California Earthquake Authority

Financial Statements
For the year ended December 31, 2002

California Earthquake Authority

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PRICEWATERHOUSECOOPERS

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Report of Independent Auditors

The Governing Board
California Earthquake Authority:

In our opinion, the accompanying balance sheet and the related statements of revenues, expenses, and changes in net assets and of cash flows present fairly, in all material respects, the financial position of the California Earthquake Authority (the Authority) at December 31, 2002, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, opening net assets (unaudited) as of January 1, 2002 have been restated for a correction of an error related to an overstatement of unearned ceded premium.

Also as discussed in Note 1, the Authority has changed its basis of accounting to conform with governmental accounting standards and has implemented the provisions of Governmental Accounting Standards Board Statement No. 34, *Basic Financial Statements – Management's Discussion and Analysis – for State and Local Governments,* as amended. The Management's Discussion and Analysis, presented on pages 2 to 9, is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures on the information as of and for the year ended December 31, 2002, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying Schedule of Participating Insurer Assessments, Schedule of Participating Insurer Premium Written and Unearned and Schedule of Participating Insurer Commission and Operating Costs as of December 31, 2002 and for the year then ended are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

PricewaterhouseCoopers LLP

February 14, 2005

HISTORY AND FINANCING

This discussion provides an assessment by management of the financial position, revenues, expenses, changes in net assets, cash flows and liquidity of the California Earthquake Authority (CEA). Readers are encouraged to consider the information presented in conjunction with the financial statements as a whole, which follows *Management's Discussion and Analysis*.

Following the unprecedented losses from the 1994 Northridge earthquake, many insurance companies either stopped or severely restricted selling new homeowners insurance policies in California. The insurer response was largely due to state law that requires insurers to offer earthquake insurance when selling or renewing residential property insurance.

In 1996, in response, the California Legislature created the CEA, an instrumentality of the State of California that sells earthquake insurance policies for residential property throughout California. CEA policies are sold to policyholders by participating insurance carriers of the CEA. Insurance companies admitted to write residential property insurance in California and who elected to become participating members of the CEA signed Insurer Participation Agreements with the Insurance Commissioner and the CEA. Under these agreements, participating insurers act as independent contractor agents on behalf of the CEA by performing policy and claims services which include underwriting, policy issuance, premium collection, and claims adjustment.

The CEA uses its capital (net assets) to leverage approximately $7 billion in claims-paying capacity (at December 31, 2002). The CEA's claims-paying capacity is determined from the CEA's net assets, reinsurance coverage, available letters of credit, and post event prospective participating insurance company assessments. The CEA derives its capital from participating insurance company assessments and from revenues generated from the sale of earthquake insurance policies. The CEA is exempt from federal income tax and from state insurance-premium tax. California Insurance Code section 10089.44 provides, in pertinent part, that "… premiums collected by the authority shall be exempt from collection of the state's insurance premium tax, and the amount of tax foregone by the state shall be considered for all purposes a contribution by the state and its citizens to the capital and operating revenues of the authority."

A Governing Board composed of the State of California's Governor, Treasurer, and Insurance Commissioner oversees the CEA. The Speaker of the Assembly and the Chairperson of the Senate Rules Committee serve as non-voting Board members. An 11-member Advisory Panel advises the Board. The Governing Board establishes premium rates, subject to the prior approval of the Insurance Commissioner.

The CEA has approximately 750,000 policyholders at December 31, 2002, most of whom insure single-family dwellings through the CEA. The CEA offers a basic residential earthquake policy to homeowners, which includes coverage for the insured dwelling and limited coverage for contents and loss-of-use if the home is uninhabitable due to an earthquake. The CEA also offers policies to condominium unit owners and renters. For an additional premium, CEA policyholders can significantly increase insured limits on contents and for loss of use, and homeowners can lower their CEA policy deductible from 15 percent to 10 percent.

By law, the CEA staff is limited to three executive officers and 25 employees who are subject to civil service provisions. Because of its limited staff size, the CEA uses an extensive network of contract vendors to perform functions on behalf of the CEA.

USING THIS REPORT

While the CEA is an instrumentality of the state, the state of California's General Fund is not liable for CEA claims, losses, or other liabilities. However, the CEA meets the definition of a governmental organization, as defined by accounting principles generally accepted in the United States of America. The CEA's financial statements for the year ended December 31, 2002 have been prepared using accounting standards applicable to governmental entities. This financial report consists of three financial statements with accompanying notes. The Balance Sheet, prepared on the accrual basis of accounting, includes all assets, liabilities and net assets of the CEA. The Statement of Revenues, Expenses, and Changes in Net Assets, also prepared on the accrual basis, takes into account all revenues and expenses for the CEA regardless of when cash is received or paid. The Statement of Cash Flows reflects the actual cash receipts and disbursements for a specified period of time.

CONDENSED BALANCE SHEET

The CEA's assets, liabilities and net assets as of December 31 are summarized as follows (in thousands):

	2002	2001 (restated)
Assets		
Cash and investments	$ 1,495,045	$ 1,253,028
Premiums receivable, net of allowance for doubtful accounts of $1,569 and $1,572 in 2002 and 2001, respectively	23,682	26,130
Unearned ceded premiums	12,517	19,792
Deferred policy acquisition costs	27,192	27,779
Other assets	3,703	10,727
	$ 1,562,139	$1,337,456
Liabilities and Net Assets		
Unearned premiums	$ 212,435	$ 217,022
Supplemental reinsurance premiums payable	4,961	4,607
Other liabilities	3,717	4,694
Total liabilities	221,113	226,323
Net assets:		
Restricted	2,881	640
Unrestricted	1,338,145	1,110,493
Total net assets	1,341,026	1,111,133
Total liabilities and net assets	$ 1,562,139	$1,337,456

Assets

Total assets grew $225 million (17%) primarily due to an increase in net assets of $230 million. Cash and investment securities grew $242 million (19%). Investment securities are managed by external managers under the guidance of the CEA. U.S. Treasuries, short-term investments and cash-equivalent securities comprise 100% of the CEA's investment portfolio.

Premium receivable balances decreased $2.4 million (9%). This is largely attributable to the CEA's ability to collect premium payments from the participating carriers more efficiently due to enhanced reporting processes. The allowance for uncollectible premium remained essentially the same at $1.6 million. The CEA does not anticipate any unusual collection problems with respect to the premium balances and had no write-offs in 2002.

Unearned ceded premium, the pro rata portion of premiums ceded to reinsurers related to the remaining terms of reinsurance policies in force, decreased $7.3 million primarily as a result of a quarterly reinsurance payment of $8.9 million that was paid in advance at December 31, 2001, but not at December 31, 2002. The unaudited financial statements for the year ended December 31, 2001, have been restated to correct an error resulting from an overstatement of unearned ceded premium at December 31, 2000 and 2001.

Deferred policy acquisition costs consisting of participating insurer commissions and operating costs, are deferred and amortized ratably over the terms of the underlying policies. Deferred policy acquisition costs remained relatively flat.

The $7.0 million decrease in other assets is largely due to the reduction of assessments receivable and prepaid line of credit fees from $2.2 million in 2001 to $0 in 2002. The balance in other assets at December 31, 2002 consists primarily of interest receivable.

Liabilities

Unpaid claims and claims expense reserves are not significant as a major earthquake has not occurred since the inception of the CEA. Other liabilities include claims and claims expense reserves, unearned supplemental commission income, and accounts payable and accrued expenses.

Unearned premiums represent the pro rata portion of the premiums written related to the remaining terms of policies in force. Unearned premiums declined $4.6 million due to the timing of new policies written and renewals.

Net Assets

The CEA's net assets grew $229.9 million (21%) in 2002. The primary reasons for the increase were underwriting profit of $189.0 million, investment income of $25.8 million, and other income of $5.3 million.

Restatement

As discussed above, net assets at January 1, 2001 have been restated to correct an error. The impact of the restatement on the unaudited December 31, 2001 balances is as follows:

	As Previously Reported	As Restated
	(in thousands)	
Unearned ceded premium	$ 95,476	$ 19,792
Net assets (equity at January 1, 2001)	1,016,364	901,995
Net assets (equity at December 31, 2001)	1,186,817	1,111,133
Premiums ceded - reinsurance	(192,606)	(194,378)
Change in unearned premiums ceded -reinsurance	(29,858)	10,599
Underwriting profit	114,897	153,582
Increase in net assets	170,453	209,138

CONDENSED STATEMENT OF REVENUES, EXPENSES, AND CHANGES IN NET ASSETS

The CEA's operating results are presented in the following table (in thousands):

	2002		2001 (restated)	
Underwriting income:				
Premiums written	$ 431,408	100%	$ 426,830	100%
Less premiums ceded - reinsurance	(159,106)		(194,378)	
Net premiums written	272,302	63%	232,452	54%
Change in net unearned premiums	6,217		10,599	
Net premiums earned	278,519	65%	243,051	57%
Expenses:				
Line of credit fees	4,315		4,733	
Mitigation Fund expenses	269		2,030	
Other underwriting expenses	84,946		82,706	
Total expenses	89,530		89,469	
Underwriting profit	188,989	44%	153,582	36%
Net investment income	25,773		43,307	
Other income	15,131		12,249	
Increase in net assets	229,893	53%	209,138	49%
Net assets, beginning of year as previously reported	1,111,133		1,016,364	
Restatement	-		(114,369)	
Net assets, beginning of year, as restated	1,111,133		901,995	
Net assets, end of year	$1,341,026		$ 1,111,133	

Increase in net assets was $230 million in 2002, which resulted in a net profit margin of 53% and an increase of $21 million from the prior year. The CEA's net premiums written increased $40 million largely due to a decrease in reinsurance costs. Reinsurance costs decreased because of the CEA's purchasing less reinsurance due to its increasing capital base and because of management's ability to purchase reinsurance at a lower price than the previous year.

The change in net unearned premiums decreased $4.4 million largely due to a decrease in the change of unearned premiums ceded.

The earthquake loss mitigation program expenses decreased due to the termination of a mitigation program near the end of 2001. This particular program subsidized California homeowners for the cost of engineering plans used to retrofit their homes to mitigate damage caused by earthquakes. The increase in other underwriting expenses was largely a result of increased commissions and operating expenses the CEA paid to its participating insurance carriers because of the increase in premiums written during 2002.

Net investment income was 40% lower in 2002 than in 2001, a difference of $17.5 million, due to the continued decline in interest rates. However, other income rose $2.9 million due to increased commissions resulting from increased sales of supplemental insurance coverages.

CONDENSED STATEMENT OF CASH FLOWS

Primary sources of cash included cash flow from operations and cash provided from the sale or maturity of invested assets. The primary use of cash was the purchase of long-term investments.

The cash flows of the CEA are summarized as follows (in thousands):

	2002	2001
Net cash provided by operating activities	$ 206,332	$ 248,451
Net cash provided by noncapital financing activities	5,628	4,695
Net cash used in capital and related financing activities	2,839	6,642
Net cash provided by (used in) investing activities	188,833	(258,875)
Net increase in cash and cash equivalents	403,632	913
Cash and cash equivalents, beginning of year	736,284	735,371
Cash and cash equivalents, end of year	$ 1,139,916	$ 736,284

Cash from operating activities decreased $42.1 million (17%) in 2002. The decrease was largely due to a combination of the reductions in premiums receivable (6.9 million), unearned ceded premiums ($37.4 million) and reinsurance premiums receivable ($28.9 million) resulting from a "no-claims" bonus from reinsurers in 2001 and a $35.4 million increase of underwriting profit due to a decrease in reinsurance costs.

Cash provided by capital and related financing activities decreased $3.8 million in 2002 because five of the participating insurers finished paying their assessments during the year.

The cash flows provided by investing activities increased $447.7 million because of the CEA's decision to purchase more investments that qualified as cash equivalents (matured in less than 90 days) in 2002 than in the prior year. In 2002, the CEA's Governing Board approved an investment policy change that allowed the CEA to purchase U.S. Treasuries with maturities of up to five years to help counteract the diminishing yields for high-quality domestic investments. However, the Board also instructed the CEA to maintain a total-portfolio modified duration of 1.75 years or less. Therefore, as the CEA acquired long-term Treasuries, the CEA also purchased the corresponding amount of cash-equivalent securities to comply with the Board's maximum portfolio modified duration requirement.

LIQUIDITY

The CEA maintains a highly liquid investment portfolio in order to be able to quickly pay claims in the event of a large earthquake. As of December 31, 2002, 76% of the portfolio was to mature in 90 days or less. Securities maturing between 91 days and one year accounted for 8% of the portfolio, while securities maturing between one to five years accounted for the remaining 16% of the portfolio. Based on actuarial studies commissioned by the CEA, management believes the CEA has sufficient liquidity to meet its obligations as they become due resulting from an earthquake below a 1 in 2,342 year event.

During 2002, the CEA also maintained a letter of credit totaling $450 million with a consortium of reinsurers and banks, for purposes of paying claims. The CEA had no borrowings under this arrangement as of December 31, 2002 and the letter of credit expired December 31, 2003 and was not renewed.

California Earthquake Authority
Balance Sheet
December 31, 2002
(in thousands)

Assets	
Cash and Investments:	
Cash and cash equivalents	$ 1,139,916
Investments	355,129
Total cash and investments	1,495,045
Premiums receivable, net of allowance for doubtful accounts of $1,569	23,682
Unearned ceded premiums	12,517
Deferred policy acquisition costs	27,192
Interest receivable and other	3,703
Total assets	$ 1,562,139
Liabilities and Net Assets	
Unearned premiums	$ 212,435
Unearned supplemental commission income	2,446
Claim and claim expense reserves	74
Supplemental reinsurance premiums payable	4,961
Accounts payable and accrued expenses	1,197
Total liabilities	221,113
Net assets:	
Restricted	2,881
Unrestricted	1,338,145
Total net assets	1,341,026
Total liabilities and net assets	$ 1,562,139

The accompanying notes are an integral part of these financial statements.

California Earthquake Authority
Statement of Revenues, Expenses and Changes in Net Assets
For the Year Ended December 31, 2002
(in thousands)

Underwriting income:	
Premiums written	$ 431,408
Less premiums ceded - reinsurance	(159,106)
Net premiums written	272,302
Change in unearned premiums	4,588
Change in unearned premiums ceded - reinsurance	1,629
Net unearned premiums	6,217
Net premiums earned	278,519
Expenses:	
Claims and claim expenses	7
Participating insurer commissions	43,653
Participating insurer operating costs	12,199
Reinsurance broker commissions	10,850
Pro forma premium taxes	9,824
Line of credit fees	4,315
Mitigation Fund expenses	269
Other underwriting expenses	8,413
Total expenses	89,530
Underwriting profit	188,989
Net investment income	25,773
Supplemental commission income, net	4,793
Other income	514
State of California premium tax contribution	9,824
Increase in net assets	229,893
Net assets, beginning of year as previously reported	1,186,817
Restatement (Note 1), unaudited	(75,684)
Net assets, beginning of year, as restated, unaudited	1,111,133
Net assets, end of year	$ 1,341,026

The accompanying notes are an integral part of these financial statements.

California Earthquake Authority
Statement of Cash Flows
For the Year Ended December 31, 2002
(in thousands)

Cash flows from operating activities:	
Cash received from premiums	$ 433,857
Cash payments for premiums ceded - reinsurance	(149,848)
Cash payments for operating expenses	(75,206)
Cash payments to employees for services	(2,471)
Net cash provided by operating activities	206,332
Cash flows from noncapital financing activities:	
Supplemental commission income, net	5,114
Other income	514
Net cash provided by noncapital financing activities	5,628
Cash flows from capital and related financing activities:	
Assessments received from participating insurers	3,035
Acquisition of equipment	(196)
Net cash provided by capital and related financing activities	2,839
Cash flows from investing activities:	
Proceeds from maturities of investments	2,703,060
Proceeds from sales of investments	170,037
Purchases of investments	(2,710,006)
Investment income	25,742
Net cash provided by investing activities	188,833
Net increase in cash and cash equivalents	403,632
Cash and cash equivalents, beginning of year	736,284
Cash and cash equivalents, end of year	$ 1,139,916

The accompanying notes are an integral part of these financial statements.

(in thousands)

Reconciliation of operating income (underwriting profit) to net cash provided by operating activities:	
Underwriting profit	$ 188,989
Adjustments to reconcile underwriting profit to net cash provided by operating activities:	
Depreciation	231
Pro forma premium tax expense	9,824
Changes in operating assets and liabilities:	
Premiums receivable	2,448
Unearned ceded premiums	7,275
Deferred policy acquisition costs	587
Other assets	2,509
Unearned premiums	(4,588)
Supplemental reinsurance premiums payable	354
Claim and claim expense reserves	(132)
Accounts payable and accrued expenses	(1,165)
Net cash provided by operating activities	$ 206,332

Noncash Investing, Capital and Financing Activities

The CEA carries investments that experience changes in fair value from year to year. Net unrealized appreciation in the fair value of investments, which is included as a component of net investment income in the Statement of Revenues, Expenses, and Changes in Net Assets, was $2,330 for 2002.

1. Reporting Entity and Summary of Significant Accounting Policies

Reporting entity

The California Earthquake Authority (CEA) is a privately financed, publicly managed authority that provides insurance coverage for earthquake damage to residential property owners, condominium owners, mobile homeowners, and renters in the state of California. The CEA also provides supplemental insurance coverage for earthquake damage.

In September 1996, legislation to create the CEA was approved by the California State Legislature. On November 26, 1996, the State of California Insurance Commissioner certified that all statutory conditions necessary for the CEA to become operational had been met, and the CEA began writing earthquake policies on December 1, 1996. The CEA is overseen by a three-member governing board consisting of the Governor, the Treasurer, and the Insurance Commissioner or their designees. The Speaker of the Assembly and the Chairperson of the Senate Rules Committee or their designees serve on the governing board as nonvoting members. The governing board is advised by an 11-member advisory panel, consisting of members of the public, consumer and insurance industry representatives.

CEA policies are sold to policyholders by participating insurance carriers of the CEA. Insurance companies admitted to write residential property insurance in California and who elected to become participating members of the CEA signed Insurer Participation Agreements with the Insurance Commissioner and the CEA. Under these agreements, participating insurers act as independent contractor agents on behalf of the CEA by performing policy and claims services which include underwriting, policy issuance, premium collection, and claims adjustment.

Under the agreements, the CEA reimburses participating insurers for nonclaims-related operating costs incurred by these companies in servicing CEA policies. The operating cost reimbursement is equal to 2.80% of premiums written for CEA policies. Additionally, participating insurers receive reimbursement for expenses associated with servicing CEA claims equal to 9% of the paid claim, as well as a producer commission equal to 10% of premiums written for CEA policies. As of December 31, 2002, there were 19 participating insurance carriers of the CEA.

Basis of accounting and restatement

While the CEA is an instrumentality of the state, the state of California's General Fund is not liable for CEA claims, losses, or other liabilities. However, the CEA meets the definition of a governmental organization, as defined by accounting principles generally accepted in the United States of America. For the year ended December 31, 2002, the CEA changed its basis of accounting to comply with governmental accounting standards. The financial statements previously identified as the balance sheet, and statements of income, of equity and comprehensive income and of cash flows are now referred to as the balance sheet and statements of revenues, expenses, and changes in net assets and of cash flows. The CEA has adopted the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – Management's Discussion and Analysis – for State and Local Governments* (GASB 34), as amended by GASB Statement No. 37, *Basic Financial Statements – Management's Discussion and Analysis – for State and Local Governments: Omnibus* and Statement No. 38, *Certain Financial Statement Note Disclosures*, effective required on January 1, 2002. The adoption of GASB 34 requires presentation of the CEA's Management Discussion and Analysis (MD&A) for each period presented. The MD&A is considered to be required supplementary information and precedes the financial statements.

(in thousands)

Additionally, the statement of cash flows has been prepared using the direct method, as required by GASB 34. The other provisions of GASB 34 did not significantly impact presentation of the CEA's financial statements, except for the presentation of net assets. GASB 34 requires the classification of net assets into three components – invested in capital assets, net of related debt; restricted; and unrestricted. Opening unaudited net assets have been restated to implement the provisions of GASB 34 and pronouncements promulgated by the Governmental Accounting Standards Board to report and account for the activities of the CEA. This restatement produced no net change of opening unaudited net assets but resulted in a recharacterization of opening unaudited net assets described below.

The unaudited net assets at January 1, 2002 have also been restated to correct an error. The error resulted from an overstatement of unearned ceded premium at January 1, 2002. The effect of the restatement is a $75,684 (unaudited) decrease in net assets at January 1, 2002.

The effect of the restatement and the recharacterization of net assets are as follows as of January 1, 2002:

Before GASB recharacterization:	**As restated, unaudited**
Contributed capital	$ 700,028
Additional paid-in capital	40,899
Mitigation fund	640
Retained earnings	369,456
Accumulated other comprehensive income	110
Total equity	$ 1,111,133
GASB recharacterization:	
Restricted	$ 640
Unrestricted	1,110,493
Net assets	$ 1,111,133

The CEA is accounted for as an enterprise fund and is financed and operated in a manner similar to that of a private business enterprise. The CEA uses the economic resources measurement focus and the accrual basis of accounting in accordance with accounting principles generally accepted in the United States of America. Under this method, revenues are recorded when earned and expenses are recorded at the time liabilities are incurred. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenue and expenses for the period, as well as the disclosure of contingent assets and liabilities. Actual results could differ from those estimates applied in the preparation of the accompanying financial statements.

In accordance with governmental accounting standards, the CEA applies all applicable statements issued by the Governmental Accounting Standards Board (GASB). The CEA applies all of the following pronouncements issued on or before November 30, 1989: Financial Accounting Standards

Board Statements and Interpretations, Accounting Principles Board Opinions and Accounting Research Bulletins, unless those pronouncements conflict with or contradict GASB pronouncements. In addition, the CEA has elected to apply statements and related interpretations issued by the Financial Accounting Standards Board after November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements.

Revenue recognition
Premiums are recognized as earned on a pro rata basis over the contract period. Unearned premiums represent amounts collected which relate to coverage in future periods.

Premiums paid or accrued by the CEA under reinsurance agreements, net of estimated return premiums, are accounted for as a reduction in the related premium revenue earned and are amortized over the remaining reinsurance contract period. Unearned ceded premium is the pro rata portion of premiums ceded applicable to the unexpired period of reinsurance coverage.

Cash and cash equivalents
For purposes of the statement of cash flows, the CEA considers investments in certificates of deposit, U.S. government money market accounts, banker's acceptances, repurchase agreements, and commercial paper with original maturities of three months or less, to be cash equivalents. In order to reduce counterparty exposure, the CEA generally maintains collateral of 105 % on repurchase agreements.

Investments
Investments consist primarily of U.S. Government and agency securities, commercial paper, repurchase agreements, corporate bonds, and bankers' acceptances, as authorized by the 1996 legislation creating the CEA. All investments are reported at fair value in the balance sheet. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, and is determined from published data provided by the exchanges, computerized pricing sources, the National Association of Securities Dealers' National Market System, securities custodians, and other authoritative sources. Investments made by the CEA during the year ended December 31, 2002, are of a similar nature as those held at December 31, 2002.

Deferred policy acquisition costs
Acquisition costs, consisting of participating insurer commissions and operating costs, are deferred and amortized ratably over the terms of the underlying policies. Deferred acquisition costs are limited to the estimated recoverable value of such costs. The determination of estimated recoverable value gives effect to the premium to be earned, losses and loss adjustment expenses incurred, investment income to be earned, and certain other costs expected to be incurred as the premium is earned.

Claims and claim expense reserves
Reserves for insurance claims and claim adjustment expenses include the accumulation of case estimates for claims reported, claims incurred but not reported, and estimates of expenses for investigating and adjusting all incurred claims. The reserve is established at a level that management estimates to be sufficient to satisfy those claims. Estimates are revised as more information becomes available. Since the CEA's inception, there has not been a major

earthquake. If a major earthquake were to occur, there would be a significant increase in the reserve for claims and claim adjustment expenses.

Participating insurer assessments
Each insurer that elected to participate in the CEA during its first year of operations was required to contribute as its share of the CEA's initial operating capital, an amount equal to $1,000,000 multiplied by the percentage representing that insurer's residential earthquake insurance market share as of January 1, 1994. Insurers that elect to participate in the CEA after December 1, 1996, are required to make an initial capital contribution calculated using their residential earthquake insurance market share as of January 1, 1994, or the latest date for which such market share information is available to the CEA, whichever contribution amount is greater. As of December 31, 2002, participating insurer capital contributions totaled $700,028, of which $65 was unfunded and is classified as other assets in the accompanying financial statements.

The California Insurance Code (Code) states that, subject to certain maximum limits as set forth in the Code, the CEA has the power to make additional assessments of participating insurance companies in the event of a major earthquake.

Net assets
The CEA classifies its net assets into two components, restricted and unrestricted net assets. Restricted net assets include the net assets of the Mitigation Fund described in Note 7. The remaining net assets of the CEA are classified as unrestricted.

Income taxes
In a private letter ruling dated November 8, 1996, the Internal Revenue Service determined the CEA to be an integral part of the state of California for federal income tax purposes. As such, the CEA is exempt from federal income tax.

State of California premium tax contributions
California Insurance Code section 10089.44 provides that "[n]otwithstanding any other provision of law, premiums collected by the authority shall be exempt from collection of the state's insurance premium tax, and the amount of tax foregone by the state shall be considered for all purposes a contribution by the state and its citizens to the capital and operating revenues of the authority." As a result, the amounts that the state would otherwise impose on the CEA as premium tax are collected by the CEA as premium and retained by the CEA as a contribution by the state; as premium is earned, the portion attributable to the premium-tax exemption is included in the CEA's net assets. State premium-tax-exemption contributions were $9,824 for the year ended December 31, 2002, and $50,723 for the period from the CEA's inception to December 31, 2002.

Supplemental commission income
The CEA cedes 100% of its risk under supplemental coverages written to reinsurers. The CEA earns a ceding commission on supplemental insurance coverages written. Of that commission, the CEA remits a portion to the agents generating the policy and 2.8% to the participating insurance company for operating expenditures. Unearned supplemental commission income represents the pro rata portion of commissions related to the remaining terms of supplemental coverages in force.

(in thousands)

2. Cash and Cash Equivalents

The CEA's cash is categorized to give an indication of the level of risk assumed by the entity at year-end. Category I includes cash that is insured or collateralized with securities held by CEA or by its agent in the CEA's name. Category II includes cash that is collateralized with securities held by the pledging financial institution's trust department or agent in the CEA's name. Category III includes cash that is uncollateralized. (This includes any bank balance that is collateralized with securities held by the pledging financial institution, or by its trust department or agent but not in the CEA's name.) The differences between bank balances and carrying value are due to deposits in transit and outstanding checks at December 31, 2002.

	Category I	Category II	Category III	Bank Balances	Carrying Value
Cash in banks	$ 241,226	$ -	$ -	$ 241,226	$ 240,797
U.S. Government money market funds	24,224	-	-	24,224	24,224
Total cash	$ 265,450	$ -	$ -	$ 265,450	265,021
Cash equivalents categorized as investments					874,895
Total cash and cash equivalents					$ 1,139,916

3. Investments and Fair Value of Financial Instruments

The CEA's investments are categorized below to give an indication of the level of credit risk at December 31, 2002. Category I includes investments that are insured or registered or for which the securities are held by the CEA or its agent in the CEA's name. Category II includes uninsured and unregistered investments for which the securities are held by the counterparty's trust department or agent in the CEA's name. Category III includes uncollateralized deposits (including deposits that are collateralized with securities held by the pledging institution, or by its trust department or agent, but not in the entity's name) and uninsured and unregistered investments for which the securities are held by counterparty or by its trust department or agent, but not in the CEA's name.

(in thousands)

	Category I	Category II	Category III	Total
U. S. Government and agency securities	$ 507,350	$ -	$ -	$ 507,350
Commercial paper	279,857	-	-	279,857
Corporate bonds	38,000	-	-	38,000
Banker's acceptances	37,972	-	-	37,972
Repurchase agreements	366,845	-	-	366,845
Total categorized investments	$ 1,230,024	$ -	$ -	$ 1,230,024

Reconciliation to statement of net assets:	
Investments	$ 355,129
Cash equivalent items included above	874,895
Total categorized investments	1,230,024
Cash items not included above	265,021
Total cash and investments	$ 1,495,045

Total investment income is comprised of interest, realized gains and losses, and unrealized gains and losses due to changes in the fair value of investments held at year-end.

Investment income for the year ended December 31, 2002, was as follows:

Certificates of deposit	$ 4,371
U.S. agency securities and government money market accounts	4,497
Repurchase agreements	5,884
Corporate bonds	2,676
U.S. Treasuries	1,244
Other short-term investments	6,002
Interest income	24,674
Plus change in fair value of investments	2,330
Less investment expenses	(1,231)
Net investment income	$ 25,773

(in thousands)

The change in fair value of investments for the year ended December 31, 2002, is calculated as follows:

Fair value of investments at the end of year	$ 355,129
Add: Proceeds of investments sold	170,037
Add: Proceeds of investments matured	2,703,060
Add: Amortization of discounts	854
Less: Cost of investments purchased	(2,710,006)
Less: fair value of investments at the beginning of year	(516,744)
Change in fair value of investments	$ 2,330

The recorded value of other receivables and payables which are financial instruments approximates fair value due to the short-term nature of these assets and liabilities.

4. Letter of Credit

At December 31, 2002, the CEA had available up to $456,000 of loans and/or letters of credit through a committed catastrophe contract entered into with a consortium of insurance and reinsurance companies. The total amount of expense associated with the committed catastrophe contract and credit agreement, including arrangement, commitment, and administrative fees, was $4,315 during the year ended December 31, 2002. There were no amounts outstanding under these arrangements as of December 31, 2002. The letter of credit arrangement expired December 31, 2003 and was not renewed.

5. Reinsurance

The CEA cedes insurance to reinsurers under catastrophe excess of loss reinsurance contracts and a supplemental coverages reinsurance contract, for purposes of limiting its maximum exposure. All contracts provide coverage for losses as well as allocated loss adjustment expenses. Although the ceding of insurance does not discharge the CEA from its primary responsibility to its policyholders, the insurance company that assumes the coverage assumes responsibility to reimburse the CEA for the related liability. Management believes that its reinsurers are and will continue to be able to satisfy their obligations under the reinsurance agreements. To date, no losses have been ceded under these contracts.

The CEA's aggregate excess reinsurance contracts in effect for 2002 expired on December 31, 2002. The 2002 aggregate excess reinsurance contracts allowed for an adjustment of premium, based on the average aggregate insurance in force and the exposure adjustment limit, as defined in the contracts. As of December 31, 2002, in accordance with these terms, the CEA had no premium adjustment due to or from reinsurers.

In 2003 and 2004, the CEA continued to cede insurance to reinsurers under catastrophe excess-of-loss reinsurance contracts. Effective January 1, 2005, the CEA is also entering into contracts to continue to cede insurance to reinsurers under catastrophe excess-of-loss reinsurance contracts, of which one will be collateralized, extending through December 31, 2005. For 2003, 2004, and 2005, the reinsurance contracts provide maximum coverages of $1.538 billion, $1.5 billion, and $1.5 billion, respectively, at varying attachment points.

The CEA also entered into a supplemental coverages quota share reinsurance contract effective July 1, 1999 through June 30, 2004, which was extended through June 30, 2006. Under the terms of this contract, the CEA cedes 100% of its gross liability under supplemental insurance policies to the reinsurer, in return for ceding 100% of premiums written on this business. The extended contract has a limit of liability for the reinsurers of $350 million. The CEA commission was 20% under the expired contract and is 16% under the extended contract. Effective January 1, 2005, the quota share contract was modified to increase the limit of liability to $450 million, increase the CEA commission to 17.5%, and extend the contract for an additional six months through December 31, 2006.

6. Statutory Compliance

The State of California Insurance Code limits CEA's "operating expenses" to 3% of its "premium income." In calculating this limitation, the CEA has determined that its premium income is its reported premiums written and that its operating expenses do not include certain start-up expenses and certain credits and payments, including payments to reinsurers, payments to investment managers and advisors, payments to participating insurers, or payments of agent commissions. Operating expenses, as determined by the CEA, for the year ended December 31, 2002, totaled $8,413, and did not exceed 3% of premiums written.

7. Mitigation Fund

California Insurance Code Section 10089.37 creates the Earthquake Loss Mitigation Fund (Mitigation Fund) as a "subaccount of the CEA". By statute, the Mitigation Fund must be used solely for the establishment and operation of the mitigation program. The transfer and setting aside of those monies into the Mitigation Fund subaccount have been formally approved by the CEA governing board. It is the opinion of the general counsel of the CEA and of the CEA's outside counsel that the monies that are resident in the Mitigation Fund subaccount within the CEA are by statute not available to pay policyholder or other claims against the CEA.

As of December 31, 2002, the balance sheet of the CEA includes restricted net assets related to the Mitigation Fund totaling $2,881.

SUPPLEMENTARY INFORMATION

California Earthquake Authority
Schedule of Participating Insurer Assessments
December 31, 2002
(dollars in thousands)

	Assessments	Assessment Receivable
Allstate Insurance Company	$ 145,613	$ -
Farmers Insurance Company	143,280	-
State Farm Insurance Company	249,188	-
United Services Automobile Association	58,992	-
Liberty Mutual Insurance Company	6,813	-
California Fair Plan	15,030	-
California State Automobile Association	39,013	-
GuideOne (formerly Preferred Risk)	123	-
Automobile Insurance Exchange of Southern California	14,444	-
Armed Forces	784	-
CNA/Continental	13,925	-
Prudential Insurance Company	11,531	-
Mercury Insurance Company	1,292	65
Total	$ 700,028	$ 65

California Earthquake Authority
Schedule of Participating Insurer Premium Written and Unearned
December 31, 2002
(dollars in thousands)

	Premiums Written	Unearned Premiums
Allstate Insurance Company	$ 95,378	$ 48,430
Farmers Insurance Company	60,087	29,318
State Farm Insurance Company	162,520	79,131
United Services Automobile Association	55,069	27,186
Liberty Mutual Insurance Company	5,980	2,990
California Fair Plan	7,168	3,700
California State Automobile Association	12,919	6,157
GuideOne (formerly Preferred Risk)	8	1
Automobile Insurance Exchange of Southern California	22,180	10,630
Armed Forces	649	318
Prudential Insurance Company	4,338	2,215
Mercury Insurance Company	4,760	2,208
Merastar (affiliated with Prudential Insurance Company)	56	32
Golden Eagle (affiliated with Liberty Mutual Insurance Company)	51	10
Homesite Insurance	220	99
Workmen's Auto Insurance	14	8
Pacific National Insurance	11	2
Total	$ 431,408	$ 212,435

California Earthquake Authority
Schedule of Participating Insurer Commissions and Operating Costs
For the year ended December 31, 2002

	Commissions	Operating Costs
Allstate Insurance Company	$ 9,734	$ 2,722
Farmers Insurance Company	6,150	1,719
State Farm Insurance Company	16,424	4,585
United Services Automobile Association	5,503	1,540
Liberty Mutual Insurance Company	587	164
California Fair Plan	727	203
California State Automobile Association	1,258	352
GuideOne (formerly Preferred Risk)	2	1
Automobile Insurance Exchange of Southern California	2,263	633
Armed Forces	66	18
Prudential Insurance Company	448	125
Mercury Insurance Company	426	119
Merastar (affiliated with Prudential Insurance Company)	4	1
Golden Eagle (affiliated with Liberty Mutual Insurance Company)	42	12
Homesite Insurance	16	5
Workmen's Auto Insurance	1	-
Pacific National Insurance	2	-
Total	$ 43,653	$ 12,199