June 30, 2006

# Financial Information

State Fund
Washington Department of
Labor and Industries

Department of
LABOR AND
INDUSTRIES

December 2006

# Contents

# *Washington State Department of Labor and Industries' Mission*

*We support the state's economic well-being by protecting the safety of Washington's workers, providing benefits to injured workers and ensuring fair wages and quality industry services.*

## *Our Commitment*

The Department of Labor and Industries (L&I) administers one of the best workers' compensation systems in the nation, one that's committed to meeting the needs and interests of injured workers and their employers. Our commitment:

- Work with employers and workers to prevent workplace injuries and illnesses.
- Provide prompt and certain relief to workers who suffer a work-related injury or illness.
- Administer the program and its finances in a way that is transparent and maximizes benefits and minimizes costs.
- Eliminate fraud and abuse by workers, employers, and health care providers.
- Listen to and respond to the needs of our customers.

## *Responsive Change*

To fulfill this commitment, L&I will look for opportunities to improve the system and be open to new ideas and change. Our administration of the workers' compensation system will evolve as new proven technologies become available. We must closely monitor medical advancements, authorizing those that improve an injured worker's condition, and resisting those that provide little or no relief. We will manage claims effectively, encourage return-to-work options, and minimize the financial impact of a claim. No one benefits when a claim lasts longer than it should.

Finally, we will continue to partner with employers and workers to improve a vital and vigorous workers' compensation system.

## *Message from Assistant Director Robert Malooly*

Our goal is to run the best workers' compensation system in the country for our customers. That means we will:

- Manage claims efficiently and eliminate unnecessary delays.
- Price the insurance correctly.
- Provide help to employers and injured workers as they navigate the system for the first time.
- Maximize investment earnings within the bounds of sound investments.
- Minimize disability so that injured workers return to a productive job they can safely do.
- Give money back to our customers when we have excess funds.
- Collect premiums owed, so that employers compete on a level playing field.
- Listen and be open to new ways of doing business.

We don't always meet those goals, but we certainly try. In the fiscal year that ended last June 30, our accomplishments were as simple as answering the phones on the first or second ring, and as complex as expanding L&I's Online Claim & Account Center to better serve our customers.

Along the way, we again succeeded at managing our health care expenses. In 2006, we held inflation to just below 5 percent, compared with a 7.7 percent average for the rest of the industry. And with help from the Washington State Investment Board, we finished the year with over $1.7 billion in our contingency reserve. A significant chunk of that money will be returned to employers and workers in the form of lower rates in 2007 and a rate holiday in the Medical Aid Fund in the second half of next year.

For that success, considerable credit goes to the vast majority of Washington employers and workers who focused on safety and avoided injuries.

L&I's commitment to you is that we will continue to work with our customers to build on those successes.

Sincerely,

Robert Malooly, Assistant Director
Insurance Services Division

# *Management Discussion and Analysis*

This section of the State Fund of the Washington Department of Labor and Industries ("The State Fund") annual financial information presents management's discussion and analysis of the financial performance of the State Fund during the year ended June 30, 2006. This discussion should be read in conjunction with the accompanying financial information and footnotes. The financial information, footnotes, and this discussion are the responsibility of the State Fund management.

**Some history and things that make the State Fund of the State of Washington unique:**

1. Washington's "Workmen's Compensation Act" established the industrial insurance system in 1911. Initially it only covered workers in hazardous jobs. The first annual report, in 1912, listed every company covered, the number of people each company employed, how much it paid in premiums, and how many injuries were reported. The first slogan was "SAFETY FIRST."

2. In 1923, Washington became the only state where workers paid a significant portion of the insurance premiums. In 2006, their share averaged 24.1 percent.

3. Washington remained an exclusive State Fund until 1972, when the system underwent a major overhaul. It was expanded to include all workers, and large employers, who met certain financial and safety criteria, were allowed to self-insure.

4. In 1999 and 2000, the State Fund's contingency reserve had grown to the point that the State Fund paid $400 million in dividends to employers and dramatically lowered rates.

5. Between 2003 and 2005, average rates rose 42.5 percent.

6. Since its inception in 1981, L&I's Retrospective Rating Program has refunded over $1.5 billion to participating employers and their associations.

7. Washington's injured-worker benefits rank fifth highest in the nation, while 35 states have premium rates that average higher than ours.

8. In Fiscal Year 2006, L&I's health care costs rose 4.9 percent, compared with a 7.7 percent average for the nation's workers' compensation insurers.

**Workplace Injuries**

In Fiscal Year 2006, Washington's workers' compensation system covered about 2.4 million workers employed by 165,000 employers. Nearly 141,000 claims were filed, though that figure is incomplete because workers have a year from the date of injury to file a claim. The vast majority of injured workers – 70 percent – were men, and half of all injuries were to workers 30 to 50 years of age. A total of 7,480,000 days were lost from work. The most common injury was cuts and abrasions, followed by back sprains and strains, and then leg and foot strains and sprains. Sixty-six fatal pensions were awarded.

**State Fund**
Better-than-expected investment earnings throughout the year resulted in considerable growth in the State Fund's contingency reserve, giving L&I the ability to lower premium rates in 2007 by an average of 2 percent. That will represent a $31 million savings for employers. Because much of the contingency reserve is concentrated in the Medical Aid Fund, L&I has proposed reducing that fund's rate to zero for the second half of 2007. The savings would be about $315 million. Because employers and workers pay equally into that fund, both would benefit equally.

In 2006, the Workers' Compensation Finance Committee was created and is made up of representatives from business, labor, and L&I. The committee's role is to advise the department on State Fund financial issues. In the past year, committee members discussed and offered advice on 2007 rates, the proposed six-month rate holiday, the appropriate level for the contingency reserve, proposed changes in the formula L&I uses to calculate an employer's rates, and use of State Fund monies to pay for non-industrial insurance programs run by Labor and Industries.

**Accomplishments in 2006**

- Through the use of evidence-based medicine, closely monitoring of prescription drug use and an emphasis on prescribing drugs from the state's preferred drug list, L&I was again able to hold medical inflation well below the national average for workers' compensation insurers.
- L&I expanded its Eastern Washington Center of Occupational Health & Education to include doctors in 16 counties east of the Cascades, ensuring that injured workers in remote areas of the state have access to quality health care.
- L&I's Online Claims & Account Center greatly expanded the amount of available information and business that can be conducted electronically, better serving injured workers, employers, and health care providers.
- L&I's Fraud Prevention and Compliance Program collected $10.20 for every dollar spent on detecting and preventing fraud and abuse of the workers' compensation system.

**Using the Annual Financial Report**
The Combining Statement of Balance Sheet, Combining Statement of Income, and the Combining Statement of Cash Flows are prepared under the Statutory Accounting Principles (SAP) basis of accounting, whereby the main purpose of SAP information is to determine solvency, the availability of an L&I's assets to satisfy its obligations to injured workers and the beneficiaries. The Notes to the Financial Information provide additional information that is essential to a full understanding of the data provided in the financial information of the State Fund.

**Cash Flow**

Premiums collected during Fiscal Year 2006 of $1.45 billion are an increase of 5.71 percent over Fiscal Year 2005. This increase is due to higher premium rates and growing exposures with the improving economy and more workers employed and, thus, more hours reported.

Benefits paid during Fiscal Year 2006 totaled $1.25 billion with a slightly increased growth rate of 5.09 percent from Fiscal Year 2005. The ratio of expenses paid to benefits paid decreased slightly, as expenses decreased 3.4 percent from Fiscal Year 2005.

Investment cash flow from equity securities dividends of $29.3 million and fixed income securities interest earnings of $524.4 million increased 13 percent from Fiscal Year 2005 as investment yields increased while the assets increased, with net cash increasing because of increases in investment realized gains.

## Financial Condition

Total fund equity holdings increased $98.66 million and fixed income holdings increased $473.4 million over 2005 year-end values. These increases, coupled with a net increase in premiums earned after adjusting for a 6 percent growth in Retrospective Rating refunds, greatly contributed to the contingency reserve growth of $516.4 million during Fiscal Year 2006. This growth is not uniform across the accounts within the State Fund as Accident is above its targeted reserve and Medical Aid is far exceeding its targeted reserve, while the Pension Reserve is slightly below.

**Contingency Reserve**

| Fund | Target % of Total Liability | Current | Target Upper Limit | Above (Below) |
|---|---|---|---|---|
| Accident | 10% | $584 M | $337 M | $247 M |
| Medical Aid | 15% | $1123 M | $293 M | $830 M |
| Pension | 1% | $2.6 M | $24 M | $(21.4) M |

## Reserves

Total benefit reserves increased by $162 million in the fiscal year. The Accident Fund reserve decreased $27 million, the Medical Aid Fund increased $51 million, and the Pension Reserve Fund increased $138 million. Non-pension benefits in the Accident and Medical Aid funds are discounted at 2.5 percent, while the pension benefits in the Accident Fund is discounted at 6.5 percent.

The Claims Administration Reserve increased by $28 million with the fund's continued investment in technology and the effect of inflation pressures.

**Benefit and Claims Administration Expense Reserves, Expressed in Thousands**

| Fund | Undiscounted (except pensions) | Discounted | Carrying Value | Difference | Percent Difference |
|---|---|---|---|---|---|
| **Accident** | | | | | |
| Benefit | $3,540,686 | $3,212,735 | $3,212,735 | $354,262 | 9.3% |
| Claim Admin | 184,175 | 160,902 | 160,902 | 19,060 | 12.6% |
| **Medical Aid** | | | | | |
| Benefit | 4,044,260 | 2,693,970 | 2,693,970 | 1,431,045 | 33.9% |
| Claim Admin | 279,734 | 238,676 | 238,676 | 30,840 | 14.7% |
| **Pension** | | | | | |
| Benefit | 2,422,276 | 2,422,276 | 2,422,276 | NA | NA |
| **Totals** | $10,471,131 | $ 8,728,559 | $ 8,728,559 | $1,742,572 | 16.6% |

## Liquidity and Capital Resources

The State Fund's operation requires liquidity sufficient to meet both short-term and long-term requirements. Short-term liquidity requirements come from three basic elements. First, workers' compensation claims are subject to some variation, usually inflationary. Second, benefit payments and investments are sensitive to variations in premium adequacy. Finally, retrospective returns require an increased degree of liquidity.

The State Fund has generally met its operating requirements by maintaining appropriate levels of liquidity in its investment portfolio and through utilization of positive cash flow. The State Fund has the financial capacity to hold its fixed income portfolio to maturity and to match projected cash inflows from premiums and investment income from this portfolio with projected cash outflows for payment of benefits.

All equity holdings are in the form of index funds with securities divided between 85 percent held in US Equity Market Fund B and 15 percent held in MSCI EAFE Index SL CTF for International Equities as of the fiscal year ended June 30, 2006. This combination yielded $29.3 million in dividends and $46 million in realized gains on trades for Fiscal Year 2006.

Fixed income securities are reported at amortized cost, which adjusts for any premiums or discounts with the respective interest payment or when traded. Unrealized gains or losses on these securities are not recognized until matured or traded. Generally these securities are purchased to provide income and are held until maturity. Carrying the value at amortized cost avoids wide swings in value because of changing interest rates. These securities yielded $524.7 million in interest income net of amortization and realized gains on trades of $28.5 million.

Costs of this investing activity included $52.9 million in management fees plus $1.3 million in administrative costs incurred by the State Investment Board in managing and reporting on the State Fund's investments

**Contacting the Workers' Compensation Fund Financial Management**
This financial information is designed to provide to all those with an interest in the state program with a general overview of the State Fund and to show the State Fund's financial condition. If you have questions about this report or need additional financial information, contact Chief Accounting Officer, Department of Labor and Industries, P.O. Box 44830, Olympia, WA 98504-4830.

# Financial Information

**State Fund**
**Combining Balance Sheet Statement**
**As of June 30, 2006**
**(Amounts rounded to the nearest thousands)**

| **Draft** | **12-14-2006** | Accident | Medical Aid | Pension Reserve | 2006 State Fund | 2005 State Fund |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| **Cash and Investments** | | | | | | |
| Investments, Net | | | | | | |
| Fixed income @ amortized cost | | $ 3,362,611,000 | $ 2,555,146,000 | $ 2,118,354,000 | $ 8,036,111,000 | $ 7,562,707,000 |
| Equities @ fair value | | 374,890,000 | 1,294,313,000 | 236,826,000 | 1,906,029,000 | 1,807,368,000 |
| Short term @ fair value | | 51,188,000 | 31,842,000 | 62,105,000 | 145,135,000 | |
| Trade receivables | | 17,000 | 10,000 | 15,000 | 42,000 | 30,121,000 |
| Sub-total investments | | 3,788,706,000 | 3,881,311,000 | 2,417,300,000 | 10,087,317,000 | 9,400,196,000 |
| Interest receivable | | 43,788,000 | 28,243,000 | 28,026,000 | 100,057,000 | 100,709,000 |
| Cash | | 2,848,000 | (243,000) | 738,000 | 3,343,000 | 629,000 |
| **Total Cash and Investments** | | 3,835,342,000 | 3,909,311,000 | 2,446,064,000 | 10,190,717,000 | 9,501,534,000 |
| **Other Assets** | | | | | | |
| Premium receivables, net | | 263,598,000 | 156,751,000 | - | 420,349,000 | 398,054,000 |
| Land, buildings, & improvements | | 5,473,000 | 5,473,000 | - | 10,946,000 | 17,228,000 |
| Self Insurance receivables, net | | 2,839,000 | 1,726,000 | 2,549,000 | 7,114,000 | 5,628,000 |
| Miscellaneous | | 22,426,000 | 434,000 | 6,000 | 22,866,000 | 1,875,000 |
| **Total Other Assets** | | 294,336,000 | 164,384,000 | 2,555,000 | 461,275,000 | 422,785,000 |
| **Total Assets** | | **$ 4,129,678,000** | **$ 4,073,695,000** | **$ 2,448,619,000** | **$ 10,651,992,000** | **$ 9,924,319,000** |
| **Liabilities & Contingency Reserve** | | | | | | |
| **Liabilities** | | | | | | |
| Benefits | | $ 3,212,735,000 | $ 2,693,970,000 | $ 2,422,276,000 | $ 8,328,981,000 | $ 8,167,206,000 |
| **Other Liabilities** | | | | | | |
| Claims administration | | 160,902,000 | 238,676,000 | - | 399,578,000 | 371,732,000 |
| Retrospective rating adjustments | | 156,593,000 | - | - | 156,593,000 | 145,761,000 |
| Accrued liabilities | | 14,736,000 | 17,517,000 | 23,788,000 | 56,041,000 | 44,362,000 |
| Deferred revenue | | 513,000 | 976,000 | - | 1,489,000 | 2,392,000 |
| **Total Other Liabilities** | | 332,744,000 | 257,169,000 | 23,788,000 | 613,701,000 | 564,247,000 |
| **Total Liabilities** | | **$ 3,545,479,000** | **$ 2,951,139,000** | **$ 2,446,064,000** | **$ 8,942,682,000** | **$ 8,731,453,000** |
| **Contingency Reserve** | | **$ 584,199,000** | **$ 1,122,556,000** | **$ 2,555,000** | **$ 1,709,310,000** | **$ 1,192,866,000** |
| **Total Liabilities & Contingency Reserve** | | **$ 4,129,678,000** | **$ 4,073,695,000** | **$ 2,448,619,000** | **$ 10,651,992,000** | **$ 9,924,319,000** |

**State Fund**
**Statements of Income**
**For Fiscal Year Ended June 30, 2006**
**(Amounts rounded to the nearest thousands)**

| | Accident | Medical Aid | Pension Reserve | 2006 State Fund | 2005 State Fund |
|---|---|---|---|---|---|
| **Revenues** | | | | | |
| Net standard premiums earned | $ 889,489,000 | $ 612,397,000 | $ - | $ 1,501,886,000 | $ 1,421,200,000 |
| Less retrospective rating adjustments | (162,289,000) | - | - | (162,289,000) | (152,987,000) |
| Net premiums earned | 727,200,000 | 612,397,000 | 0 | 1,339,597,000 | 1,268,213,000 |
| Net investment income | 211,037,000 | 160,586,000 | 128,187,000 | 499,810,000 | 472,762,000 |
| Net fixed income realized gains (losses) | 17,182,000 | (231,000) | 11,579,000 | 28,530,000 | 151,171,000 |
| Net equity realized gains | 22,069,000 | 14,047,000 | 9,927,000 | 46,043,000 | |
| Self-insured admin & pension reimbursements | 9,777,000 | 7,664,000 | 79,141,000 | 96,582,000 | 70,541,000 |
| Fines and penalties | 13,895,000 | 1,610,000 | - | 15,505,000 | |
| Other income | 13,958,000 | 1,570,000 | - | 15,528,000 | 15,540,000 |
| **Total Revenues Earned** | $ 1,015,118,000 | $ 797,643,000 | $ 228,834,000 | $ 2,041,595,000 | $ 1,978,227,000 |
| **Expenses** | | | | | |
| Benefits incurred | $ 502,595,000 | $ 560,029,000 | $ 350,515,000 | $ 1,413,139,000 | $ 1,386,587,000 |
| Claims administrative incurred | 56,671,000 | 85,164,000 | - | 141,835,000 | 112,202,000 |
| Premium administrative incurred | 22,001,000 | 17,221,000 | - | 39,222,000 | 25,615,000 |
| General insurance administrative incurred | 8,973,000 | 5,949,000 | - | 14,922,000 | 19,133,000 |
| Self-insured administrative incurred | 10,805,000 | 10,405,000 | - | 21,210,000 | |
| Other administrative incurred | 35,028,000 | 12,120,000 | 673,000 | 47,821,000 | 68,504,000 |
| **Total Expenses Incurred** | $ 636,073,000 | $ 690,888,000 | $ 351,188,000 | $ 1,678,149,000 | $ 1,612,041,000 |
| **Net Income Before Transfers** | $ 379,045,000 | $ 106,755,000 | $ (122,354,000) | $ 363,446,000 | $ 366,186,000 |
| **Contributions and Transfers** | | | | | |
| Pension Funding Adjustment | $ 31,000 | $ - | $ (31,000) | $ - | $ - |
| Pension Funding Transfer | (128,984,000) | - | 128,984,000 | - | - |
| Net Contributions and Transfers | $ (128,953,000) | $ - | $ 128,953,000 | $ - | - |
| **Net Income** | $ 250,092,000 | $ 106,755,000 | $ 6,599,000 | $ 363,446,000 | $ 366,186,000 |
| **Other Changes In Contingency Reserve** | | | | | |
| Equity Unrealized Gains | 24,793,000 | 106,507,000 | 17,853,000 | 149,153,000 | |
| Change in Non-Admitted Assets | 7,863,000 | (3,575,000) | (443,000) | 3,845,000 | 38,491,000 |
| Change in Contingency Reserve, Net | $ 282,748,000 | $ 209,687,000 | $ 24,009,000 | $ 516,444,000 | $ 404,677,000 |
| Contingency Reserve, July 1, | 301,451,000 | 912,869,000 | (21,454,000) | 1,192,866,000 | 788,189,000 |
| Contingency Reserve, June 30, | $ 584,199,000 | $ 1,122,556,000 | $ 2,555,000 | $ 1,709,310,000 | $ 1,192,866,000 |

## State Fund
## Combining Statement of Cash Flows
## For fiscal Year Ended June 30, 2006
## (Amounts rounded to the nearest thousands)

| | Accident | Medical Aid | Pension Reserve | 2006 State Fund Total | 2005 State Fund Total |
|---|---|---|---|---|---|
| Standard premiums collected | $ 827,385,000 | $ 622,781,000 | $ - | $ 1,450,166,000 | $ 1,367,351,000 |
| Less retrospective rating adjustments | (151,457,000) | - | - | (151,457,000) | (118,263,000) |
| Net Premiums Collected | 675,928,000 | 622,781,000 | - | 1,298,709,000 | 1,249,088,000 |
| Self insured pension reimbursements | - | - | 17,605,000 | 17,605,000 | 73,176,000 |
| Other income (expense) | 45,942,000 | (4,821,000) | (303,000) | 40,818,000 | 4,345,000 |
| Fund transfers In (out) | (154,273,000) | - | 216,997,000 | 62,724,000 | |
| **Cash Flow In** | $ 567,597,000 | $ 617,960,000 | $ 234,299,000 | $ 1,419,856,000 | $ 1,326,609,000 |
| Benefits Paid | $ 504,849,000 | $ 508,967,000 | $ 237,548,000 | $ 1,251,364,000 | $ 1,187,616,000 |
| Claims administration expense | $ 48,867,000 | $ 65,238,000 | $ - | $ 114,105,000 | $ 118,373,000 |
| Premium administration expense | 11,168,000 | 11,566,000 | - | 22,734,000 | 21,710,000 |
| General insurance expense | 8,336,000 | 5,448,000 | - | 13,784,000 | 13,176,000 |
| Other administration expense | 31,375,000 | 17,619,000 | - | 48,994,000 | 56,348,000 |
| Self Insured administrative, net | 495,000 | 2,598,000 | - | 3,093,000 | |
| Total Administrative Expense Paid | 100,241,000 | 102,469,000 | - | 202,710,000 | 209,607,000 |
| **Cash Flow Out** | $ 605,090,000 | $ 611,436,000 | $ 237,548,000 | $ 1,454,074,000 | $ 1,397,223,000 |
| **Operating Cash Flow** | $ (37,493,000) | $ 6,524,000 | $ (3,249,000) | $ (34,218,000) | $ (70,614,000) |
| Investment income - bonds | 237,065,000 | 152,151,000 | 135,172,000 | 524,388,000 | 454,524,000 |
| Investment income - equities | 6,498,000 | 18,834,000 | 4,011,000 | 29,343,000 | 35,251,000 |
| Realized gains | 39,251,000 | 13,816,000 | 21,506,000 | 74,573,000 | |
| Purchases | (212,909,000) | (180,526,000) | (145,394,000) | (538,829,000) | (421,706,000) |
| Expenses - Fund Mgrs & SIB | (31,847,000) | (9,126,000) | (11,570,000) | (52,543,000) | (937,000) |
| **Net Cash Flow** | $ 565,000 | $ 1,673,000 | $ 476,000 | $ 2,714,000 | $ (3,482,000) |
| **Beginning cash balance, July 1, 2005** | 2,283,000 | (1,916,000) | 262,000 | 629,000 | 4,111,000 |
| **Ending cash balance, June 30, 2006** | $ 2,848,000 | $ (243,000) | $ 738,000 | $ 3,343,000 | $ 629,000 |

# *Notes to Financial Information*

## Note 1 – Basis of Presentation

The accompanying financial information is based on statements of Statutory Accounting Principles (SAP) as promulgated by the National Association of Insurance Commissioners, as would be required of any property and casualty insurance enterprise in the United States when reporting its financial condition to state insurance regulators. The SAP are very conservative in nature and are designed to protect injured workers and policyholders to ensure that, in the event of liquidation, sufficient amounts have been set aside to provide for outstanding claims of injured workers. This accounting basis is used to present insurance solvency and the adequacy of premium rates.

### A. Source of SAP financial information

The Department of Labor and Industries prepares an annual financial statement from data recorded in the Washington State Agency Financial Reporting System. The financial statement is prepared in accordance with Generally Accepted Accounting Principles (GAAP) as promulgated by the Governmental Accounting Standards Board. Peterson Sullivan, PLLC audited the 2006 financial statement for the period ended June 30, 2006, and issued an unqualified (clean) opinion on those statements. The audited GAAP financial statement and underlying data serves as the source for the SAP-based State Fund information statements.

The principal statutory accounting practices followed by the State Fund which differ from GAAP, as prescribed by the Governmental Accounting Standards Board, applicable to its operations are:

- Investment securities are principally carried at amortized cost whereas under GAAP such securities would be carried at estimated fair value with changes in fair value reflected in net income.
- Certain assets designated as “non-admitted assets” are excluded from total assets. These assets consist principally of premiums in the course of collection outstanding over 90 days, office furniture and equipment, and prepaid expenses, the changes in which are credited or charged directly to contingency reserve (or surplus). Under GAAP, these assets would be included in total assets.
- Computer equipment purchases are expensed. Under GAAP, computer equipment purchases would be recorded as assets, less accumulated depreciation.
- The balance sheet statement presents assets available to cover benefit liabilities. Under GAAP, assets and liabilities are presented in order of liquidity. GAAP presents assets and liabilities as current and as non-current.
- The statement of cash flows differs in certain respects from the presentation required by GAAP. Cash Flows In on the statement of cash flows includes operating transfers and other income. Cash Flows Out are categorized by losses and administrative expenses.
- The statement of income presents premiums and investment income as the primary revenue sources and expenses are presented as activities. GAAP presentations

separate operating income from investment income as investment is not normally a primary revenue source. Additionally, GAAP presents expenses by object rather than as activities and the net effect of revenues and expenses as a change in net assets.

Effects of the difference between SAP and GAAP are: Under GAAP, total contingency reserve for the State Fund decreased by $22,765,000 and net income decreased by $619,634,000 with recognition of the loss in fair value of fixed income securities, as of and for the year ended June 30, 2006.

**B. Description of the State Fund**

Washington State, through Title 51 Revised Code of Washington (RCW), requires employers to secure payment of benefits for job-related injuries and diseases either by paying insurance premiums to the Workers' Compensation Fund or by self-insuring.
Direct private insurance is not authorized, although self-insurers are permitted to reinsure up to 80 percent of their obligations.

The statute provides five benefit funds to make compensation payments to injured workers or to medical providers for rehabilitation services to injured workers. The Accident, Medical Aid, and Pension Reserve Funds are required to be self-sustaining by insurance premiums. These financial information statements report on the financial condition and results of operations of these three funds known collectively as the State Fund.

<u>The Accident Fund</u> pays compensation directly to injured workers for lost wages during temporary disability, for permanent partial disability awards, and awards pensions to survivors of fatally injured workers and to workers adjudged to be permanently and totally disabled. Such claim liabilities are discounted for Fiscal Year 2005 to the present value assuming a 2.5 percent annual interest rate.

Revenues for this fund are provided by employer paid premiums, calculated on the basis of hours worked. However, employers may elect to have their premiums retrospectively rated with an adjustment for actual losses incurred. This may result in either a rebate of premiums paid or an assessment of additional premiums due. All retrospective premium adjustments are financed entirely through the Accident Fund. The adjustment calculation considers both the Accident and Medical Aid funds experience and premiums together; however, no retrospective premium adjustments are made through the Medical Aid Fund.

These funds are maintained on an actuarially solvent basis, except that a cash-flow basis is authorized for the components of the Pension Reserve Fund when self-insured employers guarantee related benefits with a surety bond.

<u>The Medical Aid Fund</u> pays for the cost of medical and vocational rehabilitation services to injured workers. Employers are allowed to withhold half of the medical aid premium from their employees' wages. Medical reserves are discounted to the present value assuming a 2.5 percent annual interest rate. Revenues for this fund are usually provided by equal contributions from employers and employees.

<u>The Pension Reserve Fund</u> pays benefits to all permanently disabled pensioners including disabled employees of self-insured employers. These reserves are discounted to the present

value assuming a 6.5 percent annual interest rate. Revenues to fund the pension payments are provided with transfers from the Accident Fund and reimbursement payments from self-insurers invested in securities selected to cover payments for the expected life of the injured worker.

### C. Other Related Funds

The Second Injury Fund and the Supplemental Pension Funds are a part of the Workers' Compensation Fund, but not a part of the State Fund.

<u>The Second Injury Fund</u> is used to pay pension costs on claims where permanent total disability is at least partially caused by a prior injury. It is funded by amounts received from the Accident and Medical Aid funds for State Fund claims and by self-insured assessments for self-insured claims. An allowance for future second injury benefit payments is contained within the Accident and Medical Aid funds claim reserves for State Fund claims. Therefore, this fund does not carry any reserves. This fund's operations are not directly reported in these financial information statements, but second injury claims, which it services, are reported appropriately in the State Fund and its three operating funds, Accident, Medical Aid, and Pension Reserve Funds.

<u>The Supplemental Pension Fund</u> provides for supplemental cost-of-living adjustments (COLA) to injured employees receiving disability payments. However, the enabling legislation requires this fund to operate on a current payment basis and is subject to legislative cancellation. No assets are allowed to accumulate for the future servicing of current claims.

Cost-of-living pension payment increases are based on the increase in the state average wage during the preceding calendar year and are granted in July of the ensuing year. Revenues for COLA payments arise from assessments to self-insured and State Fund employers; half of the assessment may be deducted from employees' wages. Income, expense, assets, or future claim liabilities related to Supplemental Pension or Second Injury funds are not included in these financial information statements.

### D. Use of estimates in preparation of financial information

The preparation of financial information in conformity with statutory accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingency assets and liabilities at the date of the financial information, and the reported amounts of revenues and expenses during the reporting period. Future premium income is not offset against claims liabilities, as the claims liabilities arise from coverage periods for which premiums have, in general, already been fully earned. The obligation to pay claims expenses and claims administration liabilities is not contingent upon any future premiums for future coverage periods. Although management records its best estimate of its liability for claims and settlement expenses, actual results could differ materially from those estimates.

Management's estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate amounts, particularly loss and loss adjustment expense reserve, at the date of the financial information. Management's judgment is based on its knowledge and experience about past and current events and circumstances and its assumptions about conditions it expects to exist in the future. Factors relevant to the estimation of loss and loss adjustment expense liabilities include the estimation of the ultimate frequency and severity of losses, the level of future medical costs inflation over long periods of time, the future legal environment, and the amount of future expenses required to investigate and settle claims. Management's estimates are reviewed after the fiscal year end by the a nationally recognized qualified consulting actuarial firm. Summary of independent actuary firm's opinion is included.

## Note 2 - Significant Accounting Policies

### A. Investments

#### 1. Summary of Investment Policies

Under RCW 43.33A.030, trusteeship over the investment of the Workers' Compensation Fund investments is vested in the Washington State Investment Board (WSIB). The Legislature established a standard of care for investment of these funds in RCW 43.33A.140. Additionally, the WSIB must comply with other state laws, such as the Ethics in Public Service Act, RCW 42.52, as it makes investment decisions and seeks to meet its investment objectives.

In accordance with state laws, Workers' Compensation Fund investments are to be managed to limit fluctuations in the industrial insurance premiums and, subject to this purpose, achieve a maximum return at a prudent level of risk. Based on this requirement, the order of the objectives is:

- Maintain the solvency of the funds.
- Maintain premium rate stability.
- Ensure sufficient assets are available to fund the expected liability payments.
- Subject to those above, achieve a maximum return at a prudent level of risk.

**Eligible Investments** – Eligible investments include:

- U.S. Equities.
- International Equities.
- U.S. Treasuries and Government Agencies.
- Credit Bonds.
- Mortgage-Backed Securities rated BBB- or higher by Standard & Poor's and Baa3 or higher by Moody's Investor's Service (Moody's).
- Asset-Backed Securities rated BBB- or higher by Standard & Poor's and Baa3 or higher by Moody's.
- Commercial Mortgage-Backed Securities rated BBB- or higher by Standard & Poor's and Baa3 or higher by Moody's.
- Investment Grade Non-U.S. Dollar Bonds.

**Investment Restrictions** - To meet stated objectives, investments of Workers' Compensation Funds are subject to the following constraints:

- Asset allocation between equity and fixed income investments must fall within prescribed limits and are to be reviewed every three to four years or sooner if there are significant changes in funding levels or the liability durations.
- No corporate fixed income issue cost shall exceed 3 percent of the fund's market value at the time of purchase, nor shall its market value exceed 6 percent of the investment's market value at any time.
- Allocation of equity investments between U.S. and International must fall within prescribed limits. The benchmark and structure for U.S. equities is the broad U.S. stock market as defined by the Dow Jones-Wilshire 5000. The benchmark and structure for international equities is the Morgan Stanley Capital Indexes Europe, Australia, Far East (MSCI EAFE) index. Both portfolios are 100 percent passively managed in commingled index funds. The commingled funds may use futures for hedging or establishing a long position.
- The fixed income portfolios' structure varies depending upon the required duration target. The duration targets are reviewed every three years, or sooner, if there are significant changes in the funding levels or the liability durations.
- Sector allocation of fixed income investments must be managed within the prescribed ranges. These targets are long term in nature. Deviations may occur in the short term as a result of interim market conditions. However, if a range is exceeded, the portfolios must be rebalanced as soon as it is practical to the target allocations.
- Total holdings of below investment grade credit bonds (rated BB+ or below by Standard & Poor's or rated Ba1 or below by Moody's) should not exceed 5 percent of total fixed income holdings.

The Fund Asset Allocation reflects this policy with the current targets and ranges:

| Fund | Fixed Income Target | Equity Target | Equity Range |
|---|---|---|---|
| Accident | 90% | 10% | 8% - 12% |
| Medical Aid | 70% | 30% | 24% - 36% |
| Pension Reserve | 90% | 10% | 8% - 12% |

**2. Interest Rate Risk**

Interest rate risk is the risk that changes in interest rates of debt investments will adversely affect the fair value of an investment. The Workers' Compensation Fund's fixed income investments are actively managed to exceed the return of the Lehman Aggregate Index, with volatility as measured by duration to be similar to or less than the index. As of June 30, 2006, the durations of the various fixed income classes were within the duration targets of the Lehman Aggregate Index.

The Workers' Compensation Fund investments include both U.S. agencies and corporate debt variable-rate securities, most of which reset periodically to the market interest rate.

Because these securities frequently re-price to prevailing market rates, interest rate risk is substantially reduced at each periodic reset date.

The following schedule, expressed in thousands, presents the Workers' Compensation Fund investments by type and provides information about the interest rate risks associated with the investments as of June 30, 2006. The schedule displays various asset classes held by maturity in years and credit ratings. Variable-rate securities are presented according to the length of time until the next reset date rather than the stated maturity.

| Investment Type | Book Value | Fair Value | 1 year | 1-5 years | 6-10 years | 10 years |
|---|---|---|---|---|---|---|
| Asset Backed Securities | $ 5,048 | $ 5,162 | $ - | $ 5,162 | $ - | $ - |
| Mortgages: | | | | | | |
| Collateralized Mortgage Obligations | 1,687,439 | 1,612,418 | 7,578 | 230,737 | 294,589 | 1,079,514 |
| Pass Throughs | 2,468 | 2,744 | 244 | 2,492 | 8 | - |
| Non-Standard Mortgages | 27,698 | 28,355 | 12,901 | 13,574 | - | 1,880 |
| Commercial Mortgage Backed Securities | 628,348 | 633,660 | 5,513 | 369,677 | 258,470 | - |
| Corporate Bonds - Domestic | 4,524,256 | 4,455,071 | 256,743 | 1,021,374 | 1,023,649 | 2,153,305 |
| Government Securities-Domestic: | | | | | | |
| US Government Treasuries | 1,029,513 | 1,077,209 | 19,682 | 73,769 | 85,823 | 897,935 |
| US Government Agencies | 162,632 | 210,062 | - | - | - | 210,062 |
| Variable Rate Notes | 62,647 | 62,785 | 62,785 | - | - | - |
| | | 8,087,466 | $ 365,446 | $ 1,716,785 | $ 1,662,539 | $ 4,342,696 |
| Commingled Index Funds-Domestic | 1,494,867 | 1,584,407 | | | | |
| Commingled Index Funds-Foreign | 208,490 | 321,622 | | | | |
| Money Market Funds | 176,990 | 176,990 | | | | |
| | 10,010,396 | $ 10,170,485 | | | | |

Investments with multiple credit ratings are presented using the Moody's rating scale as follows:

(expressed in thousands)

| | Investment Type | | | | | |
|---|---|---|---|---|---|---|
| **Moody's Equivalent Credit Rating** | Corporate Bonds - Domestic | Variable Rate Notes | Collateralized Mortgage Obligations | Non-Standard Mortgages | Commercial Mortgage Backed Securities | **Total** |
| Aaa | $ 420,927 | $ - | $ 1,542,972 | $ 26,733 | $ 586,052 | $ 2,576,684 |
| Aa1 | 131,418 | - | - | - | - | 131,418 |
| Aa2 | 111,824 | - | - | - | - | 111,824 |
| Aa3 | 509,083 | 20,053 | - | - | - | 529,136 |
| A1 | 589,182 | 34,998 | - | - | - | 624,180 |
| A2 | 465,974 | - | - | - | - | 465,974 |
| A3 | 523,906 | - | - | - | - | 523,906 |
| Baa1 | 559,517 | - | - | - | - | 559,517 |
| Baa2 | 806,528 | 7,734 | - | - | - | 814,262 |
| Baa3 | 234,391 | - | - | - | - | 234,391 |
| NR | 102,321 | - | 69,446 | 1,622 | 47,608 | 220,997 |
| **Total** | $ 4,455,071 | $ 62,785 | $ 1,612,418 | $ 28,355 | $ 633,660 | $ 6,792,289 |

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### 3. Accounting for investment accordance with SAP requirement

- Short-term investments and investments in money market funds are carried at cost, which approximates market. Bonds are principally carried at amortized costs.
- Realized gains or losses on sale or maturity of investments are determined on the basis of specific identification and are included in net income.
- Declines in fair value of investments that are deemed to be other than temporary are included in investment income as a realized loss. Subsequent recoveries in value are reflected as increases in unrealized gains and included as component of contingency reserve.
- All equity holdings are in the form of index funds with securities divided with 85 percent held in US Equity Market Fund B and 15 percent held in MSCI EAFE Index SL CTF for International equities as of the fiscal year ended June 30, 2006. Equities are carried and reported at fair or market value.
- Fixed income securities are reported at amortized cost which adjusts for any premiums or discounts with the respective interest payment or when traded. Unrealized gains or losses on these securities are not recognized until matured or traded. Generally these securities are purchased to provide income and are held until maturity. Carrying the value at amortized cost avoids wide swings in value because of changing interest rates.

### B. Cash

Cash consists of cash in banks, cash in deposit with State Treasurer, and cash on hand.

### C. Premiums Receivable, Net

All employers in Washington subject to Title 51 of the Revised Code of Washington are required to provide workers' compensation insurance by paying premiums to the Industrial Insurance Fund or by electing and qualifying to self-insure. Premiums are normally based on each employer's reported payroll hours and insurance rates based on the employer's risk classification(s) and past employee injury experience.

In addition to its regular premium plans, the Fund offers a retrospective premium rating plan under which premiums are adjusted annually for up to four years following the plan year based on the employers' loss experience. Adjustments to the original premiums are paid or collected from the associations and employers approximately 10 months after the end of each plan year.

Employers' workers' compensation insurance premiums are due 30 days following each calendar quarter in which payroll hours are reported. A premium receivable is established for each employer not fully paying or not reporting its payroll hours as of the due date set each quarter. Additionally, an allowance for uncollectible premiums is established based on an evaluation of outstanding premium receivables. Further, for reporting in accordance with SAP, all premium receivables exceeding 30 days in age are adjusted and expensed to bad debts expense in the current period. However, collection efforts are continued until the premiums are collected or all legal means are exhausted.

### D. Reinsurance

The department maintains an agreement with a reinsurance broker to purchase reinsurance at reasonable rates. Current rates exceed what are considered reasonable rates. Therefore, the department does not carry any catastrophic reinsurance coverage for its workers' compensation program. However, the department remains in contact with the broker and will purchase reinsurance coverage when it becomes available at reasonable rates.

### E. Estimated Future Benefits

Reserves for unpaid benefits and claims administration expenses in the Accident and Medical Aid funds are provided based primarily on ratios of paid-to-date losses for older accident periods. For more recent accident periods, selections of several common actuarial techniques are used. These estimates are continually under review, and as changes to these liabilities become necessary, such adjustments are reflected in current income.

For insurance reporting purposes under SAP requirements, these estimates are calculated and presented net of all recoveries. Reporting under GAAP requirements, these estimates are presented at the discounted present value without an adjustment for recoveries. Recoveries include overpayments and successful subrogation against third parties. Recoveries may be in the form of cash or deduction against continuing benefits.

The liability for benefits in the Pension Reserve Fund is determined from individual claims transferred to this fund using actuarial pension annuity tables. Such liabilities are necessarily based on estimates and, while management believes that the amount is adequate, the ultimate liability may be in excess of or less than the amounts provided.

**Claims Liability Development by Program**
**(in thousands)**

| Program/ Category | Undiscounted Liabilities | Discount Rate | SSAP Liabilities | Overpayment Adjustments | GAAP Liabilities |
|---|---|---|---|---|---|
| **Accident** | $3,540,686 | 2.5% | $3,212,735 | $22,515 | $3,235,250 |
| **Medical Aid** | 4,044,260 | 2.5% | 2,693,970 | 2, 268 | 2,696,238 |
| **Pensions** | **2,422,276** | | 2,422,276 | 2,985 | 2,425,261 |
| **Sub-Total Benefit Reserve** | $10,**007,222** | | $8,328,981 | $27,768 | $8,356,749 |
| **Claim Admin Expense (CAE)** | $463,909 | 2.5% | $399,578 | | $399,578 |
| **Total Benefits & CAE Reserves** | **$10,471,131** | | $8,728,559 | $27,768 | $8,756,327 |

## F. Claims and Judgments

The schedule below, expressed in thousands, presents the changes in claims liabilities for the past two fiscal years for the workers' compensation basic benefit (representing the Accident Fund, Medical Aid Fund, and Pension Reserve Fund.)

| | Basic Plan | |
|---|---|---|
| | FY 2006 | FY 2005 |
| Unpaid claims and claim adjustment expenses at beginning of year | $ 8,538,938 | $ 8,361,558 |
| Incurred claims and claim adjustment expenses: | | |
| Provision for insured events of the current year | 1,823,328 | 1,724,503 |
| decrease in provision for insured events of prior years | (268,238) | (239,709) |
| Total incurred claims and claim adjustment expenses | 1,555,090 | 1,484,794 |
| Payments: | | |
| Claims and claim adjustment expenses attributable: | | |
| To events of the current year | 277,626 | 259,673 |
| To insured events of prior years | 1,087,843 | 1,047,741 |
| Total payments | 1,365,469 | 1,307,414 |
| Total unpaid claims and claim adjustment expenses at fiscal year end | $ 8,728,559 | $ 8,538,938 |
| Less current portion | 1,360,224 | |
| | $ 7,368,335 | |

A description of the risks to which the State Fund is exposed and the ways the State Fund handles the risks is presented in Note 1.B. At June 30, 2006, $10.5 billion of unpaid claims and claim adjustment expenses are presented at their net present and settlement value of $8.7 billion. These claims are discounted at assumed interest rates of 2.5 percent (Accident Fund and Medical Aid Fund) to arrive at a settlement value that is net of third party recoveries.

## G. Land, Buildings and Equipment, Net

Purchased or constructed assets with a value of $5,000 or greater are capitalized and depreciated over the useful lives in accordance with the State of Washington's State Administrative and Accounting Manual. However, for insurance reporting, not all capitalized assets are admitted for reporting purposes, but are adjusted from the respective fund's contingency reserve with current purchases immediately expensed. For Fiscal Year 2006, the Accident and Medical Aid operating funds admitted only the investment in land, buildings, and other improvements, net of accumulated depreciation.

Additionally, per SSAP No. 40 (4) & (6), buildings are reported net of encumbrances, which for the State Fund are the general obligation bonds issued for the construction of the building housing most of the State Fund's employees.

**Reconciliation of Capital Assets to Financial Information**
(amounts in thousands)

| **Captial Asset** | **Accident Fund** | | | |
|---|---|---|---|---|
| | Book Value | Non Admitted | Encumbrance | Net Admitted |
| Land | $ 1,602 | $ - | $ - | $ 1,602 |
| Art & Library Reserve | 18 | (18) | - | - |
| Building, net | 21,910 | | (18,413) | 3,497 |
| Improvements, net | 374 | | | 374 |
| Equipment & Software, net | 8,404 | (8,404) | | |
| Library Resources, net | 120 | (120) | | |
| Software Underdevelopment | 2,687 | (2,687) | - | - |
| Sub-total | $ 35,115 | $ (11,229) | $ (18,413) | $ 5,473 |

| **Capital Asset** | **Medical Aid Fund** | | | |
|---|---|---|---|---|
| | Book Value | Non Admitted | Encumbrance | Net Admitted |
| Land | $ 1,602 | $ - | $ - | $ 1,602 |
| Art & Library Reserve | 18 | (18) | - | - |
| Building, net | 21,911 | | (18,412) | 3,499 |
| Improvements, net | 372 | | | 372 |
| Equipment & Software, net | 8,441 | (8,441) | | |
| Library Resources, net | 120 | (120) | | |
| Software Underdevelopment | 2,268 | (2,268) | - | - |
| Sub-total | $ 34,732 | $ (10,847) | $ (18,412) | $ 5,473 |
| **Total Capital Assets** | $ 69,847 | $ (22,076) | $ (36,825) | $ 10,946 |

## H. State Fund Employee Compensated Absences and Retirement Plan

State Fund employees accrue vested annual leave at a variable rate based on years of service. In general, accrued annual leave cannot exceed 30 days at the employee's anniversary date.

Employees accrue sick leave at the rate of one day per month without limitation on the amount that can be accumulated. Sick leave is not vested, i.e., the Workers' Compensation State Fund does not pay employees for unused sick leave upon termination except upon employee death or retirement. At death or retirement, the Workers' Compensation State Fund is liable for 25 percent of the employee's accumulated sick leave. In addition, the Workers' Compensation State Fund has a "sick leave buyout option" in which each January, employees who accumulate sick leave in excess of 60 days may redeem sick leave earned but not taken during the previous year at the rate of one day's pay in exchange for each four days of sick leave.

It is the Workers' Compensation State Fund's policy to liquidate unpaid compensated absences leave outstanding at June 30 with future resources rather than advance funding it with currently available expendable financial resources.

The Workers' Compensation State Fund recognizes the expense and accrues a liability for annual leave and estimated sick leave buyout, including related payroll taxes and benefits as applicable as the leave is earned.

State Fund employees are participating in the State of Washington Public Employees' Retirement System ("PERS"). PERS is a defined benefit pension plan. Under the plan, the employee and employer contribute a percentage of the employee's compensation. The State Fund contributed $3,020,815 to this plan during the fiscal year ended June 30, 2006. An actuarial valuation of the PERS plan for the Workers' Compensation State Fund as a stand-alone entity is not available.

### I. Commitments and Contingencies

Effective July 1, 1992, the Washington State Legislature required the State Fund under RCW 48.22.070 to participate in an assigned risk pool providing workers' compensation coverage under the United States Longshore and Harbor Workers' Act. The State Fund is obligated to participate 50 percent in the underwriting losses or surpluses of the assigned risk pool. This participation is scheduled to continue indefinitely due to amending legislation passed in 1997. However, the State Fund has not made any payments to this risk pool since enactment of this indefinite commitment.

### J. Summary of Significant Litigation

The Workers' Compensation State Fund is party to numerous routine legal proceedings that normally occur in operations. At any given point, there may be numerous lawsuits that could impact expenses. There is a recurring volume of tort and other claims for compensation and damages against the Workers' Compensation State Fund. The collective impact of these claims, however, is not likely to have a material impact on Workers' Compensation State Fund revenues or expenses.

# Supplementary Information

## Workers' Compensation Fund - Basic Plan
## Claims Development Information

Fiscal Years 1997 through 2006 (expressed in millions)

The table below illustrates how the Fund's Basic Plan earned revenues (net of reinsurance) and investment income compare to the related costs of losses (net of loss assumed by re-insurers) and other expenses assumed by the fund as of the end of each of the last ten fiscal years. The Workers' Compensation Fund has not purchased reinsurance since September 30, 2002 and has never had a qualifying event that generated a recovery.

**The rows of the table are defined as follows:**

1. This line shows each fiscal year's earned contribution revenues and investment revenues.
2. This line shows the Basic Plan's incurred claims (both paid and accrued) as originally reported at the end of the first year in which the event that triggered coverage under the contract occurred (called policy year).
3. This section shows the cumulative amounts paid as of the end of successive years for each policy year.
4. This section shows how each policy year's incurred claims increased or decreased as of the end of successive years. Annual re-estimation results from new information received on known claims, reevaluation of existing information on known claims, and emergence of new claims not previously known.
5. This line compares the latest re-estimated incurred claims amount to the amount originally established (line 2) and shows whether this latest estimate of claims cost is greater or less than originally thought. As data for individual policy years mature, the correlation between original estimates and re-estimates is commonly used to evaluate the accuracy of incurred claims currently recognized in less mature policy years.

**Workers' Compensation Fund - Basic Plan**
**Claims Development Information**
Fiscal Years 1997 through 2006 (expressed in millions)

| | | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. | Net earned required contribution and investment revenues | $ 1,257 | $ 2,013 | $ 927 | $ 1,057 | $ 1,449 | $ 1,197 | $ 2,111 | $ 1,337 | $ 2,452 | $ 1,392 |
| 2. | Estimated incurred claims and expenses, end of policy year | 1,681 | 1,700 | 1,732 | 1,902 | 1,925 | 2,124 | 2,284 | 2,505 | 2,308 | 2,141 |
| 3. | Paid (cumulative) as of: | | | | | | | | | | |
| | End of policy year | 191 | 196 | 205 | 218 | 230 | 226 | 233 | 244 | 260 | 278 |
| | One year later | 409 | 420 | 438 | 473 | 494 | 500 | 501 | 528 | 556 | |
| | Two years later | 522 | 545 | 564 | 608 | 646 | 653 | 650 | 681 | | |
| | Three years later | 596 | 627 | 643 | 706 | 747 | 756 | 751 | | | |
| | Four years later | 651 | 684 | 707 | 777 | 825 | 834 | | | | |
| | Five years later | 693 | 731 | 758 | 837 | 890 | | | | | |
| | Six years later | 731 | 770 | 800 | 889 | | | | | | |
| | Seven years later | 763 | 805 | 840 | | | | | | | |
| | Eight years later | 794 | 838 | | | | | | | | |
| | Nine years later | 825 | | | | | | | | | |
| 4. | Reestimated incurred claims and expenses: | | | | | | | | | | |
| | End of policy year | 1,681 | 1,700 | 1,732 | 1,902 | 1,925 | 2,124 | 2,284 | 2,505 | 2,308 | 2,141 |
| | One year later | 1,602 | 1,627 | 1,690 | 1,838 | 1,963 | 2,158 | 2,277 | 2,203 | 1,989 | |
| | Two years later | 1,553 | 1,651 | 1,694 | 1,913 | 2,067 | 2,277 | 2,045 | 1,971 | | |
| | Three years later | 1,575 | 1,643 | 1,770 | 1,977 | 2,226 | 2,079 | 1,853 | | | |
| | Four years later | 1,576 | 1,678 | 1,794 | 2,088 | 2,039 | 1,906 | | | | |
| | Five years later | 1,601 | 1,690 | 1,839 | 1,881 | 1,864 | | | | | |
| | Six years later | 1,593 | 1,687 | 1,682 | 1,778 | | | | | | |
| | Seven years later | 1,575 | 1,554 | 1,578 | | | | | | | |
| | Eight years later | 1,478 | 1,503 | | | | | | | | |
| | Nine years later | 1,425 | | | | | | | | | |
| 5. | Increase (decrease) in estimated incurred claims and expenses from end of policy year | (256) | (197) | (154) | (124) | (61) | (218) | (431) | (534) | (319) | |

Source: Washington State Department of Labor and Industries

**STATEMENT OF ACTUARIAL OPINION**
**DEPARTMENT OF LABOR AND INDUSTRIES**
**AS OF JUNE 30, 2006**

### *Identification*

I, David F. Mohrman, am associated with Towers, Perrin, Forster & Crosby. I am a member of the American Academy of Actuaries and meet its qualification standards for statements of actuarial opinion. I am also a Fellow of the Casualty Actuarial Society. The loss and loss adjustment expense reserves are the responsibility of the Department's management; my responsibility is to express an opinion of those reserves based on my review.

### *Scope*

I have performed separate actuarial reviews of the statutory reserves for loss and loss adjustment expense as of June 30, 2006, in the Accident Fund ($3,373,637,000), Medical Aid Fund ($2,932,646,000), and Pension Reserve Fund ($2,422,276,000) for the Department. These reserves are contained in the State Fund Balance Sheet as of June 30, 2006.

My examination of the loss and loss adjustment expense reserves was based upon the review of the data and related information, methodology, assumptions, and calculations utilized by the Department. In this regard, I relied on the Department as to the accuracy and completeness of the data. In performing this evaluation, I evaluated the data used directly in my analysis for reasonableness and consistency. My evaluation did not reveal any data points materially affecting my analysis that fell outside of the range of reasonable possibilities. In performing this evaluation, I have assumed that the Department (a) used its best efforts to supply accurate and complete data and (b) did not knowingly provide inaccurate data. In other respects, my examination included the use of such actuarial assumptions and methods and such tests of calculations as I considered necessary.

My review was limited to the items listed above and did not include an analysis of any income statement items or other balance sheet items.

I evaluated the loss and loss adjustment expense reserves on a discounted basis with regard to the time value of money. The yields for discounting were 2.5% for the Accident Fund and the Medical Aid Fund and 6.5% for the Pension Reserve Fund. The average implied discount rate was 4.0%, which I consider reasonable. I evaluated the loss and loss adjustment expense reserves, net in regards to salvage and subrogation, and gross of reinsurance.

***Opinion***

In my opinion, these reserves are consistent with reserves computed in accordance with Standards of Practice issued by the Actuarial Standards Board (including the Casualty Actuarial Society's Statement of Principles Regarding Property and Casualty Loss and Loss Adjustment Expense Reserves) and make a reasonable provision for all the unpaid loss and loss adjustment expense obligations of the Department under the terms of its policies and agreements.

***Comments***

The Department writes a coverage whose risk factors expose the Department's reserves to significant variability. I have identified the major risk factors that could have a material impact as rising medical costs and any future court decisions that could have a retrospective impact on liabilities. The absence of other risk factors from this listing does not imply that additional risk factors will not be identified in the future as having been a significant influence on the Department's reserves.

The risk factor of rising medical costs is evident by the escalation of recent trend levels and continuation at this level would have a material impact on the reserves. Future court decisions are also a risk factor that could have a material impact.

I believe the risk factors above, coupled with the variability that is inherent in any reserve estimate, could result in material adverse deviation from the carried reserve. In making this determination, I have considered a material adverse deviation to be one in which the actual reserves exceed the amounts above by an amount greater than 10% of the reserves. Other measures of materiality might be used for reserves that are being evaluated in a different context.

In evaluating whether the reserves make a reasonable provision for unpaid losses and loss expenses, it is necessary to project future loss and loss adjustment expense payments. These estimates incorporate actuarial assumptions as to future long-term contingencies based upon the available data. It is certain that actual future losses and loss adjustment expenses will not develop exactly as projected and may, in fact, vary significantly from the projections. Further, the projections make no provision for extraordinary future emergence of new classes of losses or types of losses not sufficiently represented in the Department's historical database or which are not yet quantifiable.

This statement of opinion is solely for the use of, and to be relied upon by, the Department and the State of Washington.

Date: December 28, 2006

David F. Mohrman

David F. Mohrman, FCAS, MAAA
Principal
Towers Perrin