compliance with the unclaimed property laws of a number of jurisdictions both within and outside our operating territory. The audit commenced in April 2013 and is ongoing. Additionally, EFL has been named in a lawsuit filed by the State Treasurer of West Virginia. The Complaint alleges that EFL has failed to comply with the West Virginia Uniform Unclaimed Property Act. EFL filed a motion to dismiss and a favorable decision was rendered in December 2013 with the Court dismissing the Complaint with prejudice. The State Treasurer appealed the dismissal of the lawsuit in January 2014.

It is probable that ongoing inquiries, audits, and other regulatory activity will result in the payment of additional death claims and escheatment of funds, as well as possible fines. EFL will incur expenses to identify death claims, confirm that benefits are due and notify the beneficiaries. At this time, we are not able to reasonably estimate the possible loss or range of loss related to this issue due to the early stage of development.

Note 15. Indemnity Supplemental Information

Consolidating Statement of Financial Position

(in millions)	Erie Insurance Group			
	At June 30, 2014			
	Indemnity shareholder interest	Exchange noncontrolling interest	Reclassifications and eliminations	Erie Insurance Group
Assets				
Investments				
Available-for-sale securities, at fair value:				
Fixed maturities	\$497	\$8,701	\$—	\$9,198
Equity securities	26	914	—	940
Trading securities, at fair value	—	3,377	—	3,377
Limited partnerships	141	931	—	1,072
Other invested assets	1	20	—	21
Total investments	665	13,943	—	14,608
Cash and cash equivalents	63	237	—	300
Premiums receivable from policyholders	—	1,287	—	1,287
Reinsurance recoverable	—	168	—	168
Deferred income tax asset	1	0	—	1
Deferred acquisition costs	—	579	—	579
Other assets	112	405	—	517
Receivables from the Exchange and other affiliates	339	—	(339) —
Note receivable from EFL	25	—	(25) —
Total assets	\$1,205	\$16,619	\$(364	) \$17,460
Liabilities				
Losses and loss expense reserves	\$—	\$3,964	\$—	\$3,964
Life policy and deposit contract reserves	—	1,789	—	1,789
Unearned premiums	—	2,788	—	2,788
Deferred income tax liability	0	557	—	557
Other liabilities	450	455	(364) 541

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Total liabilities	450	9,553	(364) 9,639
Shareholders' equity and noncontrolling interest				
Total Indemnity shareholders' equity	755	—	—	755
Noncontrolling interest in consolidated entity – Exchange	—	7,066	—	7,066
Total equity	755	7,066	—	7,821
Total liabilities, shareholders' equity, and noncontrolling interest	\$ 1,205	\$ 16,619	\$(364) \$ 17,460

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Consolidating Statement of Financial Position

(in millions)	Erie Insurance Group At December 31, 2013			
	Indemnity shareholder interest	Exchange noncontrolling interest	Reclassifications and eliminations	Erie Insurance Group
Assets				
Investments				
Available-for-sale securities, at fair value:				
Fixed maturities	\$526	\$8,162	\$—	\$8,688
Equity securities	50	819	—	869
Trading securities, at fair value	—	3,202	—	3,202
Limited partnerships	146	940	—	1,086
Other invested assets	1	20	—	21
Total investments	723	13,143	—	13,866
Cash and cash equivalents	49	403	—	452
Premiums receivable from policyholders	—	1,167	—	1,167
Reinsurance recoverable	—	172	—	172
Deferred income tax asset	2	0	—	2
Deferred acquisition costs	—	566	—	566
Other assets	114	337	—	451
Receivables from the Exchange and other affiliates	300	—	(300) —
Note receivable from EFL	25	—	(25) —
Total assets	\$1,213	\$15,788	\$(325	) \$16,676
Liabilities				
Losses and loss expense reserves	\$—	\$3,747	\$—	\$3,747
Life policy and deposit contract reserves	—	1,758	—	1,758
Unearned premiums	—	2,598	—	2,598
Deferred income tax liability	0	450	—	450
Other liabilities	479	419	(325	) 573
Total liabilities	479	8,972	(325	) 9,126
Shareholders' equity and noncontrolling interest				
Total Indemnity shareholders' equity	734	—	—	734
Noncontrolling interest in consolidated entity – Exchange	—	6,816	—	6,816
Total equity	734	6,816	—	7,550
Total liabilities, shareholders' equity, and noncontrolling interest	\$1,213	\$15,788	\$(325	) \$16,676

Receivables from the Exchange and EFL and concentrations of credit risk – Financial instruments could potentially expose Indemnity to concentrations of credit risk, including unsecured receivables from the Exchange. A majority of Indemnity's revenue and receivables are from the Exchange and affiliates. See also Note 4, "Variable Interest Entity."

Management fees and expense allocation amounts due from the Exchange were \$335 million and \$296 million at June 30, 2014 and December 31, 2013, respectively. The receivable from EFL for expense allocations and interest on the surplus note totaled \$4 million at June 30, 2014 and December 31, 2013.

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Note receivable from EFL – Indemnity is due \$25 million from EFL in the form of a surplus note that was issued in 2003. The note may be repaid only out of unassigned surplus of EFL. Both principal and interest payments are subject to prior approval by the Pennsylvania Insurance Commissioner. The note bears an annual interest rate of 6.7% and will be payable on demand on or after December 31, 2018, with interest scheduled to be paid semi-annually, subject to prior approval by the Pennsylvania Insurance Commissioner. For each of the six months ended June 30, 2014 and 2013, Indemnity recognized interest income on the note of \$0.8 million.

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Income attributable to Indemnity shareholder interest

(in millions)	Indemnity Shareholder Interest			
	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013
Management operations:				
Management fee revenue, net	\$366	\$336	\$685	\$632
Service agreement revenue	8	8	15	15
Total revenue from management operations	374	344	700	647
Cost of management operations	306	285	574	539
Income from management operations before taxes	68	59	126	108
Investment operations:				
Net investment income	4	3	8	7
Net realized gains on investments	0	0	1	0
Net impairment losses recognized in earnings	0	0	0	0
Equity in earnings of limited partnerships	3	5	9	8
Income from investment operations before taxes	7	8	18	15
Income from operations before income taxes	75	67	144	123
Provision for income taxes	26	23	49	42
Net income attributable to Indemnity	\$49	\$44	\$95	\$81

Indemnity's components of direct cash flows as included in the Consolidated Statements of Cash Flows

(in millions)	Indemnity Shareholder Interest	
	Six months ended June 30,	
	2014	2013
Management fee received	\$659	\$604
Service agreement fee received	15	15
Net investment income received	11	11
Limited partnership distributions	8	12
Decrease in reimbursements collected from affiliates	(13	) 0
Commissions and bonuses paid to agents	(397	) (356
Salaries and wages paid	(80	) (76
Pension contribution and employee benefits paid	(29	) (28
General operating expenses paid	(94	) (83
Income taxes paid	(44	) (42
Net cash provided by operating activities	36	57
Net cash provided by investing activities	57	15
Net cash used in financing activities	(79	) (45
Net increase in cash and cash equivalents	14	27
Cash and cash equivalents at beginning of period	49	12
Cash and cash equivalents at end of period	\$63	\$39

Note 16. Subsequent Events

No items were identified in the period subsequent to the financial statement date that required adjustment or disclosure.

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

The following discussion of financial condition and results of operations highlights significant factors influencing the Erie Insurance Group ("we," "us," "our"). This discussion should be read in conjunction with the historical financial statements and the related notes thereto included in Item 1. "Financial Statements" of this Quarterly Report on Form 10-Q, and with Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" for the year ended December 31, 2013, as contained in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 27, 2014.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

"Safe Harbor" Statement under the Private Securities Litigation Reform Act of 1995:

Statements contained herein that are not historical fact are forward-looking statements and, as such, are subject to risks and uncertainties that could cause actual events and results to differ, perhaps materially, from those discussed herein. Forward-looking statements relate to future trends, events or results and 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 forward-looking statements are discussions relating to premium and investment income, expenses, operating results, agency relationships, and compliance with contractual and regulatory requirements. Forward-looking 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, in addition to those set forth in our filings with the Securities and Exchange Commission, that could cause actual results and future events to differ from those set forth or contemplated in the forward-looking statements include the following:

Risk factors related to the Erie Indemnity Company ("Indemnity") shareholder interest:

- dependence upon Indemnity's relationship with the Exchange and the management fee under the agreement with the subscribers at the Exchange;

- costs of providing services to the Exchange under the subscriber's agreement;
- ability to attract and retain talented management and employees;
- ability to maintain uninterrupted business operations;
- factors affecting the quality and liquidity of Indemnity's investment portfolio;
- credit risk from the Exchange;
- Indemnity's ability to meet liquidity needs and access capital; and
- outcome of pending and potential litigation against Indemnity.

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Risk factors related to the non-controlling interest owned by the Erie Insurance Exchange (“Exchange”), which includes the Property and Casualty Group and Erie Family Life Insurance Company:

- general business and economic conditions;
- dependence upon the independent agency system;
 - ability to maintain our reputation for customer service;
- factors affecting insurance industry competition;
- changes in government regulation of the insurance industry;
- premium rates and reserves must be established from forecasts of ultimate costs;
- emerging claims, coverage issues in the industry, and changes in reserve estimates related to the property and casualty business;
- changes in reserve estimates related to the life business;
- severe weather conditions or other catastrophic losses, including terrorism;
- the Exchange’s ability to acquire reinsurance coverage and collectability from reinsurers;
- factors affecting the quality and liquidity of the Exchange’s investment portfolio;
- the Exchange’s ability to meet liquidity needs and access capital;
- the Exchange’s ability to maintain an acceptable financial strength rating;
- outcome of pending and potential litigation against the Exchange; and
- dependence upon the service provided by Indemnity.

A forward-looking statement speaks only as of the date on which it is made and reflects our analysis only as of that date. We undertake 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.

RECENT ACCOUNTING PRONOUNCEMENTS

See Item 1. “Financial Statements - Note 2. Significant Accounting Policies,” contained within this report for a discussion of adopted and/or pending accounting pronouncements, none of which are expected to have a material impact on our future financial condition, results of operations, or cash flows.

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OPERATING OVERVIEW

Overview

The Erie Insurance Group represents the consolidated results of Indemnity and the results of its variable interest entity, the Exchange. The Erie Insurance Group operates predominantly as a property and casualty insurer through its regional insurance carriers that write a broad range of personal and commercial coverages. Our property and casualty insurance companies include the Exchange and its wholly owned subsidiaries, Erie Insurance Company (“EIC”), Erie Insurance Company of New York (“ENY”), Erie Insurance Property and Casualty Company (“EPC”), and Flagship City Insurance Company (“Flagship”). These entities operate collectively as the “Property and Casualty Group.” The Erie Insurance Group also operates as a life insurer through the Exchange’s wholly owned subsidiary, Erie Family Life Insurance Company (“EFL”), which underwrites and sells individual and group life insurance policies and fixed annuities.

The Exchange is a reciprocal insurance exchange organized under Article X of Pennsylvania's Insurance Company Law of 1921 under which individuals, partnerships, and corporations are authorized to exchange reciprocal or inter-insurance contracts with each other, or with individuals, partnerships, and corporations of other states and countries, providing indemnity among themselves from any loss which may be insured against under any provision of the insurance laws except life insurance. Each applicant for insurance to the Exchange signs a subscriber’s agreement, which contains an appointment of Indemnity as their attorney-in-fact to transact the business of the Exchange on their behalf.

Pursuant to the subscriber’s agreement and for its services as attorney-in-fact, Indemnity earns a management fee calculated as a percentage of the direct premiums written by the Exchange and the other members of the Property and Casualty Group, which are assumed by the Exchange under an intercompany pooling arrangement.

The Indemnity shareholder interest includes Indemnity’s equity and income, but not the equity or income of the Exchange. The Exchange’s equity, which is comprised of its retained earnings and accumulated other comprehensive income, is held for the interest of its subscribers (policyholders) and meets the definition of a noncontrolling interest, which is reflected as such in our consolidated financial statements.

“Indemnity shareholder interest” refers to the interest in Erie Indemnity Company owned by the Class A and Class B shareholders. “Noncontrolling interest” refers to the interest in the Erie Insurance Exchange held for the interest of the subscribers (policyholders).

The Indemnity shareholder interest in income comprises:

- a management fee of up to 25% of all property and casualty insurance premiums written or assumed by the Exchange, less the costs associated with the sales, underwriting, and issuance of these policies;

- net investment income and results on investments that belong to Indemnity; and

- other income and expenses, including income taxes, that are the responsibility of Indemnity.

The Exchange’s or the noncontrolling interest in income comprises:

- 100% interest in the net underwriting results of the property and casualty insurance operations;

- 100% interest in the net earnings of EFL's life insurance operations;

net investment income and results on investments that belong to the Exchange and its subsidiaries; and
other income and expenses, including income taxes, that are the responsibility of the Exchange and its subsidiaries.

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Results of the Erie Insurance Group's Operations by Interest (Unaudited)

The following tables represent a breakdown of the composition of the income attributable to the Indemnity shareholder interest and the income attributable to the noncontrolling interest (Exchange). For purposes of this discussion, EFL's investments are included in the life insurance operations.

Three months ended June 30,

(in millions)	Indemnity shareholder interest		Noncontrolling interest (Exchange)		Eliminations of related party transactions		Erie Insurance Group	
	Three months ended June 30,		Three months ended June 30,		Three months ended June 30,		Three months ended June 30,	
	2014	2013	2014	2013	2014	2013	2014	2013
Management operations:								
Management fee revenue, net	\$ 366	\$ 336	\$—	\$—	\$(366)	\$(336)	\$—	\$—
Service agreement revenue	8	8	—	—	—	—	8	8
Total revenue from management operations	374	344	—	—	(366)	(336)	8	8
Cost of management operations	306	285	—	—	(306)	(285)	—	—
Income from management operations before taxes	68	59	—	—	(60)	(51)	8	8
Property and casualty insurance operations:								
Net premiums earned	—	—	1,298	1,196	—	—	1,298	1,196
Losses and loss expenses	—	—	1,101	837	(2)	(2)	1,099	835
Policy acquisition and underwriting expenses	—	—	380	348	(64)	(53)	316	295
(Loss) income from property and casualty insurance operations before taxes	—	—	(183)	11	66	55	(117)	66
Life insurance operations: ⁽¹⁾								
Total revenue	—	—	46	46	(1)	(1)	45	45
Total benefits and expenses	—	—	36	33	0	0	36	33
Income from life insurance operations before taxes	—	—	10	13	(1)	(1)	9	12
Investment operations: ⁽¹⁾								
Net investment income	4	3	89	81	(5)	(3)	88	81
Net realized gains on investments	0	0	133	58	—	—	133	58
Net impairment losses recognized in earnings	0	0	0	0	—	—	0	0
Equity in earnings of limited partnerships	3	5	23	33	—	—	26	38
Income from investment operations before taxes	7	8	245	172	(5)	(3)	247	177
Income from operations before income taxes and noncontrolling interest	75	67	72	196	—	—	147	263
Provision for income taxes	26	23	18	63	—	—	44	86
Net income	\$ 49	\$ 44	\$ 54	\$ 133	\$—	\$—	\$ 103	\$ 177

(1)

Earnings on life insurance related invested assets are integral to the evaluation of the life insurance operations because of the long duration of life products. On that basis, for presentation purposes, the life insurance operations in the table above include life insurance related investment results. However, the life insurance investment results are included in the investment operations segment discussion as part of the Exchange's investment results.

Net income in the second quarter of 2014 was primarily impacted by the losses experienced in our property and casualty insurance operations, compared to gains in the second quarter of 2013, offset somewhat by improved results in our investment operations.

Losses from the Exchange's property and casualty insurance operations increased in the second quarter of 2014 due to an increase in catastrophe losses. The Exchange's property and casualty insurance operations experienced a 8.7% increase in earned premium in the second quarter of 2014, driven by increases in policies in force and the average premium per policy.

Our investment operations generated higher levels of net realized gains on investments, primarily due to larger increases in fair value of common stocks in the second quarter of 2014, compared to the second quarter of 2013, and a slight increase in net investment income, offset somewhat by a slight decrease in equity in earnings of limited partnerships.

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Six months ended June 30,

(in millions)	Indemnity shareholder interest		Noncontrolling interest (Exchange)		Eliminations of related party transactions		Erie Insurance Group	
	Six months ended June 30,		Six months ended June 30,		Six months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013	2014	2013	2014	2013
Management operations:								
Management fee revenue, net	\$ 685	\$ 632	\$—	\$—	\$(685)	\$(632)	\$—	\$—
Service agreement revenue	15	15	—	—	—	—	15	15
Total revenue from management operations	700	647	—	—	(685)	(632)	15	15
Cost of management operations	574	539	—	—	(574)	(539)	—	—
Income from management operations before taxes	126	108	—	—	(111)	(93)	15	15
Property and casualty insurance operations:								
Net premiums earned	—	—	2,566	2,352	—	—	2,566	2,352
Losses and loss expenses	—	—	2,108	1,654	(3)	(3)	2,105	1,651
Policy acquisition and underwriting expenses	—	—	745	676	(117)	(97)	628	579
(Loss) income from property and casualty insurance operations before taxes	—	—	(287)	22	120	100	(167)	122
Life insurance operations: ⁽¹⁾								
Total revenue	—	—	96	92	(1)	(1)	95	91
Total benefits and expenses	—	—	73	68	0	0	73	68
Income from life insurance operations before taxes	—	—	23	24	(1)	(1)	22	23
Investment operations: ⁽¹⁾								
Net investment income	8	7	173	160	(8)	(6)	173	161
Net realized gains on investments	1	0	183	304	—	—	184	304
Net impairment losses recognized in earnings	0	0	0	0	—	—	0	0
Equity in earnings of limited partnerships	9	8	67	66	—	—	76	74
Income from investment operations before taxes	18	15	423	530	(8)	(6)	433	539
Income from operations before income taxes and noncontrolling interest	144	123	159	576	—	—	303	699
Provision for income taxes	49	42	42	190	—	—	91	232
Net income	\$ 95	\$ 81	\$ 117	\$ 386	\$—	\$—	\$ 212	\$ 467

Earnings on life insurance related invested assets are integral to the evaluation of the life insurance operations because of the long duration of life products. On that basis, for presentation purposes, the life insurance operations in the table above include life insurance related investment results. However, the life insurance investment results are included in the investment operations segment discussion as part of the Exchange's investment results.

Net income in the first six months of 2014 was primarily impacted by the losses experienced in our property and casualty insurance operations, compared to gains in the first six months of 2013, and generating lower earnings from our investment operations.

Losses from the Exchange's property and casualty insurance operations increased in the first six months of 2014 due to an increase in catastrophe losses and a higher volume of non-catastrophe weather related claims. The Exchange's property and casualty insurance operations experienced a 9.1% increase in earned premium in the first six months of 2014, driven by increases in policies in force and the average premium per policy.

Our investment operations generated lower levels of net realized gains on investments, primarily due to lower increases in fair value of common stocks and lower realized gains from sales of common stock recorded in the first six months of 2014, compared to the first six months of 2013, offset somewhat by a slight increase in net investment income.

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Reconciliation of Operating Income to Net Income (Unaudited)

We disclose operating income, a non-GAAP financial measure, to enhance our investors' understanding of our performance related to the Indemnity shareholder interest. Our method of calculating this measure may differ from those used by other companies, and therefore comparability may be limited.

Indemnity defines operating income as net income excluding realized capital gains and losses, impairment losses and related federal income taxes.

Indemnity uses operating income to evaluate the results of its operations. It reveals trends that may be obscured by the net effects of realized capital gains and losses including impairment losses. Realized capital gains and losses, including impairment losses, may vary significantly between periods and are generally driven by business decisions and economic developments such as capital market conditions which are not related to our ongoing operations. We are aware that the price to earnings multiple commonly used by investors as a forward-looking valuation technique uses operating income as the denominator. Operating income should not be considered as a substitute for net income prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and does not reflect Indemnity's overall profitability.

The following table reconciles operating income and net income for the Indemnity shareholder interest:

(in millions, except per share data)	Indemnity Shareholder Interest			
	Three months ended		Six months ended June	
	June 30, 2014 (Unaudited)	2013	30, 2014 (Unaudited)	2013
Operating income attributable to Indemnity	\$49	\$44	\$94	\$81
Net realized gains and impairments on investments	0	0	1	0
Income tax expense	0	0	0	0
Realized gains and impairments, net of income taxes	0	0	1	0
Net income attributable to Indemnity	\$49	\$44	\$95	\$81
Per Indemnity Class A common share-diluted:				
Operating income attributable to Indemnity	\$0.94	\$0.84	\$1.81	\$1.54
Net realized gains and impairments on investments	0.00	0.00	0.02	0.00
Income tax expense	0.00	0.00	(0.01)	0.00
Realized gains and impairments, net of income taxes	0.00	0.00	0.01	0.00
Net income attributable to Indemnity	\$0.94	\$0.84	\$1.82	\$1.54

Summary of Results – Indemnity Shareholder Interest

Three months ended June 30,

Net income attributable to Indemnity Class A per share-diluted was \$0.94 per share in the second quarter of 2014, compared to \$0.84 per share in the second quarter of 2013.

Operating income attributable to Indemnity Class A per share-diluted (excluding net realized gains or losses, impairments on investments, and related taxes) was \$0.94 per share in the second quarter of 2014, compared to \$0.84 per share in the second quarter of 2013.

Six months ended June 30,

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Net income attributable to Indemnity Class A per share-diluted was \$1.82 per share for the six months ended June 30, 2014, compared to \$1.54 per share for the six months ended June 30, 2013.

Operating income attributable to Indemnity Class A per share-diluted (excluding net realized gains or losses, impairments on investments, and related taxes) was \$1.81 per share for the six months ended June 30, 2014, compared to \$1.54 per share for the six months ended June 30, 2013.

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Operating Segments

Our reportable segments include management operations, property and casualty insurance operations, life insurance operations and investment operations.

Management operations

Management operations generate internal management fee revenue, which accrues to the Indemnity shareholder interest, as Indemnity provides services relating to the sales, underwriting, and issuance of policies on behalf of the Exchange. Management fee revenue is based upon all premiums written or assumed by the Exchange and the management fee rate, which is not to exceed 25%. Our Board of Directors establishes the management fee rate at least annually, generally in December for the following year, and considers factors such as the relative financial strength of Indemnity and the Exchange and projected revenue streams. The management fee rate was set at 25% for both 2014 and 2013. Management fee revenue is eliminated upon consolidation.

Property and casualty insurance operations

The property and casualty insurance business is driven by premium growth, the combined ratio, and investment returns. The property and casualty insurance industry is cyclical, with periods of rising premium rates and shortages of underwriting capacity followed by periods of substantial price competition and excess capacity. The cyclical nature of the insurance industry has a direct impact on the direct written premium of the Property and Casualty Group.

The property and casualty insurance operation's premium growth strategy focuses on growth by expansion of existing operations including a careful agency selection process and increased market penetration in existing operating territories. Expanding the size of our existing agency force of nearly 2,200 independent agencies, with over 10,700 licensed property and casualty representatives, will contribute to future growth as new agents build their books of business with the Property and Casualty Group.

Geographic expansion is also a component of the Property and Casualty Group's premium growth strategy. The Property and Casualty Group plans to expand operations into the Commonwealth of Kentucky by the first quarter of 2015 or earlier if possible.

The property and casualty insurance operations insure preferred and standard risks while maintaining a disciplined underwriting approach. Based upon direct written premium in 2013, 44% of our premiums were derived from personal auto, 26% from homeowners and 29% from commercial lines. Pennsylvania, Maryland, Virginia, North Carolina and Ohio made up 75% of the property and casualty lines insurance business 2013 direct written premium.

Members of the Property and Casualty Group pool their underwriting results under an intercompany pooling agreement. Under the pooling agreement, the Exchange retains a 94.5% interest in the net underwriting results of the Property and Casualty Group, while EIC retains a 5.0% interest, and ENY retains a 0.5% interest.

The key measure of underwriting profitability traditionally used in the property and casualty insurance industry is the combined ratio, which is expressed as a percentage. It is the sum of the ratio of losses and loss expenses to premiums earned (loss ratio) plus the ratio of policy acquisition and other underwriting expenses to premiums earned (expense ratio). When the combined ratio is less than 100%, underwriting results are generally considered profitable; when the combined ratio is greater than 100%, underwriting results are generally considered unprofitable.

Factors affecting losses and loss expenses include the frequency and severity of losses, the nature and severity of catastrophic losses, the quality of risks underwritten, and underlying claims and settlement expenses.

Investments held by the Property and Casualty Group are reported in the investment operations segment, separate from the underwriting business.

Life insurance operations

EFL generates revenues through the sale of its individual and group life insurance policies and fixed annuities. These products provide our property and casualty agency force an opportunity to cross-sell both personal and commercial accounts. EFL's profitability depends principally on the ability to develop, price, and distribute insurance products, attract and retain deposit funds, generate investment returns, and manage expenses. Other drivers include mortality and morbidity experience, persistency experience to enable the recovery of acquisition costs, maintenance of interest spreads over the amounts credited to deposit funds, and the maintenance of strong ratings from rating agencies. EFL plans to expand operations into the Commonwealth of Kentucky by the first quarter of 2015 or earlier if possible.

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Earnings on life insurance related invested assets are integral to the evaluation of the life insurance operations because of the long duration of life products. On that basis, for presentation purposes, the life insurance operations segment discussion includes the life insurance related investment results. However, also for presentation purposes, the segment footnote and the investment operations segment discussion also include the life insurance investment results as part of the Exchange's investment results.

Investment operations

We generate revenues from our fixed maturity, equity security, and limited partnership investment portfolios to support our underwriting business. The Indemnity and Exchange portfolios are managed with the objective of maximizing after-tax returns on a risk-adjusted basis, while the EFL portfolio is managed to be closely aligned to its liabilities and to maintain a sufficient yield to meet profitability targets. Management actively evaluates the portfolios for impairments. We record impairment writedowns on investments in instances where the fair value of the investment is substantially below cost, and we conclude that the decline in fair value is other-than-temporary, which includes consideration for intent to sell.

General Conditions and Trends Affecting Our Business

Economic conditions

Unfavorable changes in economic conditions, including declining consumer confidence, inflation, high unemployment, and the threat of recession, among others, may lead the Property and Casualty Group's customers to modify coverage, not renew policies, or even cancel policies, which could adversely affect the premium revenue of the Property and Casualty Group, and consequently Indemnity's management fee. These conditions could also impair the ability of customers to pay premiums when due, and as a result, the Property and Casualty Group's bad debt write-offs could increase. Our key challenge is to generate profitable revenue growth in a highly competitive market that continues to experience the effects of uncertain economic conditions.

Financial market volatility

Our portfolio of fixed income, preferred and common stocks, and limited partnerships are subject to market volatility especially in periods of instability in the worldwide financial markets. Over time, net investment income could also be impacted by volatility and by the general level of interest rates, which impact reinvested cash flow from the portfolio and business operations. Depending upon market conditions, which are unpredictable and remain uncertain, considerable fluctuation could exist in our reported total investment income, which could have an adverse impact on our financial condition, results of operations, and cash flows.

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RESULTS OF OPERATIONS

The information that follows is presented on a segment basis prior to eliminations.

Management Operations

Indemnity earns management fee revenue from providing services relating to the sales, underwriting, and issuance of policies on behalf of the Exchange as a result of its attorney-in-fact relationship, which is eliminated upon consolidation. A summary of the results of our management operations is as follows:

(dollars in millions)	Indemnity Shareholder Interest			Indemnity Shareholder Interest			
	Three months ended June 30,			Six months ended June 30,			
	2014	2013	% Change	2014	2013	% Change	
	(Unaudited)			(Unaudited)			
Management fee revenue, net	\$366	\$336	8.9 %	\$685	\$632	8.3 %	
Service agreement revenue	8	8	(0.2)	15	15	1.4	
Total revenue from management operations	374	344	8.7	700	647	8.2	
Cost of management operations	306	285	7.6	574	539	6.4	
Income from management operations – Indemnity ⁽¹⁾	\$68	\$59	14.2 %	\$126	\$108	16.8 %	
Gross margin	18.2 %	17.3 %	0.9 pts.	18.0 %	16.7 %	1.3 pts.	

(1) The Indemnity shareholder interest retains 100% of the income from the management operations.

Management fee revenue

Management fee revenue is based upon all premiums written or assumed by the Exchange and the management fee rate, which is determined by our Board of Directors at least annually. Management fee revenue is calculated by multiplying the management fee rate by the direct premiums written by the Exchange and the other members of the Property and Casualty Group, which are assumed by the Exchange under an intercompany pooling agreement. The following table presents the calculation of management fee revenue:

(dollars in millions)	Indemnity Shareholder Interest			Indemnity Shareholder Interest			
	Three months ended June 30,			Six months ended June 30,			
	2014	2013	% Change	2014	2013	% Change	
	(Unaudited)			(Unaudited)			
Property and Casualty Group direct written premium	\$1,474	\$1,354	8.8 %	\$2,753	\$2,541	8.3 %	
Management fee rate	25 %	25 %		25 %	25 %		
Management fee revenue, gross	368	338	8.8	688	635	8.3	
Change in allowance for management fee returned on cancelled policies ⁽¹⁾	(2)	(2)	NM	(3)	(3)	NM	
Management fee revenue, net of allowance	\$366	\$336	8.9 %	\$685	\$632	8.3 %	

NM = not meaningful

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

Management fee revenue increased \$30 million, or 8.9%, in the second quarter of 2014, and \$53 million, or 8.3%, in the first six months of 2014, compared to the same respective periods in 2013. Direct written premium of the Property and Casualty Group increased 8.8% in the second quarter of 2014 and 8.3% in the first six months of 2014, compared to the same respective periods in 2013, due to a 4.5% increase in policies in force and a 4.2% increase in the year-over-year average premium per policy for all lines of business. The year-over-year policy retention ratio was 90.6% at June 30, 2014 and December 31, 2013, and 90.9% at June 30, 2013. See the “Property and Casualty Insurance Operations” segment that follows for a complete discussion of property and casualty direct written premium, which has a direct bearing on Indemnity’s management fee.

The management fee rate was set at 25%, the maximum rate, for both 2014 and 2013. Changes in the management fee rate can affect the Indemnity shareholder interest's revenue and net income from this segment significantly.

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Service agreement revenue

Service agreement revenue includes service charges Indemnity collects from policyholders for providing extended payment terms on policies written by the Property and Casualty Group and late payment and policy reinstatement fees. The service charges are fixed dollar amounts per billed installment. Service agreement revenue totaled \$8 million in both the second quarters of 2014 and 2013, and \$15 million in both the six months ended June 30, 2014 and 2013. The consistency in the service fee revenue compared to the growth in policies in force reflects the continued shift in policies to the monthly direct debit payment plan, which does not incur service charges, and the no-fee single payment plan, which offers a premium discount. The shift to these plans is driven by the consumers' desire to avoid paying service charges and to take advantage of the discount in pricing offered for paid-in-full policies.

Cost of management operations

(in millions)	Indemnity Shareholder Interest			Six months ended June 30,				
	2014 (Unaudited)	2013 (Unaudited)	% Change	2014 (Unaudited)	2013 (Unaudited)	% Change		
Commissions:								
Total commissions	\$205	\$187	10.0	%	\$379	\$351	8.1	%
Non-commission expense:								
Sales and advertising	\$16	\$15	1.5	%	\$30	\$29	1.9	%
Underwriting and policy processing	32	30	6.6		64	60	7.1	
Information technology	31	27	15.8		59	53	11.4	
Customer service	6	6	8.6		13	11	14.2	
Administrative and other	16	20	(22.9	)	29	35	(18.4)
Total non-commission expense	\$101	\$98	2.8	%	\$195	\$188	3.2	%
Total cost of management operations	\$306	\$285	7.6	%	\$574	\$539	6.4	%

Commissions – Commissions increased \$18 million in the second quarter of 2014 and \$28 million for the six months ended June 30, 2014, compared to the same respective periods in 2013. These increases were primarily a result of the 8.8% and 8.3%, respectively, increase in direct written premiums of the Property and Casualty Group. In the second quarter of 2014, commission growth outpaced direct premium written growth primarily due to an increase in agent incentive costs.

Non-commission expense – Non-commission expense increased \$3 million in the second quarter of 2014, compared to the second quarter of 2013. Sales and advertising costs increased \$1 million due to advertising costs. Underwriting and policy processing costs increased \$2 million due to the increased cost of underwriting reports and increased postage costs. Information technology costs increased \$4 million, which included \$2 million of professional fees and \$2 million of hardware costs. Customer service costs remained flat compared to the second quarter of 2013. Administrative and other expenses decreased \$4 million driven by decreases of \$3 million in personnel costs, primarily from decreased employee incentive plan costs related to underwriting performance and decreased pension costs, and a decrease of \$1 million in professional fees.

Non-commission expense increased \$7 million in the six months ended June 30, 2014, compared to the six months ended June 30, 2013. Sales and advertising costs increased \$1 million due to advertising costs. Underwriting and policy processing costs increased \$4 million due to the increased cost of underwriting reports, personnel costs and postage expense. Information technology costs increased \$6 million, which included \$3 million in professional fees, \$2 million in hardware costs and \$1 million in personnel costs. Customer service costs increased \$2 million due to an increase of \$1 million each in credit card processing fees and personnel costs. Administrative and other expenses decreased \$6 million driven by decreases of \$4 million in personnel costs, primarily from decreased employee

incentive plan costs related to underwriting performance and decreased pension costs, and a decrease of \$2 million in professional fees.

Gross margin

The gross margin in the second quarter of 2014 was 18.2%, compared to 17.3% in the second quarter of 2013, and was 18.0% for the six months ended June 30, 2014, compared to 16.7% for the six months ended June 30, 2013, as a result of revenue growth outpacing expense increases.

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Property and Casualty Insurance Operations

The Property and Casualty Group operates in 11 Midwestern, Mid-Atlantic, and Southeastern states and the District of Columbia and primarily writes private passenger automobile, homeowners, commercial multi-peril, commercial automobile, and workers compensation lines of insurance. A summary of the results of our property and casualty insurance operations is as follows:

(dollars in millions)	Property and Casualty Group			Six months ended June 30,		
	Three months ended June 30, 2014 (Unaudited)	2013	% Change	2014 (Unaudited)	2013	% Change
Premiums:						
Direct written premium	\$1,474	\$1,354	8.8 %	\$2,753	\$2,541	8.3 %
Reinsurance premium – assumed and ceded	(9)	(3)	NM	(16)	(16)	3.4
Net written premium	1,465	1,351	8.5	2,737	2,525	8.4
Change in unearned premium	(167)	(155)	(7.0)	(171)	(173)	1.4
Net premiums earned	1,298	1,196	8.7	2,566	2,352	9.1
Losses and loss expenses:						
Current accident year, excluding catastrophe losses	866	774	11.9	1,793	1,557	15.2
Current accident year catastrophe losses	244	45	NM	337	72	NM
Prior accident years, including prior year catastrophe losses	(9)	18	NM	(22)	25	NM
Losses and loss expenses	1,101	837	31.5	2,108	1,654	27.5
Policy acquisition and other underwriting expenses	380	348	9.4	745	676	10.3
Total losses and expenses	1,481	1,185	25.0	2,853	2,330	22.5
Underwriting (loss) income – Exchange ⁽¹⁾	\$(183)	\$11	NM %	\$(287)	\$22	0.0 %
Loss and loss expense ratios:						
Current accident year loss ratio, excluding catastrophe losses	66.6 %	64.8 %	1.8 pts.	69.9 %	66.2 %	3.7 pts.
Current accident year catastrophe loss ratio	18.8	3.7	15.1	13.1	3.0	10.1
Prior accident year loss ratio, including prior year catastrophe losses	(0.7)	1.5	(2.2)	(0.9)	1.1	(2.0)
Total loss and loss expense ratio	84.7	70.0	14.7	82.1	70.3	11.8
Policy acquisition and other underwriting expense ratio	29.3	29.1	0.2	29.0	28.7	0.3
Combined ratio	114.0 %	99.1 %	14.9 pts.	111.1 %	99.0 %	12.1 pts.

NM = not meaningful

(1) The Exchange retains 100% of the income from the property and casualty insurance operations.

We measure profit or loss from our property and casualty insurance segment based upon its underwriting results, which are represented by net premiums earned less losses and loss expenses and policy acquisition and other underwriting expenses on a pre-tax basis. The loss and loss expense ratio and combined ratio are key performance indicators that we use to assess business trends and to make comparisons to industry results. The investment results related to our property and casualty insurance operations are included in our investment operations segment

discussion.

Premiums

Direct written premium – Direct written premium of the Property and Casualty Group increased 8.8% to \$1.5 billion in the second quarter of 2014, from \$1.4 billion in the second quarter of 2013, driven by an increase in policies in force and increases in average premium per policy. Year-over-year policies in force for all lines of business increased by 4.5% in the second quarter of 2014 as the result of continuing strong policyholder retention and an increase in new policies written, compared to an increase of 4.4% in the second quarter of 2013. The year-over-year average premium per policy for all lines of business increased 4.2% at June 30, 2014, compared to 4.8% at June 30, 2013.

Premiums generated from new business increased 5.4% to \$182 million in the second quarter of 2014, compared to an increase of 11.8% in the second quarter of 2013. Underlying the trend in new business premiums was a 3.6% increase in new business policies written in the second quarter of 2014, compared to 11.1% in the second quarter of 2013, while the year-over-year average premium per policy on new business increased 1.5% at June 30, 2014, compared to 4.6% at June 30, 2013.

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Premiums generated from renewal business increased 9.3% to \$1.3 billion in the second quarter of 2014, compared to an increase of 8.9% to \$1.2 billion in the second quarter of 2013. Underlying the trend in renewal business premiums were increases in average premium per policy and steady policy retention ratios. The renewal business year-over-year average premium per policy increased 4.6% at June 30, 2014, compared to 4.9% at June 30, 2013. The Property and Casualty Group's year-over-year policy retention ratio was 90.6% at June 30, 2014 and December 31, 2013, and 90.9% at June 30, 2013.

Personal lines – Total personal lines premiums written increased 8.1% to \$1.0 billion in the second quarter of 2014, from \$963 million in the second quarter of 2013, driven by an increase of 4.5% in the total personal lines policies in force and an increase of 3.7% in the total personal lines year-over-year average premium per policy.

New business premiums written on personal lines increased 6.1% in the second quarter of 2014, compared to 18.8% in the second quarter of 2013, driven by increases in new business policies written and average premium per policy. Personal lines new business policies written increased 3.9% in the second quarter of 2014, compared to 13.3% in the second quarter of 2013, while the year-over-year average premium per policy on personal lines new business increased 4.2% at June 30, 2014, compared to 5.0% at June 30, 2013.

Private passenger auto new business premiums written increased 7.3% in the second quarter of 2014, compared to 20.0% in the second quarter of 2013. New business policies written for private passenger auto increased 4.9% in the second quarter of 2014, compared to 16.2% in the second quarter of 2013, while the new business year-over-year average premium per policy for private passenger auto increased 3.7% at June 30, 2014, compared to 3.3% at June 30, 2013.

Homeowners new business premiums written increased 3.0% in the second quarter of 2014, compared to 17.4% in the second quarter of 2013. New business policies written for homeowners decreased 0.1% in the second quarter of 2014, compared to an increase of 11.2% in the second quarter of 2013. The new business year-over-year average premium per policy for homeowners increased 4.8% at June 30, 2014, compared to 8.6% at June 30, 2013.

Renewal premiums written on personal lines increased 8.3% in the second quarter of 2014, compared to 7.5% in the second quarter of 2013, driven by increases in average premium per policy and steady policy retention ratios. The year-over-year average premium per policy on personal lines renewal business increased 3.7% at June 30, 2014, compared to 3.9% at June 30, 2013. The personal lines year-over-year policy retention ratio was 91.1% at June 30, 2014, 91.2% at December 31, 2013, and 91.5% at June 30, 2013.

Private passenger auto renewal premiums written increased 6.4% in the second quarter of 2014, compared to 4.7% in the second quarter of 2013. The year-over-year average premium per policy on private passenger auto renewal business increased 1.7% at June 30, 2014, compared to 1.5% at June 30, 2013. The private passenger auto year-over-year policy retention ratio was 91.9% at June 30, 2014, 92.1% at December 31, 2013, and 92.2% at June 30, 2013.

Homeowners renewal premiums written increased 11.6% in the second quarter of 2014, compared to 12.3% in the second quarter of 2013. The year-over-year average premium per policy on homeowners renewal business increased 7.7% at June 30, 2014, compared to 8.9% at June 30, 2013. The homeowners year-over-year policyholder retention ratio was 90.0% at June 30, 2014, 90.1% at December 31, 2013, and 90.6% at June 30, 2013.

Commercial lines – Total commercial lines premiums written increased 10.7% to \$433 million in the second quarter of 2014, from \$391 million in the second quarter of 2013, driven by a 4.7% increase in the total commercial lines policies in force and a 5.4% increase in the total commercial lines year-over-year average premium per policy.

New business premiums written on commercial lines increased 4.1% in the second quarter of 2014, compared to an increase of 1.2% in the second quarter of 2013, driven by an increase in new business policies written seen across all major commercial lines of business. Commercial lines new business policies written increased 2.2% in the second quarter of 2014, compared to an increase of 1.7% in the second quarter of 2013, while the year-over-year average premium per policy on commercial lines new business decreased 0.2% at June 30, 2014, compared to an increase of 9.8% at June 30, 2013.

Renewal premiums for commercial lines increased 12.0% in the second quarter of 2014, compared to an increase of 12.6% in the second quarter of 2013, driven by increases in average premium per policy and steady policy retention ratios. The combined impact of these increases was seen primarily in the commercial multi-peril, commercial auto and workers compensation lines of business. The year-over-year average premium per policy on commercial lines renewal business

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increased 6.3% at June 30, 2014, compared to 6.6% at June 30, 2013. The year-over-year policy retention ratio for commercial lines was 86.9% at June 30, 2014, 86.7% at December 31, 2013, and 86.4% at June 30, 2013.

Future trends — premium revenue – We plan to continue our efforts to grow Property and Casualty Group premiums and improve our competitive position in the marketplace. Expanding the size of our agency force through a careful agency selection process and increased market penetration in our existing operating territories will contribute to future growth as existing and new agents build their books of business with the Property and Casualty Group. At June 30, 2014, we had nearly 2,200 agencies with over 10,700 licensed property and casualty representatives. The Property and Casualty Group plans to expand operations into the Commonwealth of Kentucky by the first quarter of 2015 or earlier if possible.

Changes in premium levels attributable to the growth in policies in force and rate changes directly affect the profitability of the Property and Casualty Group and have a direct bearing on Indemnity's management fee. Our continued focus on underwriting discipline and the maturing of our pricing sophistication models have contributed to the Property and Casualty Group's growth in new policies in force, steady policy retention ratios, and increased average premium per policy.

Losses and loss expenses

Current accident year, excluding catastrophe losses – The current accident year loss and loss expense ratio for all lines of business, excluding catastrophe losses, was 66.6% in the second quarter of 2014, compared to 64.8% in the second quarter of 2013, and was 69.9% for the six months ended June 30, 2014, compared to 66.2% for the six months ended June 30, 2013. The higher ratio for the first six months of 2014 was driven primarily by a higher volume of non-catastrophe weather related claims resulting from more severe winter weather experienced in the first quarter and a few large commercial property claims in the second quarter, compared to the first six months of 2013.

Current accident year catastrophe losses – Catastrophic events, destructive weather patterns, or changes in climate conditions are an inherent risk of the property and casualty insurance business and can have a material impact on our property and casualty insurance underwriting results. In addressing this risk, we employ what we believe are reasonable underwriting standards and monitor our exposure by geographic region. The Property and Casualty Group's definition of catastrophes includes those weather-related or other loss events that we consider significant to our geographic footprint which, individually or in the aggregate, may not reach the level of a national catastrophe as defined by the Property Claim Service ("PCS"). The Property and Casualty Group maintains property catastrophe reinsurance coverage from unaffiliated reinsurers to mitigate future potential catastrophe loss exposures and no longer participates in the voluntary assumed reinsurance business, which lowers the variability of the Property and Casualty Group's underwriting results.

Catastrophe losses for the current accident year, as defined by the Property and Casualty Group, totaled \$244 million in the second quarter of 2014, compared to \$45 million in the second quarter of 2013, and contributed 18.8 points and 3.7 points, respectively, to the loss ratios. In the second quarter of 2014, catastrophe losses primarily resulted from a large hail storm that occurred in May in the state of Pennsylvania. For the six months ended June 30, 2014, catastrophe losses for the current accident year totaled \$337 million, compared to \$72 million compared to the six months ended June 30, 2013, and contributed 13.1 and 3.0 points, respectively, to the loss ratios.

Prior accident years, including prior accident year catastrophe losses – The following table provides a breakout of our property and casualty insurance operation's prior year loss reserve development, including prior accident year catastrophe loss reserves, by type of business:

(in millions)	Property and Casualty Group			
	Three months ended June 30,		Six months ended June 30,	
	2014	2013	2014	2013

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	(Unaudited)		(Unaudited)	
Direct business, including reserves for catastrophe losses and salvage and subrogation	\$(10) \$20	\$(27) \$29
Assumed reinsurance business	2	4	10	3
Ceded reinsurance business	(1	) (6	) (5	) (7
Total prior year loss development	\$(9	) \$18	\$(22	) \$25

Negative amounts represent a redundancy (decrease in reserves), while positive amounts represent a deficiency (increase in reserves).

Direct business, including reserves for catastrophe losses and salvage and subrogation – In the second quarter of 2014, the Property and Casualty Group experienced favorable development on direct prior accident year loss reserves of \$10 million that

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improved the combined ratio by 0.8 points, compared to adverse development of \$20 million in the second quarter of 2013 that contributed 1.7 points to the combined ratio. For the six months ended June 30, 2014, favorable development of direct prior accident year loss reserves totaled \$27 million and improved the combined ratio by 1.1 points, compared to adverse development of \$29 million that contributed 1.2 points for the six months ended June 30, 2013.

The favorable development in the first six months of 2014 was primarily due to the workers compensation line of business, offset somewhat by adverse development in the commercial auto line of business. In the first six months of 2013, the adverse development was primarily related to increased reserves that occurred in the first quarter on two massive injury lifetime medical claims in the workers compensation line of business, combined with adverse development in the commercial multi-peril line of business that occurred in the second quarter.

Assumed reinsurance – The Property and Casualty Group experienced adverse development on prior accident year loss reserves for its assumed involuntary reinsurance business totaling \$2 million in the second quarter of 2014, compared to adverse development of \$4 million in the second quarter of 2013. In the first six months of 2014, adverse development on prior accident year loss reserves for the assumed reinsurance business totaled \$10 million, compared to adverse development of \$3 million in the first six months of 2013.

Ceded reinsurance – The Property and Casualty Group’s ceded reinsurance reserve recoveries increased by \$1 million and \$6 million in the second quarters of 2014 and 2013, respectively, and increased by \$5 million and \$7 million in the first six months of 2014 and 2013, respectively. An increase in ceded recoveries is reflected as favorable loss development as it represents an increase in recoveries resulting from adverse development on our direct loss reserves, while a decrease in ceded recoveries is reflected as adverse loss development as it represents a decrease in recoveries resulting from favorable development on our direct loss reserves. In the first six months of 2014, the increase in ceded recoveries was primarily due to adverse development related to the business catastrophe liability, whereas the increase in the first six months of 2013 was primarily due to adverse development related to the pre-1986 automobile massive injury claims and in the commercial multi-peril and business catastrophe liability lines of business.

Policy acquisition and other underwriting expenses – Our policy acquisition and other underwriting expense ratio increased 0.2 points to 29.3% in the second quarter of 2014, from 29.1% in the second quarter of 2013, and increased 0.3 points to 29.0% for the six months ended June 30, 2014, from 28.7% for the six months ended June 30, 2013. The management fee rate was 25% for the periods ended June 30, 2014 and 2013.

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Life Insurance Operations

EFL is a Pennsylvania-domiciled life insurance company which underwrites and sells individual and group life insurance policies and fixed annuities and operates in 10 states and the District of Columbia. EFL plans to expand operations into the Commonwealth of Kentucky by the first quarter of 2015 or earlier if possible. A summary of the results of our life insurance operations is as follows:

(in millions)	Erie Family Life Insurance Company						
	Three months ended June 30,			Six months ended June 30,			
	2014	2013	% Change	2014	2013	% Change	
	(Unaudited)			(Unaudited)			
Individual and group life premiums, gross	\$32	\$31	4.3	% \$62	\$60	4.2	%
Reinsurance premiums – ceded	(10)	(11)	1.3	(20)	(21)	1.1	
Individual and group life premiums, net	22	20	7.5	42	39	7.0	
Other revenue	0	0	52.5	1	1	27.9	
Total net policy revenue	22	20	8.1	43	40	7.2	
Net investment income	23	23	1.2	47	46	1.4	
Net realized gains on investments	0	3	(94.8)	5	6	(19.3)	
Impairment losses recognized in earnings	0	(1)	52.6	0	(1)	(85.5)	
Equity in earnings of limited partnerships	1	1	(40.1)	1	1	(33.5)	
Total revenues	46	46	(2.7)	96	92	2.8	
Benefits and other changes in policy reserves	27	26	4.6	55	52	5.5	
Amortization of deferred policy acquisition costs	3	3	(5.1)	6	6	4.9	
Other operating expenses	6	4	22.9	12	10	14.9	
Total benefits and expenses	36	33	6.1	73	68	6.8	
Income before taxes – Exchange ⁽¹⁾	\$10	\$13	(26.2)%	\$23	\$24	(8.9)%	

NM = not meaningful

(1) The Exchange retains 100% of the income from the life insurance operations.

Policy revenue

Gross policy revenues increased 4.3% to \$32 million in the second quarter 2014, from \$31 million in the second quarter of 2013. EFL uses, and has used, a variety of reinsurance programs to reduce claims volatility and for other financial benefits. While the amount of risk that EFL retains can vary based upon the type of policy issued and the year it was issued, EFL generally does not retain more than \$1 million of risk on any individual life. Ceded reinsurance premiums totaled \$10 million and \$11 million in the second quarter of 2014 and 2013, respectively. For the six months ended June 30, 2014, compared to 2013, gross policy revenues totaled \$62 million and \$60 million, respectively, while ceded reinsurance premiums totaled \$20 million and \$21 million for the six months ended June 30, 2014 and 2013, respectively.

Annuity and universal life premiums that are recorded as deposits totaled \$16 million in both the second quarters of 2014 and 2013, respectively, and \$32 million for both the six months ended June 30, 2014 and 2013, and therefore are not reflected in individual and group life premiums in the table above.

Investment revenue

EFL's investment revenue remained relatively flat in the second quarter and first six months of 2014, compared to the second quarter and first six months of 2013. See the "Investment Operations" segment discussion that follows for further

information.

Benefits and expenses

In the second quarter and first six months of 2014, total benefits and expenses were primarily impacted by an increase in death benefits and future life policy benefits, compared to the second quarter and first six months of 2013.

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Investment Operations

The investment results related to our life insurance operations are included in the investment operations segment discussion as part of the Exchange's investment results. A summary of the results of our investment operations is as follows:

(in millions)	Erie Insurance Group					
	Three months ended June 30,			Six months ended June 30,		
	2014	2013	% Change	2014	2013	% Change
	(Unaudited)			(Unaudited)		
Indemnity						
Net investment income	\$4	\$3	11.9 %	\$8	\$7	15.1 %
Net realized gains on investments	0	0	NM	1	0	NM
Net impairment losses recognized in earnings	0	0	NM	0	0	NM
Equity in earnings of limited partnerships	3	5	(38.4)	9	8	18.7
Net revenue from investment operations – Indemnity	\$7	\$8	(17.0)%	\$18	\$15	23.3 %
Exchange						
Net investment income	\$112	\$104	8.0 %	\$220	\$206	6.7 %
Net realized gains on investments	133	61	NM	188	310	(39.5)
Net impairment losses recognized in earnings	0	(1)	NM	0	(1)	NM
Equity in earnings of limited partnerships	24	34	(28.6)	68	67	1.4
Net revenue from investment operations – Exchange ⁽¹⁾	\$269	\$198	35.2 %	\$476	\$582	(18.4)%

NM = not meaningful

(1) The Exchange's investment results for the second quarter of 2014 and 2013 include net investment revenues from EFL's operations of \$24 million and \$26 million, respectively. The Exchange's investment results for the first six months of 2014 and 2013 include net investment revenues from EFL's operations of \$53 million and \$52 million, respectively

Net investment income

Net investment income primarily includes interest and dividends on our fixed maturity and equity security portfolios net of investment expenses. Indemnity's net investment income increased \$1 million in the second quarter of 2014, compared to the second quarter of 2013, while the Exchange's net investment income increased \$8 million.

Indemnity's net investment income increased \$1 million for the six months ended June 30, 2014, compared to the six months ended June 30, 2013, while the Exchange's net investment income increased \$14 million. The increases in net investment income for Indemnity were primarily due to higher invested balances, while the increases for the Exchange were primarily due to higher invested balances and higher dividend income from equity securities.

Net realized gains on investments

Net realized gains and losses on investments include the changes in fair value of common stocks designated as trading securities, and gains and losses resulting from the actual sales of all security categories. Indemnity generated net realized gains of \$0.2 million in the second quarter of both 2014 and 2013, while the Exchange generated net realized gains of \$133 million in the second quarter of 2014, compared to gains of \$61 million in the second quarter of 2013. Indemnity generated net realized gains of \$1 million for the six months ended June 30, 2014, compared to gains of \$0.2 million for the six months ended June 30, 2013 while the Exchange generated net realized gains of \$188 million for the six months ended June 30, 2014, compared to gains of \$310 million for the six months ended June 30, 2013.

Net realized gains for Indemnity during the six months ended June 30, 2014 primarily represented gains from the sale of equity securities. Net realized gains for the Exchange increased in the second quarter of 2014 primarily due to larger increases in fair value of common stocks compared to the second quarter of 2013. Net realized gains for the Exchange decreased for the six months ended June 30, 2014 primarily due to lower increases in fair value of common stocks and lower realized gains from sales of common stock compared to the six months ended June 30, 2013.

Net impairment losses recognized in earnings

Net impairment losses recorded in earnings for Indemnity were \$0.1 million for the second quarter and six months ended June 30, 2014 and June 30, 2013. Net impairment losses recorded in earnings for the Exchange were \$0.1 million for the second quarter and \$0.3 million for the six months ended June 30, 2014, compared to net impairment losses of \$1 million for the second quarter and the six months ended June 30, 2013.

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Equity in earnings of limited partnerships

Indemnity's equity in earnings of limited partnerships decreased \$2 million in the second quarter of 2014, compared to the second quarter of 2013, while the Exchange's equity in earnings of limited partnerships decreased \$10 million. Equity in earnings of limited partnerships for both Indemnity and the Exchange increased \$1 million for the six months ended June 30, 2014, compared to the six months ended June 30, 2013. The decrease in earnings for both Indemnity and the Exchange during the second quarter of 2014 was due to lower earnings from private equity investments, partially offset by higher earnings from mezzanine debt investments for Indemnity, and higher earnings from real estate investments for the Exchange. The increase in earnings for Indemnity during the six months ended June 30, 2014 was due to higher earnings from private equity investments partially offset by lower earnings from real estate, while earnings increased slightly for the Exchange due to minor changes in earnings from each investment sector.

A breakdown of our net realized gains (losses) on investments is as follows:

(in millions)	Erie Insurance Group		Six months ended June 30,	
	Three months ended June 30, 2014	2013	2014	2013
Indemnity	(Unaudited)		(Unaudited)	
Securities sold:				
Fixed maturities	\$0	\$0	\$0	\$0
Equity securities	0	0	1	0
Total net realized gains – Indemnity ⁽¹⁾	\$0	\$0	\$1	\$0
Exchange				
Securities sold:				
Fixed maturities	\$4	\$4	\$9	\$17
Equity securities	1	2	8	4
Common stock equity securities	45	51	112	141
Common stock increases in fair value ⁽²⁾	83	4	59	148
Total net realized gains – Exchange ⁽³⁾	\$133	\$61	\$188	\$310

(1) See Item 1. "Financial Statements – Note 7. Investments," contained within this report for additional disclosures regarding net realized gains (losses) on investments.

(2) The fair value on our common stock portfolio is based upon exchange traded prices provided by a nationally recognized pricing service.

(3) The Exchange's results for the second quarter of 2014 and 2013 include net realized gains from EFL's operations of \$0.2 million and \$3 million, respectively. The Exchange's results for the first six months of 2014 and 2013 include net realized gains from EFL's operations of \$5 million and \$6 million, respectively.

The components of equity in earnings (losses) of limited partnerships are as follows:

(in millions)	Erie Insurance Group		Six months ended June 30,	
	Three months ended June 30, 2014	2013	2014	2013
Indemnity	(Unaudited)		(Unaudited)	
Private equity	\$0	\$3	\$4	\$2
Mezzanine debt	1	0	1	