Application No: A.16-09-XXX
Exhibit No.:
Witness: K. Carbon

| | |
|---|---|
| Application of Southern California Gas Company (U 904 G) and San Diego Gas & Electric Company (U 902 G) to Recover Costs Recorded in the Pipeline Safety and Reliability Memorandum Accounts, the Safety Enhancement Expense Balancing Accounts, and the Safety Enhancement Capital Cost Balancing Accounts | Application 16-09-XXX |

**CHAPTER X**

**DIRECT TESTIMONY OF**

**KATHERINE CARBON**

**ON BEHALF OF**

**SOUTHERN CALIFORNIA GAS COMPANY**

**AND**

**SAN DIEGO GAS & ELECTRIC COMPANY**

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

September 2, 2016

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# I. PURPOSE AND OVERVIEW OF TESTIMONY

The purpose of my direct testimony on behalf of Southern California Gas Company (SoCalGas) and San Diego Gas & Electric Company (SDG&E) (collectively, the "Utilities") is to explain the prudence of our Owner Controlled Insurance Program (OCIP) procurement and reasonableness of OCIP costs which over the course of PSEP's Phase 1A will cost between approximately $11.5 million and $12.5 million. In this application, however, SoCalGas and SDG&E are requesting recovery of PSEP-specific insurance overheads of $1.9 million and $0.24 million respectively through the PSEP insurance overhead (*see* Chapter IX (Huleis)).[1] In Chapter IX, the portion of insurance overheads allocated to the projects presented for review and recovery in this application is included.

## A. Insurance Background

OCIPs are commonly used in large-scale infrastructure, construction and energy-related projects domestically and abroad because an OCIP provides significant benefits to involved stakeholders. In 2012, SoCalGas and SDG&E evaluated whether to procure an OCIP for PSEP. In 2012 and 2013, premiums for operational casualty insurance increased and available capacity for energy casualty insurance shrank; largely due to the San Bruno event and increasing loss frequency and severity in energy industry claims. In fact, due to the limited capacity, the Utilities saw its operational insurance coverage limits decline from the previous year and pricing increased. The primary carrier for SDG&E and SoCalGas' operational coverage, AEGIS, a member-owned mutual requested a 10% increase in excess liability premiums in 2012 (see attached 2013 Annual Report at 4-5 (emphasis added)). These facts led us to the insurance

[1] In addition to the OCIP discussed here, the insurance overhead request also includes costs associated with the placement of Professional Liability insurance. This smaller placement is addressed in greater detail in Chapter II (Phillips).

market for construction projects, where OCIPs are purchased; which was more favorable both in terms of availability of limits and pricing.

The PSEP OCIP specifically is an owner purchased and owner controlled master insurance, safety and claims management program that provides specific coverages for SoCalGas and SDG&E and their enrolled contractors, while they are performing work at the project site within the scope of PSEP. Traditionally, operational casualty insurance coverages are procured by each individual contractor working within the scope of PSEP and expensed to SoCalGas and SDG&E through its contract price. Contractors enrolled in the OCIP, however, do not include these insurance coverages in its contract price. Instead, the OCIP structure provides all stakeholders with insurance coverage, safety, and cost benefits.

**B. OCIP Costs Are Favorable for Customers**

SoCalGas and SDG&E opted to implement an OCIP in 2013 for a variety of reasons, but primarily to optimize competition for PSEP related construction efforts, enhance supplier diversity, and promote the competitiveness of costs for PSEP. Additionally, it was important to mitigate the negative impact of the insurance markets at the time on the suppliers and customers. The OCIP provided several important elements to enhance customer benefit from the PSEP program:

- Consistent and dedicated limits for the entire project of $300MM in Commercial General Liability coverage, with a $165MM sublimit for wildfire losses.
- Comprehensive enrollment and insurance validation process of covered work.
- Ten (10) year tail coverage per project, providing additional protections after each project within the PSEP program is complete.
- Reduced administrative burden to track compliance items of concern.

It's also important to note that the Utilities' operational casualty program accounted for PSEP OCIP underlying limits when evaluating our operational non-PSEP program, and, as a result, our operational non-PSEP program costs have seen slight reductions since the underlying PSEP OCIP limits were in place.

Finally, OCIP was procured so as to promote value for customers through competitive sourcing efforts. Specifically, Request for Proposals (RFP) were requested from several insurance brokers to cover PSEP activities, and the broker providing best value for customers was selected, that both lowered total cost of ownership, and maximized our access to global insurance markets. The broker marketed the program to global markets, and selected a panel of carriers that maximized coverage protections and minimized total cost. Additionally, this broker committed to (and has followed through on) commitments for subcontracting and supplier diversity.

### C. OCIP Costs Enhance Competition, Streamline Services, and Enhance Supplier Diversity

Optimizing competition and costs were a critical goal for PSEP. Very few contractors had the scale and breadth to compete for both the volume and size of the projects, if they each individually had to bring in their own elevated insurance limits (i.e. the higher level risk work). As such, placing an OCIP was favorable to attract a higher number of suppliers to compete on PSEP projects, which increased competition beyond the top handful of larger construction and services-based contractors.

Additionally, supplier diversity was maximized as a result of an OCIP. Smaller, diverse suppliers may not have been able to compete for this work absent an OCIP structure, or would've had to procure additional limits to be on the program, which if accessible, would likely have been cost prohibitive. The following table is indicative of the success that the OCIP structure brought to our supplier diversity results. In each 2013, 2014 and 2015; supplier diversity on the PSEP program was at least on par, and in most cases maximized – compared to overall enterprise-wide spend. This is true for each utility respectively, and combined. The OCIP promoted the ability of our supplier base to compete for PSEP work on a level playing field.

| Year | SoCalGas DBE Results (Includes PSEP) | SDGE DBE Results (Overall results, includes PSEP) | Combined PSEP-Only Spend Results | SoCalGas PSEP-Only Spend Results | SDGE PSEP-Only Spend Results |
|---|---|---|---|---|---|
| 2013 | 45.38% | 44.88% | 47.64% | 46.46% | 85.15% |
| 2014 | 48.42% | 44.40% | 66.70% | 67.94% | 60.69% |
| 2015 | 44.66% | 42.74% | 46.81% | 47.66% | 42.79% |

The OCIP insurance consultant and broker also provided critical ancillary services to the program, including claims administration and support, payroll reporting, policy and certificate issuance, program evaluation, and contract review and support. This level of support reduces downtime and project management distractions for items like certificate validation and other administrative tasks.

## II. CONCLUSION

SoCalGas and SDG&E's implementation of the OCIP was reasonable and prudent and provides value to customers and other stakeholders by streamlining services and promoting competition, diversity, and reasonable costs.

This concludes my prepared direct testimony.

## III. WITNESS QUALIFICATIONS

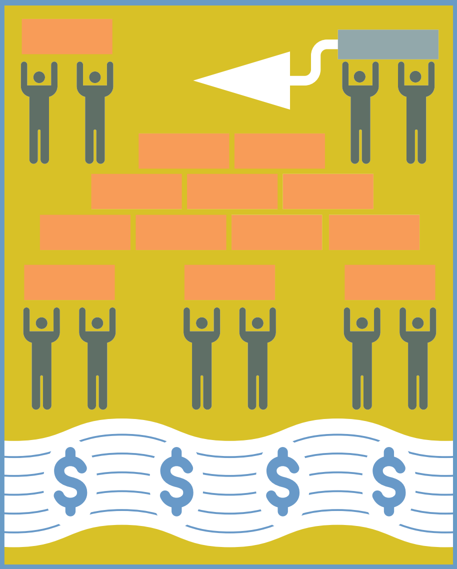
My name is Katherine Carbon, and I am the Director of Insurance & Risk Advisory for Sempra Energy. My business address is 488 8th Avenue HQ06N1, San Diego, CA 92101.

I have previously testified before the Commission.

# ATTACHMENT

## AEGIS 2013 ANNUAL REPORT

Real



group

effort.

AEGIS 2013 ANNUAL REPORT

# Five-Year Financial Highlights

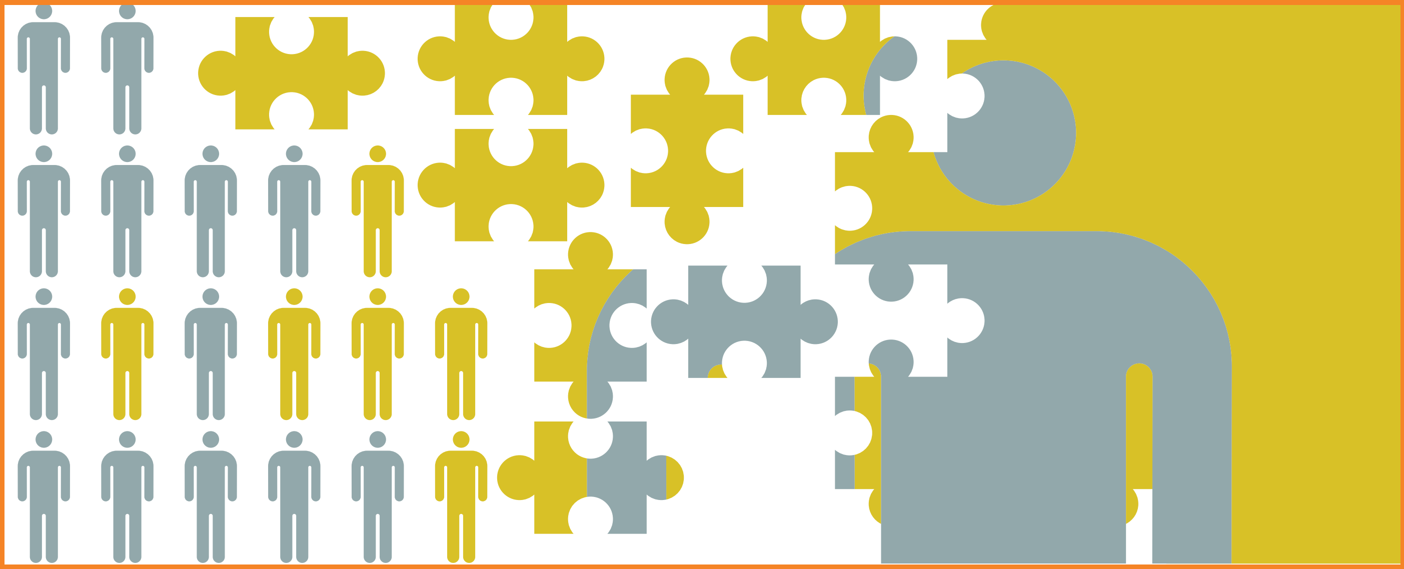
*Associated Electric & Gas Insurance Services Limited*

**FOR THE YEARS ENDED DECEMBER 31,**

| (Expressed in thousands of U.S. dollars) | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|
| **REVENUE:** | | | | | |
| Gross premiums written | $ 1,114,219 | $ 1,015,905 | $ 1,140,260 | $ 1,244,704 | $ 1,280,125 |
| Net premiums written | 767,618 | 787,127 | 827,915 | 763,257 | 878,492 |
| Net premiums earned | 847,603 | 806,632 | 810,437 | 802,689 | 805,473 |
| Net investment income | 187,780 | 144,171 | 104,797 | 146,472 | 111,064 |
| Change in fair value of insurance and reinsurance contracts | 53,757 | (7,280) | (38,110) | (17,291) | 38,420 |
| *Total revenue* | 1,089,140 | 943,523 | 877,124 | 931,870 | 954,957 |
| **EXPENSES:** | | | | | |
| Losses and loss expenses incurred | 746,324 | 559,558 | 583,139 | 628,139 | 572,215 |
| Commission expense | 110,631 | 103,339 | 116,675 | 113,382 | 97,773 |
| Other underwriting expenses | 89,801 | 100,891 | 116,161 | 127,436 | 114,812 |
| *Total expenses* | 946,756 | 763,788 | 815,975 | 868,957 | 784,800 |
| *Income before continuity and other premium credits and income taxes* | 142,384 | 179,735 | 61,149 | 62,913 | 170,157 |
| Continuity and other premium credits | 48,561 | 20,208 | 18,982 | 34,163 | 35,544 |
| *Income before income taxes* | 93,823 | 159,527 | 42,167 | 28,750 | 134,613 |
| Income tax provision (benefit) | 14,449 | 14,112 | (4,894) | 9,155 | 44,981 |
| *Net income* | 79,374 | 145,415 | 47,061 | 19,595 | 89,632 |
| Other comprehensive income (loss), net of income tax expense (benefit) | 24,741 | (6,469) | 1,846 | 30,654 | (33,639) |
| Total surplus, beginning of year | 757,973 | 862,088 | 1,001,034 | 1,049,941 | 1,100,190 |
| *Total surplus, end of year* | $ 862,088 | $ 1,001,034 | $ 1,049,941 | $ 1,100,190 | $ 1,156,183 |
| Total assets | $ 5,029,223 | $ 5,201,074 | $ 5,290,224 | $ 5,599,079 | $ 5,757,767 |
| Reserve for losses and loss expenses | 2,949,656 | 3,012,685 | 2,904,281 | 2,993,698 | 3,104,771 |

*See notes to the consolidated financial statements.*

Together



THE MISSION OF AEGIS IS TO ASSURE UTILITY AND RELATED ENERGY INDUSTRY MEMBERS CONSISTENTLY SUPERIOR INSURANCE AND RISK MANAGEMENT PRODUCTS AND SERVICES THROUGH A SECURE AND STABLE MARKET ENABLING MEMBERS TO ACHIEVE THE LOWEST OVERALL LONG-TERM COST OF RISK.

we

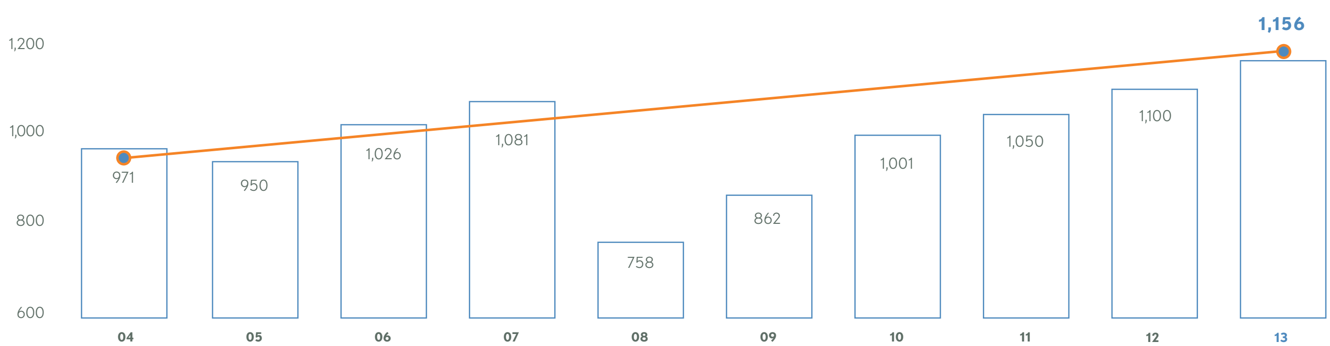
succeed.

## Letter to our Membership

Our continued success in working together produced another fine year for the company in 2013. Our bottom-line measure of financial success is policyholder surplus growth, and we grew surplus by $56 million, to $1.156 billion, a new high for AEGIS. Since the 2008 financial crisis, we have grown surplus by close to $400 million, thanks to strong support from our members and brokers at renewals and a contribution of $210 million from the efforts of our AEGIS London operations.

Your support of premium adjustments this year was particularly important in our excess liability business, where it was most needed. As a result, our overall combined ratio, including the effect of our successful London operations, was 97%, which was an 11% improvement over the prior year. This included an 8% improvement from the favorable adjustment of prior years' loss estimates in our excess liability, London and D&O lines. We produced a very favorable 85% combined ratio in our London operations, which was 7% better than last year. The combined ratio for our U.S. and Canada operations was 111%, which was a substantial improvement over the 128% combined ratio these operations generated in 2012.

**TOTAL SURPLUS**
DECEMBER 31 (MILLIONS OF U.S. DOLLARS)



ALAN J. MAGUIRE
PRESIDENT AND CEO

WESLEY W. VON SCHACK
CHAIRMAN OF THE BOARD

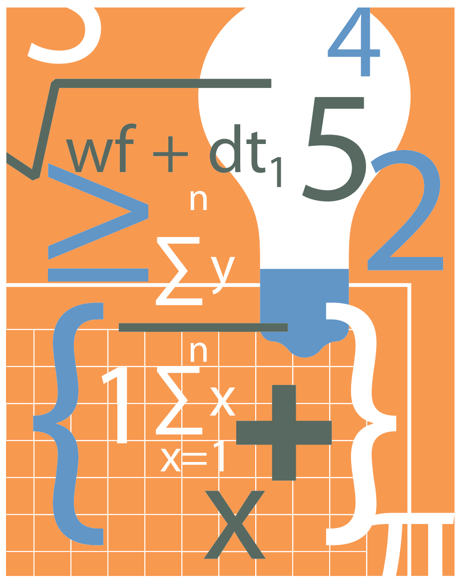
# Letter (CONTINUED)

**UNDERWRITING WITH SUSTAINABILITY IN MIND**

Our underwriters worked closely with members and brokers throughout the year to improve the balance between claims paid and premiums collected, especially for our excess liability and property coverages.

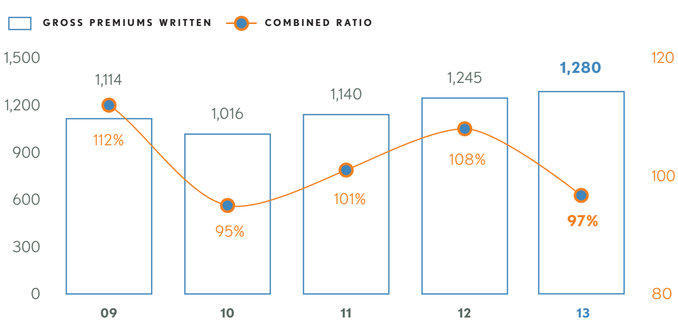
Our members know and appreciate that getting the balance right between premiums and losses, especially at a time when we can't rely heavily on investment income, is essential to everyone's long-term success. They understand our direct and transparent approach to writing each individual risk, and they know this is ultimately why we can continue to offer the same broad coverage, year after year. This is the essence of the mutual model.

Our members know and appreciate that getting the balance right between premiums and losses, especially at a time when we can't rely heavily on investment income, is essential to everyone's long-term success.



**GROSS PREMIUMS WRITTEN AND COMBINED RATIO**

FOR THE YEARS ENDED DECEMBER 31 (MILLIONS OF U.S. DOLLARS)



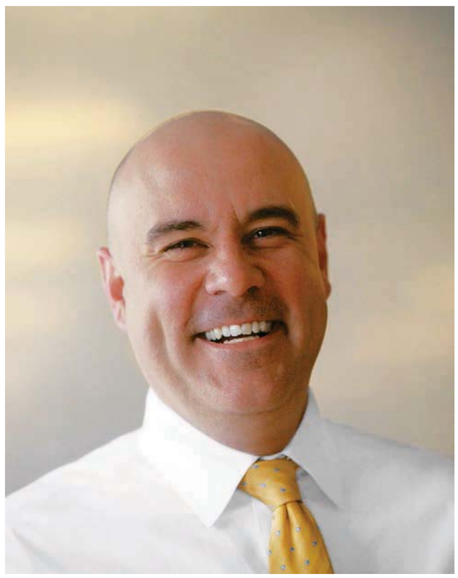

The stability of AEGIS coverages, when coupled with our willingness to pay claims fairly and our loss control expertise, differentiates us from the commercial market, and this translates into an uncommon level of loyalty and satisfaction among AEGIS members. In 2013, excluding the effects of merger activity in the energy industry, almost every core member company renewed its coverage with us.

Thanks to the loyalty of our members, premium revenues generated by our New Jersey-based operations, when combined with premium revenues from AEGIS London, totaled $1.280 billion, which is the highest level in the history of your mutual.

**EXCESS LIABILITY BUSINESS BEGINS TO IMPROVE**

The improvement in our excess liability business was directly attributable to member and broker support for the 10% rate increases we requested for this important line of business. Thanks to universal support, after years of stubbornly high loss ratios, our excess liability line of business finally began to show improvement in 2013. As a result of the 2013 premium adjustments and relatively better loss experience, the combined ratio for the year was 113% – down 56% from 169% in 2012. Without the effect of positive prior year loss reserve runoff, the combined ratio was 116%. While the 2013 underwriting results were a significant step toward sustainability, we still need to bring this flagship line of business closer to the break-even point. We sincerely thank you for working with us to achieve these improved results.

The AEGIS excess liability policy continued to form the foundation for the liability program for most member companies in 2013 because the broad $35 million coverage and the value of our collaborative claims handling are unmatched in the commercial market. Premium revenues totaled $418 million for the year, which was 8% greater than 2012.



The revenue level we achieved reflected the willingness of members to pay premiums that are more commensurate with the loss experience of their company and their industry, as well as the six new construction-related policies we wrote during the year.

### DIRECTORS & OFFICERS MARKET REMAINS COMPETITIVE — FOR NOW

The market for D&O coverage has remained very competitive since the Enron crisis, and opportunistic commercial carriers have aggressively pursued regulated utilities, which offer an appealing risk profile. Our members have remained loyal, however, and they continue to count on our broad $35 million coverage, our willingness to pay the industry's D&O claims and our unwavering commitment to the energy sector in times of crisis.

Our D&O combined ratio was 29% and included 57% of favorable prior year loss reserve runoff. For the current underwriting year, the combined ratio was 86%, without prior year loss runoff. Premium revenues for D&O were $75 million in 2013, which was about 1% lower than 2012. We lost two accounts to merger activity; however, we did write 30 new policies in 2013, including 11 for Side A coverage, which we offer through

*There's a reason our excess liability clients build their programs on the AEGIS foundation. With AEGIS in the first layer, our clients have the security and peace of mind that comes with having AEGIS's industry-leading terms and conditions as the basis of their program. Year over year, AEGIS stands shoulder to shoulder with members to develop and implement effective risk management solutions. Our clients view this as true market leadership.*

Sean Faulkner

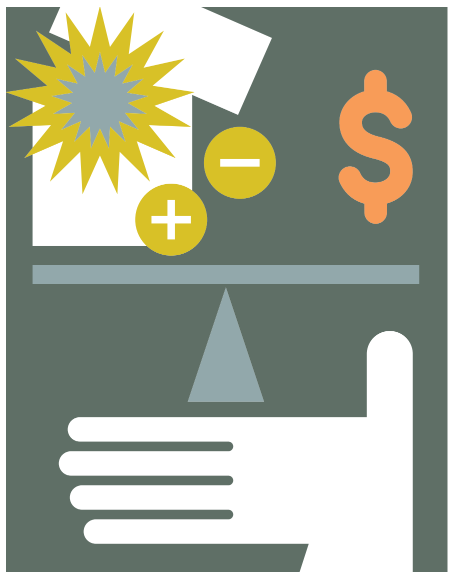
VICE PRESIDENT
MARSH, NEW YORK

# Letter (CONTINUED)

our alliance with Endurance Risk Solutions–U.S. Looking ahead, some market watchers expect D&O litigation to heat up in 2014 as a result of merger activity, continuing environmental issues and cyber attacks, which may trigger significant losses.

### PROPERTY COVERAGE RESPONDS TO SIGNIFICANT LOSSES

Our property line of business in the U.S. and Canada produced a combined ratio of 230% in 2013. Of this, 69% was due to the further development of Superstorm Sandy losses. An additional 58% resulted from two of the largest losses in the history of the mutual. Fortunately, our reinsurance program contained these losses to manageable levels. In 2014, we look forward to a more normal level of property losses, as well as improved results from insuring the construction of more pipelines and combustion turbine generating plants.

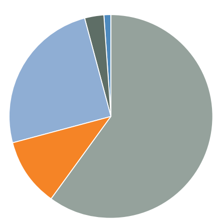


Property premiums totaled $181 million, which was about 6% greater than 2012. While construction activity was down in general versus a year ago, we were pleased to write a total of 42 new policies for member companies in the U.S. and Canada – 14 for construction risk and 28 for operational risk.

More than 150 AEGIS members turned to our New Jersey property underwriters during 2013 to provide coverage for their operational and construction risks. Each of them appreciated our consistent $200 million capacity, and more than a third took advantage of the property engineering services available through AEGIS Loss Control to help improve the safety and reliability of their systems.

In 2013, we partnered with GCube to offer a deductible buydown property program for AEGIS members that own or operate wind and solar facilities. The program covers the gap between

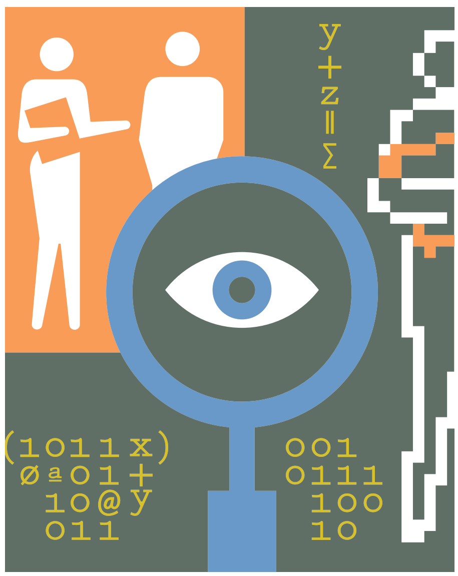
**AEGIS U.S. PROPERTY PREMIUM BY OPERATION TYPE**
DECEMBER 31, 2013 (MILLIONS OF U.S. DOLLARS)



the AEGIS corporate policy and the desired lower deductible, with deductibles as low as $100,000 for property damage and 30 days for business interruption, as well as lower deductibles for small-scale projects such as solar facilities with a capacity below ten megawatts.

### NEW CYBER COVERAGE AND SERVICES DEVELOPED WITH MEMBER INPUT

In the area of cyber liability, we are doing what your mutual has always been designed to do – we seek out areas that are not well served by the commercial market and determine what we can do, with your help, to provide a solution that better suits your specific needs. Working with the Risk Management Advisory Committee's cyber task force and our AEGIS London cyber underwriting team, we introduced our first package of cyber coverage and services in 2013. This initial policy provides a $15 million limit in combination with a range of loss control services that assist members with data loss, privacy breach response and reputation management. To date, ten AEGIS members have purchased this package of coverage and services.




As the scope and nature of cyber terrorism continues to evolve, the need to protect the operational technology (OT) environments that control assets and infrastructure has become just as critical for many companies as the need to protect information technology (IT) environments. In early 2014, working again with our member advisory committees and cyber underwriters at AEGIS London, we introduced our new *CyberResilience* policy – a unique approach that covers exposures related to both IT and OT. The policy offers first- and third-party coverage for cyber attacks against OT and critical infrastructure – in addition to data protection and privacy insurance – the first to do so in a standard product. Given the convergence of IT and OT environments, increased cyber terrorism activity and the interdependence of operational assets within the energy industry, there is a clear

In the area of cyber liability, we are doing what your mutual has always been designed to do – we seek out areas that are not well served by the commercial market and determine what we can do, with your help, to provide a solution that better suits your specific needs.

## Letter (CONTINUED)

need to develop tailored cyber insurance for our members to help protect their unique exposures. Our new product therefore combines coverage with a service-based offering that includes cyber underwriting assessment, risk management consultancy, loss control, threat analysis, incident response and vulnerability management, which we offer in conjunction with global experts in the critical infrastructure industry.

At the same time, we jointly published a white paper – *Cybersecurity Report for the Energy and Utility Industry* – in conjunction with BAE Systems, a world-renowned cybersecurity consultant. The BAE Systems team interviewed a number of member companies in the U.S. and Canada to assess the development and implementation of security measures that protect OT environments. The white paper provides observations from the member

company interviews along with insights from BAE's extensive field research efforts related to cybersecurity risks, best practices for identifying and managing these risks, as well as trends of particular interest to those responsible for protecting OT environments in the energy and utility industry. Paper copies are available by request at *inquiry@aegislimited.com*, or you may download the PDF from the password-protected section of our new website at *aegislink.com*.

### LIBERTY MUTUAL ALLIANCE ATTRACTS MORE MEMBERS

More than 90 AEGIS members took advantage of our alliance with Liberty Mutual in 2013, and this generated total alliance premium revenues to AEGIS of $34 million, which was 62% higher than 2012. We assumed a 17.5% share of this alliance business in 2013.

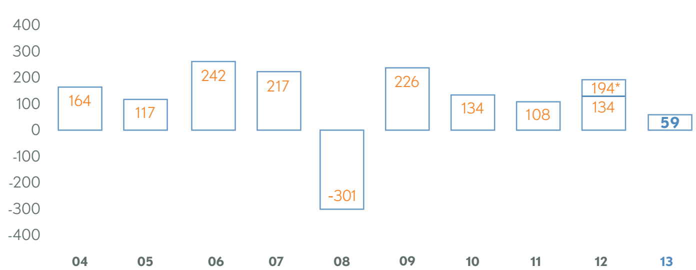
Our new *CyberResilience* policy covers cyber attacks against operational technology and critical infrastructure – in addition to data protection and privacy insurance – the first to do so in a standard product. It combines coverage with cyber underwriting assessment, risk management consultancy, loss control, threat analysis, incident response and vulnerability management services.

Our core utility members and small to midsize E&P companies typically rely on our Liberty Mutual alliance for primary auto, workers' compensation and general liability coverage. The utilities use the coverage for their unregulated subsidiaries, their standard programs where admitted paper is required, and workers' compensation coverage excess of AEGIS for nuclear operations. The E&P companies use the alliance for their primary coverage. AEGIS members also purchase railroad protective liability insurance from Liberty Mutual at more favorable rates than those offered by the commercial markets or the railroads themselves. AEGIS bears a portion of this risk via its reinsurance of Liberty Mutual.

AEGIS members continued to demonstrate strong loyalty to the Liberty Mutual alliance, much as they do to our excess liability, D&O and property programs. Almost 80% renewed their coverage in 2013, which is better than general commercial retention trends.

**TOTAL NET INVESTMENT RETURN**

FOR THE YEARS ENDED DECEMBER 31 (MILLIONS OF U.S. DOLLARS)




* $194 MILLION INCLUDES ONE-TIME $60 MILLION BENEFIT FROM RECLASSIFICATION OF HELD-TO-MATURITY SECURITIES

## INVESTMENT OPPORTUNITIES PUT PRESSURE ON UNDERWRITING RATIOS

In this ongoing low-interest-rate investment environment, improved underwriting ratios are essential to our continued financial success because we are unable to make up for significant premium shortfalls with the strong investment returns we were able to generate in the past. We have a conservative investment allocation of broadly 90% fixed-income and 10% equity and equity-like investments. This careful approach helps us protect surplus and safely generate measured surplus growth so that we continue to be well prepared to handle the volatile nature of the underwriting risks we assume for the membership.

In 2013, our net investment return was 1.6%. This was fueled by our equity return of 24.4%, which offset our fixed-income return of (0.2%). Low investment returns are part of what all insurers and reinsurers must grapple with these days. Given that our investment advisors are pointing to similar levels of investment opportunity in 2014 and 2015, we will continue to strive to make our underwriting more sustainable through rate increases where appropriate. As always, these increases will be on an account-by-account basis rather than any across-the-board increase. To assist you in your budgetary efforts, our underwriters are always available to discuss the specifics of your account.

**AEGIS LONDON PERFORMANCE BENEFITS EVERYONE**

Premium revenues for AEGIS London totaled $571 million in 2013, which was just $18 million below last year's all-time high for our London operations. These revenues helped contribute $50 million to member surplus in 2013, and since the 2008 financial crisis, AEGIS London has contributed $210 million toward rebuilding our surplus.

Like many syndicates at Lloyd's in 2013, AEGIS London enjoyed a year with relatively few catastrophic losses; in fact, the largest single new claim was only $3 million, net of reinsurance. This translated into a very favorable 85% combined ratio, which as noted earlier, helped greatly improve our overall combined ratio.

*AEGIS has two underwriting platforms that both exert market power and leadership. AEGIS in New Jersey has been solving the utility industry's toughest risk financing problems for 40 years. AEGIS London acquires new capabilities quickly, bringing products like* CyberResilience *to market in short order. And London's diversified book of less volatile business contributes to AEGIS's overall strength. Lastly, I know that when market conditions change I can depend on AEGIS London to help AEGIS members complete their Lloyd's placements as they have in more difficult markets.*

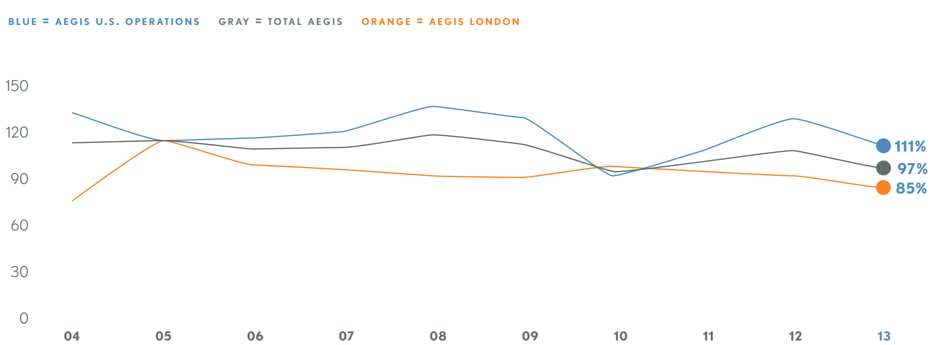
Prentice McIntosh

VICE PRESIDENT, ENERGY GROUP
STEPHENS INSURANCE, LITTLE ROCK

During a year when one-third of the 91 syndicates at Lloyd's lost money, AEGIS London ranked 18th in terms of gross written premium, 19th in profitability and 23rd in combined ratio.

**COMBINED RATIOS**

FOR THE YEARS ENDED DECEMBER 31




AEGIS London continues to be one of the best-performing syndicates at Lloyd's of London. During a year when one-third of the 91 syndicates at Lloyd's lost money, AEGIS London ranked 18th in terms of gross written premium, 19th in profitability and 23rd in combined ratio. The Syndicate's strong financial performance and risk management framework also continues to be recognized by external ratings agencies and regulators, including AM Best, which reaffirmed its "A (Excellent)" financial strength rating.

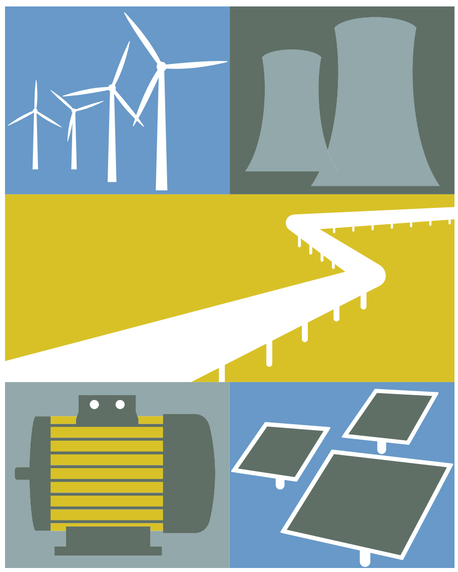
AEGIS London has grown dramatically since 1999, when our operations focused exclusively on helping AEGIS members with their Lloyd's placements. We quickly became a leader in the energy business at Lloyd's, and we have since diversified into and now write 20 classes of business in the London market, including our new cyber insurance offerings. This diversification has brought balance and stability to our London book and, more important, it helps balance our commitment to serve the more volatile energy sector of our core membership in North America.

Our Claims Division in New Jersey continued to be busy in 2013. We paid more than $636 million in claims to our members, an increase of $108 million over 2012.

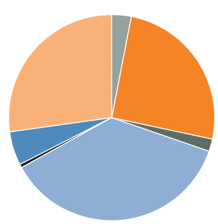
### MANAGING THE CLAIMS PROCESS IS A GROUP ACTIVITY

One of the best examples of a real group effort is our approach to managing the claims process. We like to say that we work with our members as partners – not adversaries – to manage claims together, and it's true. Our collaborative approach to claims has distinguished us from commercial insurers since the beginning, and it's one of the fundamental reasons AEGIS was created by its members. We succeed as a group by balancing our desire to pay each claim fairly with our responsibility to pay claims for all of the other members. This helps our members manage their losses while we continue to maintain the financial strength we need to provide stable and sustainable coverage over the long term.

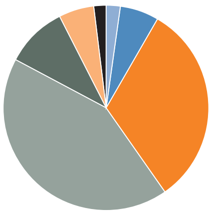
Our Claims Division in New Jersey continued to be busy in 2013. We paid more than $636 million in claims to our members, an increase of $108 million over 2012. Over the course of the year, our U.S. operations received 1,052 new property and casualty claim reports. While this number is about average, more noticeably, we established 305 initial reserves on both newly reported claims in 2013 and events occuring in prior years, for a total of $543 million. And for both excess liability and property, these new claims came from all segments of the business. More than 1,200 property and casualty claims were settled or closed in 2013, bringing the total number of claims that we managed together during the year to more than 3,200.



AEGIS U.S. EXCESS LIABILITY CLAIMS INCURRED BY TYPE
DECEMBER 31, 2013 (MILLIONS OF U.S. DOLLARS)



**AEGIS U.S. PROPERTY CLAIMS INCURRED BY TYPE**
DECEMBER 31, 2013 (MILLIONS OF U.S. DOLLARS)



ELECTRIC: 9.0
EXPLOSION: 24.9
FIRE: 125.6
FLOOD: 168.1
MECHANICAL BREAKDOWN: 39.0
WATER LEAKAGE: 22.2
OTHER: 6.7

A benefit of all this claims activity is that our claims professionals develop great experience and expertise they can share with you. And we have expanded the forums for this. For example, we recently held a wildfire claims symposium that received very favorable reviews from the attendees. We also continued to offer the AEGIS Claims Roundtable seminars in 2013, and they attracted 138 attendees from 59 member companies who gathered to learn more about managing mass tort litigation, litigation involving catastrophic injuries, and witness selection and preparation. Seminar attendees are eligible for Continuing Legal Education (CLE) credits, and beginning in 2014, we are offering the Roundtable seminars as webinars. We encourage you and your colleagues to take advantage of these educational opportunities because every claims dollar saved by any one of us benefits all of us.

*I've been working with AEGIS for many years now, but the way AEGIS seeks me out to learn more about what our industry needs in general, and what my own company needs in particular, still amazes me. We examine our losses very carefully at Southern, then we implement new infrastructure improvements and we revise our procedures to reflect the lessons we've learned. As a true specialist in our industry and our partner, AEGIS understands the measures we've taken, and the underwriting reflects the changes we've made. They really know what they're doing.*

Debbie Gaffney

MANAGER, RISK MANAGEMENT
SOUTHERN COMPANY, ATLANTA

## Letter (continued)

**LOSS CONTROL WORKS WITH MORE THAN 220 MEMBER COMPANIES**

Similarly, we have been expanding our loss control educational opportunities. For example, we recently held a seminar on call center operations that a number of members found very helpful. Call center operations have featured in some of our most notorious claims in recent years.

To further assist you in drawing attention to opportunities for improved loss control measures, we will soon publish a white paper – *Utility-Related Losses: What We've Learned and What You Should Know* – that explores the industry's loss history, and highlights the claims that have consumed the largest portions of the mutual's surplus over time. We felt it would be useful to write a comprehensive white paper that describes these findings in greater detail, as well as the loss control measures and other AEGIS services that can help minimize these kinds of losses in the future. We encourage you to circulate the white paper widely in your companies to help impress upon your colleagues the importance of state-of-the-art loss control policies and procedures. Going forward, we are planning to share more frequently what we are learning from our claims and loss control efforts.

In 2013, 221 member companies worked with AEGIS Loss Control to learn how to reduce the cost of risk – for their own companies and for the membership as a whole – while maintaining safe and reliable operating systems. Our work together also helped improve the quality of the information that supports the underwriting process, which helps us do a better job of matching risk with price, making for a more effective and equitable process across the membership.

In 2013, 221 member companies worked with AEGIS Loss Control to learn how to reduce the cost of risk – for their own companies and for the membership as a whole – while maintaining safe and reliable operating systems.

*Over the course of the year, we worked as a group to:*

- Complete 130 risk assessments at 103 member companies with natural gas, electric or water operations, and 555 property and machinery risk assessments at 59 member companies. Seventy-eight power plant surveys were performed at 27 member companies.
- Complete 30 Focused Services engagements for 25 member companies to address issues identified during risk assessments.
- Train 1,651 employees at 19 member companies with natural gas operations.
- Conduct seminars and workshops on a wide variety of topics:
  - A two-day electric utility machinery seminar that attracted 107 employees from 25 member companies and 11 broker firms.
  - A two-day fire protection training course for personnel from eight member companies and two broker firms.

– A two-day emergency preparedness and response seminar to address topics that affect electric and natural gas systems during and following wildfires, tornadoes, ice storms, earthquakes, floods and hurricanes. The seminar attracted 101 employees from 39 member companies and eight industry organizations.

– A one-day seminar on the topic of media relations at utility incident scenes.

– Four Investigating Electrical Incident Workshops and six Investigating Natural Gas Incident Workshops, training 300 attendees from 14 member companies.

• Broadcast four webinars on a variety of utility operations topics.

• Publish 20 new Review of Major Liability Losses claims summaries and loss control articles on the new AEGIS website.

*What other carrier do you know that hires engineering talent from our industry with so many years of hands-on utility and related energy experience? No one. AEGIS Loss Control performs two important functions in a way few carriers can. Their knowledge of our plants and equipment, policies, practices and procedures guides the underwriting process and ensures fairness across the entire membership. And that same intelligence gives us what we need to benchmark our own operations and control and prevent losses.*

Karl Zimmel

MANAGER, RISK MANAGEMENT SERVICES
UNS ENERGY CORPORATION, TUCSON

### SHARING INFORMATION MAKES US ALL SMARTER

One of the most unique and powerful characteristics of the mutual model is the way we share information. Members and brokers continuously tell us what's on their minds, what concerns them and what we can do to help. The regional member and broker meetings we conduct across the country are one of the most popular forums for these discussions. At these meetings, small groups of members and brokers meet with AEGIS senior management to discuss current insurance market conditions and emerging trends, which is a tremendous help to us in terms of fine-tuning our products and services.

In addition to the regional meetings, our members serve on a variety of underwriting, claims and loss control task forces and committees that foster the free exchange of information across the membership and throughout the ranks at AEGIS. The Risk Management Advisory Committee (RMAC) is the nucleus of these groups, and the RMAC task forces are currently focused on evolving utility industry risks, cyber risk and the updating of one of our most-requested publications – *What Every Director and Officer Should Know: Corporate Governance and Accountability for Public Utilities and Energy-Related Companies.*

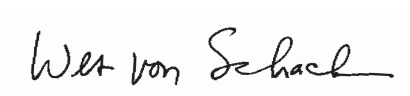
Together, we're able to stay on top of current topics and emerging trends, including cyber risk, electromagnetic pulses and solar storms, distributed energy, stray voltage, global climate change and alternating current corrosion. As a result, we're able to take a smarter approach to managing risk for the energy and utility industry. We encourage members and brokers to share information with us by participating in the numerous meetings and events we hold throughout the year, which are constantly updated on our new website at *aegislink.com,* or by simply picking up the phone or sending us an e-mail.

Letter (CONCLUSION)

## A very good year, thanks to a "real group effort."

In sum, 2013 was a very good year despite the difficult investment environment. We expect the investment return challenges to continue in 2014, but with ongoing member and broker support and our collaborative approach to managing the mutual, we hope to achieve solid, sustainable results again. This level of success is possible only because we work together, which has allowed AEGIS for nearly 40 years to provide stable, sustainable coverage and specialized services that can't be matched by any commercial insurance company.

More than 70 people representing 44 member companies serve on the AEGIS Board of Directors and our advisory committees and task forces, which are made up of risk managers, loss control engineers and claims professionals. They generously provide the expertise and guidance that are the foundation of our mutual model. Their contributions are essential in helping AEGIS management balance member needs with the prudent financial management of the company that is necessary for long-term sustainability. We are grateful for their valuable contributions, as well as the contributions of our capable staff in New Jersey and London, because "real group effort" is the reason we succeed.



**WESLEY W. VON SCHACK**
**CHAIRMAN OF THE BOARD**

**ALAN J. MAGUIRE**
**PRESIDENT AND CEO**

## Transitions

### Don Greene retired from the AEGIS Board of Directors and the AEGIS London Board of Directors, but he will remain in contact with the Company as part of his new role as Vice Chairman Emeritus.

Don has been involved with AEGIS since 1977, when at LeBoeuf Lamb he counseled the gas and electric industries on the formation of AEGIS. For his work as U.S. General Counsel for Lloyd's of London, he was invested as Honorary Commander of the Most Excellent Order of the British Empire by the British Ambassador, on behalf of Her Majesty and Her Majesty's Government, for his service to Lloyd's, the British insurance industry, and the community of international insurance and law. Don served on the Board of AXA, Equitable Life and Axis Capital Holdings, and upon his retirement from his legal practice in 2001, he served on the AEGIS Board, the Board's Executive Committee and the AEGIS London Board. Don has contributed tremendously to the success of AEGIS, and we will be forever grateful.

We are pleased to welcome Ron Litzinger to the AEGIS Board of Directors. Ron is the president of Southern California Edison, one of the nation's largest investor-owned electric utilities, where he has served in numerous capacities since he joined as an engineer in 1986. Prior to joining Edison, he was an engineer for Texaco subsidiaries. In addition to his responsibilities on the AEGIS Board, Ron will serve on the Board's Loss Control Committee. We welcome Ron to the Board and look forward to his contributions.

AEGIS VICE CHAIRMAN EMERITUS DONALD J. GREENE, CHAIRMAN EMERITUS DEWEY & LEBOEUF LLP

AEGIS BOARD MEMBER RONALD L. LITZINGER, PRESIDENT, SOUTHERN CALIFORNIA EDISON

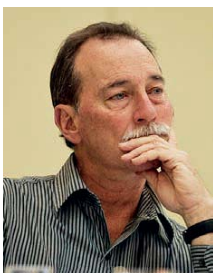
We would also like to thank two long-serving members of our Task Forces. Rich Babinecz stepped down after many years of service on the Claims Task Force upon his retirement from Consolidated Edison, where he was Associate General Counsel for 25 years. Sandy Hart retired from her role as Director – Risk, Environment and Land at NW Natural, as well as from the Loss Control Task Force, where she was a valued member for more than ten years. We are grateful for their many contributions and wish each of them a happy and fulfilling retirement.

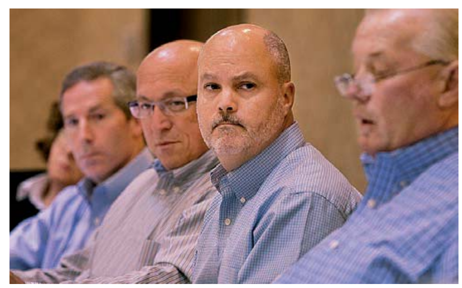
Deborah Edwards, Deputy General Counsel at Piedmont Natural Gas, and Judy Liu, Assistant General Counsel at CenterPoint, were appointed to the Claims Task Force. John Mellette, Manager – Corporate Insurance at SCANA, and Richard Stevens, Director – Corporate Risk Management at Avista, joined the Loss Control Task Force. We welcome these four new Task Force members and look forward to their contributions.

## Regional member and broker meetings

Our regional member and broker meetings are some of the best examples of a "real group effort." Small groups of about 30 or 40 members and brokers meet with Alan Maguire, our CEO, and senior members of our underwriting staff. We discuss current insurance market conditions, energy industry trends, emerging risks and whatever else is on the minds of our members. These open roundtable discussions help us tailor our existing products and services, develop new ones and assure members that they're getting exactly what they need from us. This personal level of communication and service distinguishes AEGIS from the commercial market, and it's the key to our ongoing success.

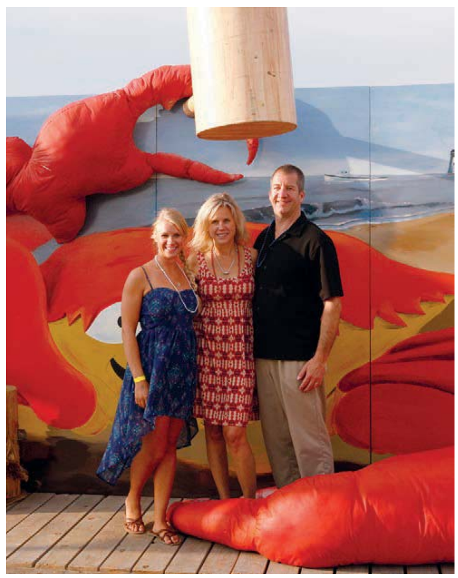


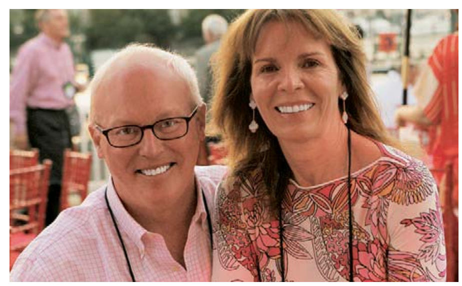




# Annual AEGIS Policyholders' Conference

Our Policyholders' Conference takes place in July each year, as it has since we first began hosting the conference in 1979. In those early days, about 100 members and brokers attended, and many of the conferences were held in Toronto. Today, the conference has grown to include more than 1,000 members, brokers and guests, who gather for four days to learn more about the insurance and energy industries, network with peers and enjoy the family-friendly hospitality. The 2013 AEGIS Policyholders' Conference was held in Baltimore, the 2014 PHC will be held in San Diego, and we plan to meet in Nashville in 2015 to mark the 40th anniversary of the mutual's formation.









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AEGIS

PHC13
AEGIS
AEGIS


# Leadership

Our mutual efforts are guided by these experienced executives and professionals drawn primarily from the member companies we serve. They generously contribute their time and expertise, and they are essential to our success.

## BOARD OF DIRECTORS

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CHAIRMAN
ASSOCIATED ELECTRIC & GAS INSURANCE SERVICES LIMITED

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PRESIDENT & CEO
AEGIS INSURANCE SERVICES, INC.

PHILIP C. ACKERMAN
CHAIRMAN, RETIRED
NATIONAL FUEL GAS COMPANY

KEITH E. BAILEY
CHAIRMAN, PRESIDENT & CEO, RETIRED
WILLIAMS

ROBERT W. BEST
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ATMOS ENERGY CORPORATION

THOS. E. CAPPS
CHAIRMAN, RETIRED
DOMINION RESOURCES, INC.

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EXECUTIVE DIRECTOR, RETIRED
HSBC HOLDINGS PLC

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NV ENERGY, INC.

WILLIAM H. GRIGG
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PRESIDENT & CEO
ASCENDANT GROUP LIMITED

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ASSOCIATED ELECTRIC COOPERATIVE, INC.

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HAWAIIAN ELECTRIC INDUSTRIES, INC.

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PRESIDENT
SOUTHERN CALIFORNIA EDISON

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VICE CHAIRMAN, RETIRED
PANENERGY (NOW SPECTRA ENERGY)

EUGENE R. MCGRATH
CHAIRMAN & CEO, RETIRED & DIRECTOR
CONSOLIDATED EDISON, INC.

CORBIN A. MCNEILL, JR.
CHAIRMAN, RETIRED
PORTLAND GENERAL ELECTRIC

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PAST PRESIDENT & CEO
BRITISH COLUMBIA TRANSMISSION CORPORATION

RICHARD G. REITEN
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NW NATURAL

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INTEGRYS ENERGY GROUP, INC.

WILLIAM B. TIMMERMAN
CHAIRMAN & CEO, RETIRED
SCANA CORPORATION

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DONALD J. GREENE
CHAIRMAN EMERITUS
DEWEY & LEBOEUF LLP

### DIRECTORS EMERITUS

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CHAIRMAN, RETIRED
PUGET SOUND ENERGY, INC.

DON D. JORDAN
CHAIRMAN & CEO, RETIRED
RELIANT ENERGY

## OFFICERS

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CHAIRMAN OF THE BOARD

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PRESIDENT & CEO

WILLIAM H. GRIGG
VICE CHAIRMAN & VICE PRESIDENT

JOHN J. DENMAN, JR.
TREASURER

WILLIAM P. CULLEN
ASSISTANT VICE PRESIDENT

GILBERT GOULD
ASSISTANT VICE PRESIDENT

MICHAEL S. JOHNSON
CONTROLLER

SIMON DAY
ACTUARY

RIP REEVES
ASSISTANT TREASURER

TIMOTHY C. FARIES
SECRETARY

MARY ELLEN LENAHAN
ASSISTANT SECRETARY

STEPHEN P. BYRNE
ASSISTANT SECRETARY

## COMMITTEES

### EXECUTIVE COMMITTEE

WESLEY W. VON SCHACK
COMMITTEE CHAIRMAN

R. DON CASH
WILLIAM H. GRIGG
ALAN J. MAGUIRE
GEORGE L. MAZANEC
RICHARD G. REITEN

### AUDIT & FINANCE COMMITTEE

W.R.P. DALTON
COMMITTEE CHAIRMAN

R. DON CASH
STEPHEN E. FRANK
WILLIAM B. TIMMERMAN
WESLEY W. VON SCHACK, EX-OFFICIO

### INVESTMENT COMMITTEE

GEORGE L. MAZANEC
COMMITTEE CHAIRMAN

PHILIP C. ACKERMAN
KEITH E. BAILEY
CONSTANCE H. LAU
RICHARD G. REITEN
WESLEY W. VON SCHACK, EX-OFFICIO

### CLAIMS COMMITTEE

ROBERT W. BEST
COMMITTEE CHAIRMAN

THOS. E. CAPPS
JANE L. PEVERETT
CHARLES A. SCHROCK

### LOSS CONTROL COMMITTEE

CORBIN A. MCNEILL, JR.
COMMITTEE CHAIRMAN

WALTER M. HIGGINS
JAMES J. JURA
RONALD L. LITZINGER
EUGENE R. MCGRATH

## AEGIS LONDON BOARD OF DIRECTORS

ALAN J. MAGUIRE
CHAIRMAN

WESLEY W. VON SCHACK
JOHN CHAMBERS
DAVID CROOM-JOHNSON
W.R.P. DALTON
STUART R. DAVIES
CHRISTOPHER FORBES
JAMES HALLEY
PAUL KEDNEY
THOMAS J. MAHONEY
MICHAEL ONSLOW
ALEX POWELL
MATTHEW C. YELDHAM

## RISK MANAGEMENT ADVISORY COMMITTEE (RMAC)

WESLEY W. VON SCHACK
COMMITTEE CHAIRMAN

MICHAEL R. ANDERSON
XCEL ENERGY INC.

LINDA F. BARNETT
DOMINION RESOURCES SERVICES, INC.

JOHAN G. BRAMER
TRANSCANADA CORPORATION

JUSTIN LEE BROWN
SOUTHWEST GAS CORPORATION

JOHN H. IRELAND
NORTHEAST UTILITIES

MICHAEL S. KAMINSKI
WISCONSIN ENERGY CORPORATION

THOMAS J. MCDONNELL
FIRSTENERGY CORP.

ERICA A. MCNABB
NEXTERA ENERGY, INC.

MICHAEL A. MEE
EXELON CORPORATION

J. GARY MEGGS
SOUTHERN COMPANY

ROBERT MOUSSAID
ENERGY FUTURE HOLDINGS CORP.

TERRY NOVATNACK
PPL CORPORATION

DENNIS A. SACCO
NEW YORK POWER AUTHORITY

MAUREEN E. SAMMON
MIDAMERICAN ENERGY
HOLDINGS COMPANY

## RMAC — CYBER RISK AND IDENTITY THEFT TASK FORCE

MICHAEL R. ANDERSON
JOHAN G. BRAMER
MICHAEL S. KAMINSKI
J. GARY MEGGS

## RMAC — EVOLVING UTILITY INDUSTRY RISK TASK FORCE

WILLIAM E. FRESE, ESQ.
PUBLIC SERVICE ENTERPRISE GROUP, INC.

GEORGE W. MARGET III, ESQ.
DOMINION RESOURCES SERVICES, INC.

J. GARY MEGGS

JOHN E. REITER
AES GLOBAL INSURANCE CO.

RONALD D. RISPOLI
ENTERGY SERVICES, INC.

MAUREEN E. SAMMON

## RMAC — WORKERS' COMPENSATION TASK FORCE

LINDA F. BARNETT
ERICA A. MCNABB
MICHAEL A. MEE
J. GARY MEGGS
ROBERT MOUSSAID

## CLAIMS TASK FORCE

DAVID P. ABERNATHY, ESQ.
LACLEDE GAS COMPANY

KEITH BONE
DUKE ENERGY CORPORATION

DEREK BOYD
ATMOS ENERGY CORPORATION

WILLIAM R. BURCH, ESQ.
EXELON CORPORATION

C. LARRY DAVIS, ESQ.
SAN DIEGO GAS & ELECTRIC COMPANY

DEBORAH L. EDWARDS, ESQ.
PIEDMONT NATURAL GAS COMPANY, INC.

WILLIAM E. FRESE, ESQ.

JUDY Y. LIU, ESQ.
CENTERPOINT ENERGY SERVICE COMPANY, LLC

GEORGE W. MARGET III, ESQ.

TIMOTHY J. SAVIANO, ESQ.
WE ENERGIES

MARK J. SWEENEY, ESQ.
PACIFIC GAS & ELECTRIC COMPANY

## LOSS CONTROL TASK FORCE

### UTILITY OPERATIONS SUBCOMMITTEE

STEPHEN P. FORD
MISSISSIPPI POWER COMPANY

DAN V. GIOVANNI
HAWAIIAN ELECTRIC COMPANY, INC.

JOHN MELLETTE
SCANA CORPORATION

DAVID S. NALEPKA
INTEGRYS BUSINESS SUPPORT, LLC

JOHN C. NORMAN
IBERDROLA USA MANAGEMENT CORPORATION

JEREMY STEPHENS
CITIZENS ENERGY GROUP

RICHARD N. STEVENS
AVISTA CORPORATION

KARL ZIMMEL
UNS ENERGY CORPORATION

### PROPERTY OPERATIONS SUBCOMMITTEE

MARK BOONE
DOMINION RESOURCES, INC.

JOSHUA M. FLEISCHER
PACIFIC GAS & ELECTRIC COMPANY

ROBERT A. GREEN
PSEG SERVICES CORPORATION

JOHN E. REITER

RONALD D. RISPOLI

ROD ROBERTS
PACIFICORP ENERGY

## Financial Section

# Consolidated Balance Sheets

*Associated Electric & Gas Insurance Services Limited*

**AS OF DECEMBER 31, 2013 AND 2012**

| (Expressed in thousands of U.S. dollars) | 2013 | 2012 |
|---|---|---|
| **ASSETS:** | | |
| Cash and cash equivalents | $ 428,629 | $ 415,912 |
| Investments | 3,258,595 | 3,264,688 |
| *Total cash and investments* | 3,687,224 | 3,680,600 |
| Due from reinsurers | 1,108,374 | 914,944 |
| Accrued interest | 18,268 | 25,329 |
| Premiums receivable | 186,656 | 176,736 |
| Receivable for securities sold | 1,528 | 366 |
| Current income taxes receivable | 19,357 | — |
| Unearned continuity and other premium credits | 13,168 | 23,281 |
| Prepaid reinsurance premiums | 192,551 | 217,447 |
| Net deferred tax asset | 239,966 | 269,325 |
| Deferred acquisition costs | 59,593 | 57,571 |
| Deposit assets | 105,229 | 123,726 |
| Other assets | 125,853 | 109,754 |
| *Total assets* | $5,757,767 | $5,599,079 |
| **LIABILITIES AND SURPLUS:** | | |
| **LIABILITIES:** | | |
| Reserve for losses and loss expenses | $3,104,771 | $2,993,698 |
| Unearned premiums | 699,466 | 654,143 |
| Current income taxes payable | — | 8,427 |
| Fair value of insurance and reinsurance contracts | 363,632 | 401,083 |
| Deposits from insureds | 6,846 | 19,864 |
| Due to reinsurers | 106,596 | 102,968 |
| Payable for securities purchased | 25,085 | 4,607 |
| Deposit liabilities | 105,777 | 123,726 |
| Accrued expenses and other liabilities | 189,411 | 190,373 |
| *Total liabilities* | 4,601,584 | 4,498,889 |
| **SURPLUS:** | | |
| Statutory surplus fund | 250 | 250 |
| Policyholders' surplus | 1,115,968 | 1,026,336 |
| Accumulated other comprehensive income | 39,965 | 73,604 |
| *Total surplus* | 1,156,183 | 1,100,190 |
| *Total liabilities and surplus* | $5,757,767 | $5,599,079 |

See notes to the consolidated financial statements.

# Consolidated Statements of Income and Comprehensive Income

*Associated Electric & Gas Insurance Services Limited*

**FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012**

| (Expressed in thousands of U.S. dollars) | 2013 | 2012 |
|---|---|---|
| **REVENUE:** | | |
| Gross premiums written | $1,280,125 | $1,244,704 |
| Net premiums written | 878,492 | 763,257 |
| Net premiums earned | 805,473 | 802,689 |
| Net investment income | 111,064 | 146,472 |
| Change in fair value of insurance and reinsurance contracts | 38,420 | (17,291) |
| *Total revenue* | 954,957 | 931,870 |
| **EXPENSES:** | | |
| Losses and loss expenses incurred | 572,215 | 628,139 |
| Commission expense | 97,773 | 113,382 |
| Other underwriting expenses | 114,812 | 127,436 |
| *Total expenses* | 784,800 | 868,957 |
| *Income before continuity and other premium credits and income taxes* | 170,157 | 62,913 |
| Continuity and other premium credits | 35,544 | 34,163 |
| *Income before income taxes* | 134,613 | 28,750 |
| Income taxes: | | |
| Current (benefit) provision | (2,585) | 42,823 |
| Deferred provision (benefit) | 47,566 | (33,668) |
| *Total income tax provision* | 44,981 | 9,155 |
| *Net income* | 89,632 | 19,595 |
| **OTHER COMPREHENSIVE INCOME (LOSS):** | | |
| Unrealized gains (losses) on securities: | | |
| Unrealized holding (losses) gains arising during year (net of income tax (benefit) expense of ($3,873) and $14,561, respectively) | (7,192) | 27,043 |
| Unrealized holding gain on held-to-maturity investments reclassified to available-for-sale (net of income tax expense of $0 and $21,143, respectively) | — | 39,267 |
| Reclassification adjustment for amounts included in net income (net of income tax benefit of $14,240 and $19,199, respectively) | (26,447) | (35,656) |
| *Other comprehensive (loss) income* | (33,639) | 30,654 |
| *Comprehensive income* | $ 55,993 | $ 50,249 |

See notes to the consolidated financial statements.

# Consolidated Statements of Changes in Surplus

*Associated Electric & Gas Insurance Services Limited*

**FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012**

| (Expressed in thousands of U.S. dollars) | 2013 | 2012 |
|---|---|---|
| STATUTORY SURPLUS FUND | $ 250 | $ 250 |
| POLICYHOLDERS' SURPLUS: | | |
| Balance at January 1 | 1,026,336 | 1,006,741 |
| Net income | 89,632 | 19,595 |
| *Balance at December 31* | 1,115,968 | 1,026,336 |
| ACCUMULATED OTHER COMPREHENSIVE INCOME: | | |
| Balance at January 1 | 73,604 | 42,950 |
| Other comprehensive (loss) income | (33,639) | 30,654 |
| *Balance at December 31* | 39,965 | 73,604 |
| *Total surplus at December 31* | $1,156,183 | $1,100,190 |

See notes to the consolidated financial statements.

# Consolidated Statements of Cash Flows

*Associated Electric & Gas Insurance Services Limited*

**FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012**

| (Expressed in thousands of U.S. dollars) | 2013 | 2012 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES:** | | |
| Premiums collected | $1,125,843 | $1,076,690 |
| Reinsurance premiums paid | (357,397) | (401,355) |
| Losses and loss expenses paid | (948,812) | (860,057) |
| Losses and loss expenses recovered from reinsurers | 268,336 | 112,500 |
| Proceeds from commutation of reinsurance contract | — | 155,000 |
| Other underwriting expenses paid | (142,872) | (109,890) |
| Interest and dividends received | 112,244 | 106,437 |
| Income taxes paid | (25,310) | (27,160) |
| *Net cash provided by operating activities* | 32,032 | 52,165 |
| **CASH FLOWS FROM INVESTING ACTIVITIES:** | | |
| Purchases of available-for-sale and other investments | (2,752,340) | (1,454,653) |
| Purchases of held-to-maturity investments | — | (128,601) |
| Proceeds from sales or redemptions of available-for-sale and other investments | 2,733,025 | 1,298,419 |
| Proceeds from maturities of held-to-maturity investments | — | 181,444 |
| *Net cash utilized in investing activities* | (19,315) | (103,391) |
| *Increase (decrease) in cash and cash equivalents* | 12,717 | (51,226) |
| Cash and cash equivalents, beginning of year | 415,912 | 467,138 |
| *Cash and cash equivalents, end of year* | $ 428,629 | $ 415,912 |
| **RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:** | | |
| Net income | $ 89,632 | $ 19,595 |
| Net investment gains on securities | (56,908) | (63,307) |
| Net investment foreign exchange (losses) gains | 16,434 | (436) |
| Amortization of securities | 33,546 | 22,181 |
| Depreciation and other charges | 7,797 | 7,358 |
| Deferred income tax provision (benefit) | 47,566 | (33,668) |
| Changes in assets and liabilities: | | |
| Due from reinsurers | (193,430) | (17,955) |
| Accrued interest | 7,061 | 124 |
| Premiums receivable | (9,920) | (24,774) |
| Current income taxes receivable | (19,357) | 6,693 |
| Unearned continuity and other premium credits | 10,113 | (4,230) |
| Prepaid reinsurance premiums | 24,896 | (74,290) |
| Deferred acquisition costs | (2,022) | 5,557 |
| Deposit assets | 18,497 | 3,558 |
| Other assets | (21,291) | 11,225 |
| Reserve for losses and loss expenses | 111,073 | 89,417 |
| Unearned premiums | 45,323 | 44,471 |
| Current income taxes payable | (8,427) | 8,427 |
| Fair value of insurance and reinsurance contracts | (37,451) | 24,895 |
| Deposits from insureds | (13,018) | 11,385 |
| Due to reinsurers | 3,628 | 29,132 |
| Deposit liabilities | (17,949) | (5,317) |
| Accrued expenses and other liabilities | (3,574) | (7,533) |
| Other | (187) | (343) |
| *Net cash provided by operating activities* | $ 32,032 | $ 52,165 |

See notes to the consolidated financial statements.

# Notes to the Consolidated Financial Statements

*Associated Electric & Gas Insurance Services Limited*

**FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012**

(Expressed in thousands of U.S. dollars)

## 1. THE COMPANY AND ITS PRINCIPAL ACTIVITY

Associated Electric & Gas Insurance Services Limited ("AEGIS" or the "Company") was incorporated in Bermuda in 1971 and commenced underwriting activities in 1975. AEGIS is registered as a non-assessable mutual insurance company in Bermuda, is regulated under that country's Insurance Act of 1978, and is a Class 2 Company under the Insurance Amendment Act of 1995.

The principal activity of the Company is to provide, directly and through alliances and affiliates, a full array of liability and property coverages. AEGIS writes Excess Liability, Employers Liability, Employment Practices Liability, Professional Liability, Property, and Boiler and Machinery coverages. AEGIS also writes Directors and Officers Liability, Fiduciary and Employee Benefits Liability, and Excess Workers' Compensation coverages. Through strategic alliance partners, which it reinsures, AEGIS offers General Liability, Commercial Automobile Liability, Directors and Officers Liability, Umbrella Liability and Workers' Compensation coverages. The Company operates a federally licensed Canadian branch offering Excess Liability, Directors and Officers Liability, Property, and Boiler and Machinery coverages.

Syndicate 1225 ("AEGIS Energy Syndicate") at Lloyd's underwrites primarily Property, Casualty, Specialty Lines, Marine and Energy insurance. It is wholly owned by AEGIS through its subsidiary, AEGIS London Holding Limited ("AEGIS London Holding"). Effective January 1, 2012, the Company provides 93 percent of the capacity for AEGIS Energy Syndicate.

## 2. SIGNIFICANT ACCOUNTING POLICIES

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("U.S. GAAP"), and reflect the following policies:

### a. BASIS OF PRESENTATION

The consolidated financial statements include the accounts of AEGIS and its wholly owned subsidiaries. All significant inter-company transactions are eliminated in consolidation. Certain prior year amounts have been reclassified to conform to the current year presentation. The prior year amounts for other assets and accrued expenses and other liabilities each have been increased by $28,636 from the amounts previously reported in order to include appropriately the collateral held by the custodian for the benefit of the Company and the related obligation of the Company to return such collateral in accordance with ASC 860, Transfers and Servicing.

#### VARIABLE INTEREST ENTITIES

The Company, through its subsidiary, AEGIS London Holding Limited, holds investments in two entities that are variable interest entities ("VIEs"). Each of these VIEs provides 3.5% of the underwriting capacity of the AEGIS Energy Syndicate and maintains whole account quota share reinsurance contracts with third parties. The Company holds the power to direct the most significant activities of the entities, as well as an economic interest in the entities and, as such, is the primary beneficiary. Therefore, these VIEs are consolidated in the Company's financial statements.

## b. CASH AND CASH EQUIVALENTS

Cash and cash equivalents include demand deposits and money market funds and short-term investments with an original maturity of less than three months. Cash and cash equivalents are carried at amortized cost, which approximates fair value.

## c. INVESTMENTS

The Company has classified its marketable securities as available-for-sale ("AFS"). AFS securities are stated at fair value, with unrealized holding gains and losses, net of income tax effects, included in other comprehensive income and reported as a component of accumulated other comprehensive income. The amortized cost of debt securities is adjusted for the amortization of premiums and accretion of discounts to maturity using the effective yield method. Such amortization and accretion is included in net investment income.

AFS securities include mortgage- and asset-backed securities ("MBS" and "ABS" respectively). Amortization of the premium or accretion of the discount from the purchase of these securities is recognized after considering the estimated timing and amount of prepayments of the underlying loans. Actual prepayment experience is periodically reviewed and effective yields are recalculated when differences arise between the prepayments originally anticipated and the actual prepayments received and currently anticipated.

In 2013, the Company began investing in syndicated bank loans, either as individual or groups of loans. The initial investment in a bank loan is inclusive of the value of the loans plus or minus any fees paid or received, which are directly attributable to the investment. The difference between the initial investment and the related loan's principal amount at the date of purchase is recognized as an adjustment to yield over the life of the loan. All other costs incurred in committing to purchase and acquire the loans are expensed as incurred. Syndicated bank loans are classified as AFS securities and are stated at fair value with unrealized holding gains or losses, net of income tax effects, included in other comprehensive income and reported as a component of accumulated other comprehensive income. As of December 31, 2013, the Company's traded but unsettled syndicated bank loans totaled $17,001, these loans were recorded as AFS securities.

The Company invests in fund of fund investments where it does not exercise control. These investments are generally accounted for using the equity method of accounting. The carrying value of these holdings, which approximates fair value, is included in investments. The Company's share of distributed and undistributed net income from fund of fund investments is included in net investment income.

As of December 31, 2013 and 2012, the Company had no investments classified as held to maturity ("HTM"). This was attributable to a December 20, 2012 determination that the Company no longer had the positive intent to hold its municipal bond investments to maturity. In December 2012, all investments classified as HTM were transferred to an AFS classification, reflecting the Company's intention to divest all tax-free municipal bond holdings to support its taxable income strategy. At the date of the transfer, the securities had an amortized cost of $1,153,486 and an unrealized gain of $39,267, net of income taxes, which was included in other comprehensive income for the year ended December 31, 2012.

The Company participates in securities lending arrangements whereby specific securities are loaned to other institutions, primarily banks and brokerage firms, for short periods of time. Securities loaned are recorded in accrued expenses and other liabilities, while cash collateral held by our custodian and monitored and maintained by the lending agent is recorded in other assets. Company policy requires the borrower to provide collateral in an amount equal to or greater than the fair value of the domestic and foreign securities loaned. The Company receives interest income on the invested collateral, which is included in net investment income. The Company monitors the fair value of the underlying securities to ensure such transactions are adequately collateralized.

The Company performs periodic reviews of its investment portfolios where individual holdings have experienced a decline in fair value below their respective amortized costs. The Company considers a number of factors in the evaluation of whether a decline in value is other-than-temporary, including: (a) the present value of expected future cash flows; (b) the financial condition and near-term prospects of the issuer; (c) the period and degree to which the fair value has been below amortized cost; (d) with respect to equity securities, the Company's ability and intent to retain the investment for a period of time sufficient to allow for an anticipated recovery in value; and (e) with respect to AFS debt securities, whether the Company has the intent to sell or will more likely than not be required to sell a particular security before the decline in estimated fair value below its cost or amortized cost recovers. A security is other-than-temporarily impaired when it becomes apparent that the present value of the expected cash flows over the expected holding period is less than its amortized cost basis.

Where the decline in fair value of an AFS debt security is deemed to be other-than-temporary and the Company neither intends to sell, nor is it more likely than not that the Company will be required to sell the security, a charge is recorded to net investment income for the credit-related impairments and a new cost basis is established. A decline in fair value for non-credit related impairments is recorded as a reduction of other comprehensive income. In periods subsequent to the recognition of an other-than-temporarily impaired loss for debt securities, the discount or reduced premium recorded for the debt security, based on the new cost basis, is amortized over the remaining life of the debt security in a prospective manner based on the amount and timing of future estimated cash flows at the balance sheet date.

The Company's investments are externally managed by professional investment managers who have the discretion to buy and sell securities subject to certain Company-imposed guidelines. Management does not assess, on a security-by-security basis, whether our investment managers had the intent to sell impaired debt securities, or the intent to hold impaired equity securities, as of and for the years ended December 31, 2013 and 2012. Therefore, all other-than-temporary impairments, inclusive of net unrealized losses on AFS securities, were recorded as a charge to net investment income.

Investment income, net of investment-related expenses, is recognized when earned. Realized investment gains or losses on the sales of investments, generally determined on a first-in, first-out basis, are included in net investment income.

The recognition of income on MBS and ABS is dependent upon market conditions, which could result in prepayments and changes in amounts to be earned.

### d. CONCENTRATION OF CREDIT RISK

Financial instruments that potentially subject the Company to concentrations of credit risk include cash balances in excess of government-insured limits, amounts due from reinsurers and marketable debt securities. Although the Company places its temporary cash investments with creditworthy financial institutions and purchases reinsurance contracts from highly rated reinsurers, the Company is exposed to a concentration of credit risk with respect to cash and temporary cash investments held at financial institutions and amounts due from its reinsurers. Management monitors the credit standing of the relevant financial institutions and the financial condition of the Company's reinsurers.

The Company holds bonds and notes issued by U.S. and foreign corporations, the U.S. government and foreign governments. By policy, these investments are kept within limits designed to prevent risks caused by concentration. As of December 31, 2013, there are no known significant concentrations of credit risk with regard to invested assets.

## e. DEFERRED ACQUISITION COSTS

The Company incurs brokers' commissions and premium taxes in acquiring insurance premiums for executed contracts. These costs are deferred and amortized over the lives of the policies to which they relate, excluding contracts measured at fair value, where such costs are included in commission expense in the year incepted. The amortization of deferred acquisition costs is included in commission expense. The recoverability of these deferred costs is reviewed periodically and includes the consideration of future investment income.

## f. DERIVATIVE FINANCIAL INSTRUMENTS

The Company uses foreign currency forward contracts and index futures contracts, generally with terms of 90 days or less. The primary objective of investing in foreign currency forward contracts is to protect the U.S. dollar value of foreign currency-denominated monetary assets and liabilities from the effects of volatility in foreign exchange rates that might occur prior to their receipt or settlement in U.S. dollars. These forward contracts are not designated as hedges and are marked to fair value through net investment income and substantially offset the change in spot value of the underlying foreign currency-denominated monetary asset or liability.

Furthermore, the Company periodically uses bond futures contracts to offset return differentials in its fixed-income portfolio that arise due to the inability to fully invest all assets directly in securities. These contracts are not designated as hedges; therefore, changes in the fair value of these derivatives are recognized in earnings as part of net investment income as they occur.

As of December 31, 2013, the Company had foreign currency forward contracts with notional amounts of $430 and a fair value loss of $7. As of December 31, 2012, the Company had no derivative contracts outstanding.

## g. FOREIGN OPERATIONS AND FOREIGN CURRENCY TRANSLATION

The functional and reporting currency of the Company is U.S. dollars. Monetary assets and liabilities denominated in foreign currencies are translated at the rate of exchange in effect at the balance sheet date. Revenues and expenses are translated at the average rate prevailing during the year. Any resulting operating foreign exchange gain or loss is included in other underwriting expenses. The Company recorded net operating foreign exchange gains of $2,568 and losses of $5,930 for the years ended December 31, 2013 and 2012, respectively.

Unrealized gains and losses resulting from changes in the foreign currency exchange rates on AFS securities are recorded in the consolidated balance sheets in accumulated other comprehensive income. Realized foreign currency gains and losses resulting from the sale of securities are recorded in net investment income.

The AEGIS Energy Syndicate assets, liabilities, revenues and expenses are recorded after making certain adjustments to convert U.K. GAAP accounting to U.S. GAAP. The most significant U.S. GAAP adjustments relate to investment income recognition. The Canadian Branch files statutory financial statements based upon International Financial Reporting Standards. The most significant U.S. GAAP adjustments to the Canadian branch relate to the method of estimation of loss reserves.

## h. INCOME TAXES

The Company's provision for income taxes represents management's best estimate of various events and transactions and includes the impact of reserve provisions and changes to reserves that are considered appropriate. The Company reflects interest and penalties attributable to income taxes, to the extent they arise, as a component of its income tax provision or benefit as well as its outstanding income tax assets and liabilities.

Deferred tax assets and liabilities resulting from temporary differences between the financial reporting and tax bases of assets and liabilities are measured at the balance sheet date using enacted tax rates expected to apply to taxable income in the years the temporary differences are expected to reverse. A valuation allowance is established when it is more likely than not that some portion of the Company's deferred tax assets will not be realized.

Significant judgment is required in evaluating the Company's tax positions and determining its provision for income taxes as there are many transactions and calculations for which the ultimate tax determination is uncertain. The assessment to determine whether a valuation allowance is required and the amount of any allowance requires significant judgment and includes the long-range forecast of future taxable income and the evaluation of tax planning initiatives. Adjustments to the deferred tax valuation allowances are made to earnings in the period such management assessments are made.

The Company recognizes a tax benefit relating to uncertain tax positions only where the position is more likely than not to be sustained assuming examination by tax authorities. The Company establishes reserves for tax-related uncertainties based on estimates of whether, and the extent to which, additional taxes will be due. These reserves are established when the Company believes that certain positions might be challenged despite its belief that the Company's tax return positions are fully supportable. The Company adjusts these reserves in light of changing facts and circumstances, such as the outcome of tax audits.

## i. PREMIUMS

Premiums are earned as income ratably over the period covered by the policies. Unearned premium reserves are established relative to the unexpired contract period. It is the Company's practice to price certain of its policies at amounts that are not expected to fully recover anticipated losses, loss expenses and underwriting expenses. Such practice anticipates that sufficient investment income will be earned over the period in which underwriting losses are settled.

## j. LOSSES

The reserve for losses and loss expenses represents the Company's best estimate, based on its latest studies, of the gross amount of losses and loss expenses to be paid on ultimate settlement of all incurred losses, reported and unreported, as of the respective balance sheet dates. These estimates are periodically reviewed by the Company's management and independent actuaries, and are adjusted in accordance with the latest available information. Any adjustments in estimates are reflected in earnings in the period the adjustment is made. Management believes that an adequate provision has been made for the Company's losses and loss expenses.

## k. FAIR VALUE MEASUREMENTS

The Company measures certain assets and liabilities using fair value. Fair value is a market-based measurement and not an entity-specific measurement, and requires the use of a fair value hierarchy with the highest priority given to quoted prices in active markets. In determining fair value, the Company uses various valuation approaches. Assets and liabilities measured and reported at fair value are classified and disclosed in one of the following categories:

- *Level 1* – Quoted prices available in active markets for identical investments as of the reporting date are used to determine fair value. Assets measured at fair value and classified as Level 1 include publicly traded equity securities and money market funds.

- *Level 2* – Pricing inputs other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting date, are used to determine fair value through the use of models or other valuation methodologies. Assets measured at fair value and classified as Level 2 include certain domestic and foreign government and agency securities, domestic and foreign corporate bonds, MBS, ABS, syndicated bank loans and commercial paper. Because many debt securities do not trade on a daily basis, independent pricing services estimate fair value through processes such as bid evaluation using observable inputs and matrix pricing of similar securities to calculate the fair value of domestic and foreign government and agency securities. For domestic and foreign corporate bonds and commercial paper, the pricing provider considers credit spreads, interest rate data and market news in the valuation of each security. For MBS and ABS the pricing provider applies models including observable inputs such as dealer quotes and other available trade information as well as prepayment speeds, yield curves and credit spreads. Syndicated bank loans are priced using dealer quotes relying on available market data. The Company's foreign currency forward contracts are traded in the over-the-counter derivative market and are classified within Level 2. These contracts are classified as Level 2 because they are valued by models that utilize actively quoted or observable market input values from external market data providers, third-party pricing vendors and/or recent trading activity.

- *Level 3* – Significant pricing inputs are unobservable and include situations where there is little, if any, observable market activity for the investment, asset or obligation. The liability for the fair value of excess workers' compensation insurance and reinsurance contracts is classified as Level 3. Management must make assumptions about inputs that a market participant would use to value the liability. If quoted market prices are not available, fair value is based upon vendor or internally developed valuation models that use, where possible, current market-based or independently sourced market parameters.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, the level in the fair value hierarchy is determined based on the lowest-level input that is significant to the fair value measurement in its entirety. There have been no material changes in the Company's valuation techniques during the periods presented.

The Company also considers its own nonperformance risk when measuring the fair value of liability positions and the counterparty's nonperformance risk when measuring the fair value of asset positions.

### FAIR VALUE OPTION

Effective January 1, 2008, the Company elected the fair value option ("FVO") for all direct insurance contracts classified as excess workers' compensation, as well as the related reinsurance contracts.

The Company records these contracts at fair value to reflect the significant elapsed time between the issuance of the contracts and final settlement of the obligations, adjusted for the risk of variation in the amount and timing of future cash flows. These contracts are recorded at fair value, with changes in fair value recorded in the consolidated statements of income and comprehensive income in the period of change. As such, reported premiums and incurred losses do not include activity related to the Company's excess workers' compensation insurance and reinsurance contracts. Cash flows from the underlying insurance and reinsurance contracts are reported in cash flows from operating activities. Management reevaluates, on an annual basis, its fair value election for future insurance and reinsurance contracts.

## l. CONTINUITY AND OTHER PREMIUM CREDITS

Continuity credits are based on each respective member's proportionate share of premiums and total surplus. Other premium credits are based on each eligible policyholder's proportionate share of its contribution to the underwriting results for the given measurement period. Continuity and other premium credits are declared by the Company's Board of Directors. Such credits are provided only to eligible members and other policyholders renewing coverage with the Company and are subject to certain restrictions. The application of continuity and other premium credits to policy renewal premiums is limited to the amount of premium charged. Excess credits are carried forward for potential use in future periods; such credits are forfeited when a member leaves the Company. Issued credits are earned over the periods covered by the underlying policies.

## m. ESTIMATES

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, in particular investments, reserve for losses and loss expenses, the allowance for uncollectible reinsurance, the fair value of excess workers' compensation direct insurance and related reinsurance contracts, deferred tax assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

## n. DEPOSIT ASSETS AND LIABILITIES

The Company enters into certain contracts that do not meet U.S. GAAP risk transfer provisions requiring that a transaction contain a significant assumption of insurance risk and a reasonable possibility that the Company may realize a significant loss from the contract. These contracts are accounted for using the deposit accounting method. For these contracts, the Company records deposit liabilities for an amount equivalent to the assets received with any differences due to the timing of receipts and payments. In some cases, the Company transfers assets to another insurer or reinsurer and records a deposit asset for the amount paid.

## o. PROPERTY AND EQUIPMENT

Property and equipment are stated at cost less accumulated depreciation and are included in other assets. Depreciation and amortization are provided, beginning at the inception of the asset's use, under the straight-line method based upon the following estimated useful lives:

| | ESTIMATED LIFE (YEARS) |
|---|---|
| Property and leasehold improvements | * |
| Furniture and fixtures | 5 - 15 |
| Information technology equipment and software | 3 - 5 |

* Amortized over the lesser of the useful life or the remaining life of the lease from the date placed in service.

A summary of property and equipment at December 31, 2013 and 2012 is as follows:

| | 2013 | 2012 |
|---|---|---|
| Property and leasehold improvements | $ 11,161 | $ 11,161 |
| Furniture and fixtures | 6,208 | 6,113 |
| Information technology equipment and software | 32,265 | 27,903 |
| Total cost | 49,634 | 45,177 |
| Accumulated depreciation | (32,813) | (27,627) |
| Net property and equipment | $ 16,821 | $ 17,550 |

Depreciation expense amounted to $5,192 and $4,753 for the years ended December 31, 2013 and 2012, respectively.

## p. RETIREMENT BENEFIT PLANS

Prior to January 1, 1998, the Company maintained a qualified defined benefit pension plan for eligible employees of AEGIS Insurance Services, Inc. through membership in the Pension Plan for Employees of AEGIS Insurance Services, Inc. (the "Pension Plan"). Benefits are based on a participant's credited service ending no later than December 31, 2011, as defined by the Pension Plan. On January 1, 1998, the Pension Plan was frozen to new participants.

Effective December 31, 2011, the Plan was amended to discontinue the accrual of additional participant benefits after December 31, 2011. On July 15, 2012, the Plan was amended for a one-time adjustment, which increased frozen Participant's accrued benefit base by 10% provided the participant was an active employee on July 31, 2012. The Company also has a non-qualified supplemental defined benefit plan for certain employees. The non-qualified plan is funded from the general assets of the Company, including corporate-owned life insurance policies purchased to provide for the benefits earned by eligible employees; however, these policies cannot be considered in the determination of the funded status of the non-qualified plan.

The Company's funding policy is to contribute funds to the Pension Plan, as necessary, to provide for any unfunded projected benefit obligation over a reasonable period. To the extent that these requirements are fully covered by assets in the Pension Plan, the Company may elect not to make any contributions in a particular year.

As of December 31, 2013 and 2012, the total projected benefit obligation for the Pension Plan and the non-qualified plan was $35,830 and $50,768, respectively, based on discount rates of 4.25% for the Pension Plan and 4.50% for the non-qualified plan for 2013 and 4.25% for the Pension Plan and 3.75% for the non-qualified plan in 2012, with a 3.0% rate of compensation increase for the non-qualified plan as of December 31, 2013 and 2012. The fair value of Pension Plan assets as of December 31, 2013 and 2012 was $22,180 and $17,881, respectively, and the total unfunded status was $13,860 and $32,888, respectively. The expected rate of return on Pension Plan assets is 7.50% for 2013 and 2012 and is determined based on historical and expected future returns of the Pension Plan's asset classes, consisting of various equity and debt securities.

The Company currently maintains a post-retirement medical benefit plan for eligible employees of the Company, with benefits based on a participant's age and credited service. In 2012, the Plan was amended to reduce the Company's share of the costs if the annual premium increase exceeds 3%. The Plan benefits are funded from the general assets of the Company, including corporate-owned life insurance policies purchased to provide for the benefits earned by eligible employees. These policies cannot be considered in the determination of the funded status of the plan. As of December 31, 2013 and 2012, the unfunded balance related to this plan was $11,036 and $13,709, respectively, based upon a discount rate of 5.0% for 2013 and 4.5% for 2012.

All unfunded balances for the plans above are recorded within accrued expenses and other liabilities within the consolidated balance sheets.

### q. NEW ACCOUNTING PRONOUNCEMENTS

In June 2011, the FASB issued an accounting standard update that requires the presentation of comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components, followed consecutively by a second statement that presents total other comprehensive income and its components. This update was effective for annual periods ending after December 15, 2012, with retrospective application required. The implementation of this guidance did not have a material impact on the consolidated financial statements, as the Company previously presented comprehensive income in a single continuous statement.

In December 2011 and January 2013, the FASB issued updated guidance regarding the disclosure of derivative instruments, repurchase agreements and securities borrowing and lending transactions that are offset in the financial statements or have the legal right to offset under master netting agreements or similar arrangements. The new guidance requires that an entity disclose information on both a net and gross basis and provide an explanation of the items being offset. This update is effective for annual periods ending after January 1, 2013, with retrospective application required. The implementation of this guidance does not have a material impact on the consolidated financial statements, as the Company's foreign currency forward contracts are not netted, and no collateral is provided or received for these contracts. The Company's securities lending portfolio and related collateral are discussed in Footnote 3–Investments.

Effective February 7, 2013, nonpublic entities are not required to disclose certain fair value information for financial assets and liabilities not recorded at fair value on the Balance Sheet. The implementation of this guidance did not have a material impact on the consolidated financial statements.

In February 2013, the FASB issued updated guidance regarding the presentation of comprehensive income. Under the respective guidance an entity is required to present information pertaining to significant items reclassified from accumulated other comprehensive income by component as well as changes in other comprehensive income by component in either the financial statements or the notes to the financial statements. This guidance does not require any changes to the items presented in other comprehensive income nor does it change when items are reclassified to net income, and it does not amend existing requirements for reporting other comprehensive income. This is effective for annual reporting periods after December 15, 2013, and should be applied prospectively. The implementation of this guidance does not have a material impact on the consolidated financial statements, as the Company previously presented comprehensive income in a single continuous statement with the gains and losses realized from the sale of AFS securities being the only item of significance reclassified to net income. This reclassification is currently being reflected as a separate component of other comprehensive income.

In July 2013, the FASB issued updated guidance related to the presentation of unrecognized tax benefits when net operating loss carryforwards or similar tax carryforwards exist. This new guidance is effective for annual reporting periods that begin after December 15, 2013, and should be adopted prospectively. This guidance does not have a significant impact on the Company's consolidated position, results of operations or financial statement disclosures.

## 3. INVESTMENTS

On December 20, 2012, all investments previously classified as HTM, having an amortized cost of $1,153,486 and fair value of $1,213,896, were reclassified as AFS. For the year ended December 31, 2012, unrealized gains of $39,267, net of income taxes, were included in other comprehensive income as a result of the transfer.

The fair value of the Company's AFS investments compared with their cost or amortized cost at December 31, 2013 and 2012 were:

| 2013: | COST/AMORTIZED COST | GROSS UNREALIZED GAINS | GROSS UNREALIZED LOSSES* | FAIR VALUE |
|---|---|---|---|---|
| Debt securities: | | | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 92,968 | $ 7 | $— | $ 92,975 |
| Obligations of U.S. states and political subdivisions | 2,489 | 7 | — | 2,496 |
| Debt securities issued by foreign governments | 192,000 | 89 | — | 192,089 |
| U.S. corporate debt securities | 1,170,513 | 21,156 | — | 1,191,669 |
| Foreign corporate debt securities | 84,494 | 1,985 | — | 86,479 |
| Agency MBS | 927,088 | 4,534 | — | 931,622 |
| Non-agency MBS | 76,990 | 196 | — | 77,186 |
| ABS | 71,783 | 167 | — | 71,950 |
| Syndicated bank loans | 149,948 | 1,415 | — | 151,363 |
| Total debt securities | 2,768,273 | 29,556 | — | 2,797,829 |
| Equity securities | 240,096 | 28,004 | — | 268,100 |
| Mutual funds: | | | | |
| Equity | 157,391 | 3,891 | — | 161,282 |
| Bonds | 25,214 | 32 | — | 25,246 |
| Total mutual funds | 182,605 | 3,923 | — | 186,528 |
| *Total AFS investments* | $3,190,974 | $61,483 | $— | $3,252,457 |

| 2012: | COST/AMORTIZED COST | GROSS UNREALIZED GAINS | GROSS UNREALIZED LOSSES* | FAIR VALUE |
|---|---|---|---|---|
| Debt securities: | | | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ 280,874 | $ 2,818 | $— | $ 283,692 |
| Obligations of U.S. states and political subdivisions | 447,769 | 35,479 | — | 483,248 |
| Debt securities issued by foreign governments | 197,424 | 2,404 | — | 199,828 |
| U.S. corporate debt securities | 1,310,217 | 41,442 | — | 1,351,659 |
| Foreign corporate debt securities | 94,903 | 2,581 | — | 97,484 |
| Agency MBS | 355,106 | 8,142 | — | 363,248 |
| Non-agency MBS | 50,247 | 720 | — | 50,967 |
| ABS | 39,449 | 268 | — | 39,717 |
| Total debt securities | 2,775,989 | 93,854 | — | 2,869,843 |
| Equity securities | 220,343 | 17,761 | — | 238,104 |
| Mutual funds: | | | | |
| Equity | 98,079 | 1,574 | — | 99,653 |
| Bonds | 25,045 | 79 | — | 25,124 |
| Total mutual funds | 123,124 | 1,653 | — | 124,777 |
| *Total AFS investments* | $3,119,456 | $113,268 | $— | $3,232,724 |

* For the years ended December 31, 2013 and 2012, no gross unrealized losses are reported, as all unrealized losses are treated as other-than-temporary-impairment adjustments and are recorded as a deduction in net investment income and the amortized cost of investments.

(Expressed in thousands of U.S. dollars)

Purchases of AFS investments were $2,752,340 and $1,454,653 in 2013 and 2012, respectively. Proceeds from sales of AFS investments were $2,421,808 and $964,080 in 2013 and 2012, respectively. In 2013, gross gains of $116,888 and gross losses of $59,426 (including $39,829 of other-than-temporary impairments) were recognized during the year. In 2012, gross gains of $69,176 and gross losses of $14,581 (including $10,391of other-than-temporary impairments) were recognized during the year.

Proceeds from maturities of HTM investments were $181,444 for the year ended December 31, 2012. As these proceeds resulted from the maturity of the securities, there were no gains or losses recognized related to these HTM investments.

The carrying value, which approximates fair value, of other invested assets was $6,138 and $31,964 at December 31, 2013 and 2012, respectively. The Company made no purchases of other invested assets in 2013 or 2012. The Company redeemed $24,356 and $139,868 of other invested assets for the years ended December 31, 2013 and 2012, respectively. The Company recognized a loss of $379 and a gain of $7,483 on these investments for the years ended December 31, 2013 and 2012, respectively.

The evaluation for other-than-temporary impairments is a quantitative and qualitative process that is subject to risks and uncertainties in the determination of whether declines in the fair value of investments are other-than-temporary. The risks and uncertainties include changes in general economic conditions, the issuer's financial condition or near-term recovery prospects, and the effects of changes in interest rates over the period of time the investment is expected to be held. As of December 31, 2013, the Company evaluated all securities for credit-related impairment and concluded all significant unrealized losses were included in the other-than-temporary impairment charge.

The amortized cost and fair value of AFS debt securities at December 31, 2013, by contractual maturity, are shown in the following table. As MBS and ABS are generally more likely to be prepaid than other fixed maturity securities, MBS and ABS are shown separately.

| | AMORTIZED COST | FAIR VALUE |
|---|---|---|
| Due in one year or less | $ 207,097 | $ 209,044 |
| Due after one year through five years | 1,150,288 | 1,168,744 |
| Due after five years through ten years | 189,695 | 192,538 |
| Due after ten years | 145,332 | 146,745 |
| Subtotal | 1,692,412 | 1,717,071 |
| Agency MBS | 927,088 | 931,622 |
| Non-agency MBS | 76,990 | 77,186 |
| ABS | 71,783 | 71,950 |
| *Total debt securities* | $ 2,768,273 | $2,797,829 |

Expected maturities will differ from stated maturities because underlying borrowers have the right to call or prepay certain obligations with or without prepayment penalties.

The Company participates in securities lending arrangements whereby specific securities are loaned to other institutions, primarily banks and brokerage firms, for short periods of time. Collateral is held by our custodian and is monitored and maintained by the lending agent. Company policy requires the borrower to provide a minimum of 102% and 105% of the fair value of the domestic and foreign loaned securities, respectively, as collateral. As of December 31, 2013 and 2012, investment securities on loan had a fair value of $32,784 and $28,173, respectively, while the cash collateral from borrowers was $33,517 and $28,636 for the same respective periods. The Company receives interest income on the invested collateral, which is included in net investment income.

Net investment income for the years ended December 31, 2013 and 2012 consists of the following:

| | 2013 | 2012 |
|---|---|---|
| Interest and dividend income | $ 89,830 | $104,591 |
| Net realized investment gains | 57,237 | 62,849 |
| Net realized foreign currency (losses) gains | (16,272) | 436 |
| Net realized loss on foreign currency forward contracts | (156) | — |
| Net unrealized convertible asset (losses) gains | (27) | 120 |
| Net unrealized loss on foreign currency forward contracts | (7) | — |
| Net fund of funds and other (losses) gains | (300) | 338 |
| Total investment income | 130,305 | 168,334 |
| Investment expenses | (19,241) | (21,862) |
| *Net investment income* | $111,064 | $146,472 |

At December 31, 2013 the Company has securities on deposit of $668,961 in order to comply with various U.S., Canadian and U.K. insurance and tax regulatory requirements. The Company has also entered into letter of credit facilities with four financial institutions totaling $385,000, of which $301,237 was committed at December 31, 2013. At December 31, 2013, the Company has pledged cash and debt securities valued at $1,356,484 as collateral to secure these letters of credit.

## 4. FAIR VALUE MEASUREMENTS

The following tables present information about the Company's assets and liabilities at fair value at December 31, 2013 and 2012:

| 2013: | LEVEL 1 | LEVEL 2 | LEVEL 3 | TOTAL |
|---|---|---|---|---|
| **ASSETS:** | | | | |
| Investments: | | | | |
| Debt securities: | | | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ — | $ 92,975 | $ — | $ 92,975 |
| Obligations of U.S. states and political subdivisions | — | 2,496 | — | 2,496 |
| Debt securities issued by foreign governments | — | 192,089 | — | 192,089 |
| U.S. corporate debt securities | — | 1,191,669 | — | 1,191,669 |
| Foreign corporate debt securities | — | 86,479 | — | 86,479 |
| Agency MBS | — | 931,622 | — | 931,622 |
| Non-agency MBS | — | 77,186 | — | 77,186 |
| ABS | — | 71,950 | — | 71,950 |
| Syndicated bank loans | — | 151,363 | — | 151,363 |
| Total debt securities | — | 2,797,829 | — | 2,797,829 |
| Equity securities | 268,100 | — | — | 268,100 |
| Mutual funds: | | | | |
| Equity funds | — | 161,282 | — | 161,282 |
| Bond funds | — | 25,246 | — | 25,246 |
| Total mutual funds | — | 186,528 | — | 186,528 |
| Total investments | 268,100 | 2,984,357 | — | 3,252,457 |
| Cash equivalents including money market funds and short-term debt securities | 10,109 | 252,453 | — | 262,562 |
| *Total assets* | $278,209 | $3,236,810 | $ — | $ 3,515,019 |
| **LIABILITIES:** | | | | |
| Fair value of insurance and reinsurance contracts | $ — | $ — | $363,632 | $ 363,632 |
| Foreign currency forward contracts | — | 7 | — | 7 |
| *Total liabilities* | $ — | $ 7 | $363,632 | $ 363,639 |

(Expressed in thousands of U.S. dollars)

| 2012: | LEVEL 1 | LEVEL 2 | LEVEL 3 | TOTAL |
|---|---|---|---|---|
| **ASSETS:** | | | | |
| Investments: | | | | |
| Debt securities: | | | | |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | $ — | $ 283,692 | $ — | $ 283,692 |
| Obligations of U.S. states and political subdivisions | — | 483,248 | — | 483,248 |
| Debt securities issued by foreign governments | — | 199,828 | — | 199,828 |
| U.S. corporate debt securities | — | 1,351,659 | — | 1,351,659 |
| Foreign corporate debt securities | — | 97,484 | — | 97,484 |
| Agency MBS | — | 363,248 | — | 363,248 |
| Non-agency MBS | — | 50,967 | — | 50,967 |
| ABS | — | 39,717 | — | 39,717 |
| Total debt securities | — | 2,869,843 | — | 2,869,843 |
| Equity securities | 238,104 | — | — | 238,104 |
| Mutual funds: | | | | |
| Equity funds | — | 99,653 | — | 99,653 |
| Bond funds | — | 25,124 | — | 25,124 |
| Total mutual funds | — | 124,777 | — | 124,777 |
| Total investments | 238,104 | 2,994,620 | — | 3,232,724 |
| Cash equivalents including money market funds and short-term debt securities | 7,209 | 340,986 | — | 348,195 |
| *Total assets* | $ 245,313 | $3,335,606 | $ — | $3,580,919 |
| **LIABILITIES:** | | | | |
| Fair value of insurance and reinsurance contracts | $ — | $ — | $401,083 | $ 401,083 |
| *Total liabilities* | $ — | $ — | $401,083 | $ 401,083 |

Investments noted in the tables above exclude other invested assets. Other invested assets are accounted for under the equity method of accounting.

The Company's policy is to transfer assets and liabilities from Level 1 to Level 2 and from Level 2 to Level 1 at their fair values at the end of each reporting period, consistent with the date of the determination of fair value. Investments are transferred from Level 1 to Level 2 when they are no longer transacted with sufficient frequency and volume to indicate an active market. Conversely, assets are transferred from Level 2 to Level 1 when transaction volume and frequency are indicative of an active market. The Company had no transfers between Levels 1 and 2 during the years ended December 31, 2013 and 2012.

The following tables present additional information about Level 3 liabilities measured at fair value on a recurring basis at December 31, 2013 or 2012. The Company did not hold any Level 3 assets at December 31, 2013 and 2012.

### INSURANCE AND REINSURANCE CONTRACTS:

| | 2013 | 2012 |
|---|---|---|
| Balance, January 1 | $(401,083) | $(376,188) |
| Total gains (losses), realized/unrealized: | | |
| Included in earnings | 38,420 | (17,291) |
| Purchases, issuances, sales and settlements: | | |
| Purchases | 11,589 | 4,272 |
| Issuances | (33,703) | (27,550) |
| Settlements | 21,145 | 15,674 |
| *Balance, December 31* | $(363,632) | $(401,083) |
| Changes in unrealized gains (losses) included in earnings related to obligations still held at reporting date | $ 38,420 | $ (17,291) |

The Company's policy is to transfer assets and liabilities into and out of Level 3 at their fair values at the end of each reporting period, consistent with the date of the determination of fair value.

### QUANTITATIVE INFORMATION ABOUT LEVEL 3 FAIR VALUE MEASUREMENTS

The table below presents information about the significant unobservable inputs used for recurring fair value measurements for insurance and reinsurance contracts:

| FAIR VALUE AT DECEMBER 31, 2013 | VALUATION TECHNIQUE | UNOBSERVABLE INPUT | SELECTED ESTIMATE |
|---|---|---|---|
| $363,632 | Risk-adjusted discounted cash flows | Nominal net value of contracts | $531,786 |
| | | Effective average discount rate | 53.01% |
| | | Risk margin | 26.63% |

| FAIR VALUE AT DECEMBER 31, 2012 | VALUATION TECHNIQUE | UNOBSERVABLE INPUT | SELECTED ESTIMATE |
|---|---|---|---|
| $401,083 | Risk-adjusted discounted cash flows | Nominal net value of contracts | $505,140 |
| | | Effective average discount rate | 64.10% |
| | | Risk margin | 22.90% |

The Company's insurance and reinsurance contracts do not have observable market prices. The fair value of insurance and reinsurance contracts represents the Company's estimate of the cost to completely transfer its obligations and related reinsurance assets to another party of comparable creditworthiness.

# Notes to the Consolidated Financial Statements

*Associated Electric & Gas Insurance Services Limited*

**FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012**

(Expressed in thousands of U.S. dollars)

The fair value of insurance and reinsurance contracts is based on the present value of expected future cash flows and a risk margin that would be payable to transfer the obligation to a third party. Expected future cash flows are comprised primarily of estimated payments to be made by the Company under the insurance contracts net of anticipated future recoveries under the related reinsurance contracts. The Company estimates future cash flows based on expected loss and loss expense payments estimated using accepted actuarial techniques, the timing of related future cash receipts or payments from these contracts and risk-free discount rates. A risk margin is calculated for potential deviations in the amount and timing of those estimated cash flows given the credit rating of the Company as well as additional return on capital a purchaser would require. These estimates are not observable in any marketplace, and actual future cash flows or other inputs could differ materially from these estimates.

## 5. PREMIUMS

Written and earned premiums are comprised of the following:

| | 2013 | 2012 |
|---|---|---|
| Written Premiums: | | |
| Direct | $1,245,204 | $1,223,905 |
| Assumed | 34,921 | 20,799 |
| Subtotal | 1,280,125 | 1,244,704 |
| Ceded | 401,633 | 481,447 |
| *Net* | $ 878,492 | $ 763,257 |
| Earned Premiums: | | |
| Direct | $1,206,195 | $1,180,087 |
| Assumed | 26,355 | 20,345 |
| Subtotal | 1,232,550 | 1,200,432 |
| Ceded | 427,077 | 397,743 |
| *Net* | $ 805,473 | $ 802,689 |

## 6. RESERVE FOR LOSSES, LOSS EXPENSES AND REINSURANCE

Activity in the reserve for losses and loss expenses is summarized as follows:

| 2013: | GROSS | CEDED | NET |
|---|---|---|---|
| Reserve at January 1 | $2,993,698 | $ 875,910 | $2,117,788 |
| Incurred losses and loss expenses: | | | |
| Current year | 1,006,594 | 372,313 | 634,281 |
| Prior years | 34,690 | 96,756 | (62,066) |
| Total incurred losses and loss expenses | 1,041,284 | 469,069 | 572,215 |
| Paid losses and loss expenses: | | | |
| Current year | 122,537 | 41,476 | 81,061 |
| Prior years | 804,345 | 228,019 | 576,326 |
| Total paid losses and loss expenses | 926,882 | 269,495 | 657,387 |
| Effects of foreign exchange rate changes | (3,329) | (51) | (3,278) |
| Reserve at December 31 | $3,104,771 | 1,075,433 | $2,029,338 |
| Amounts currently due from reinsurers | | 32,941 | |
| *Due from reinsurers* | | $1,108,374 | |

| 2012: | GROSS | CEDED | NET |
|---|---|---|---|
| Reserve at January 1 | $2,904,281 | $ 716,226 | $2,188,055 |
| Incurred losses and loss expenses: | | | |
| Current year | 1,031,941 | 388,707 | 643,234 |
| Prior years | (111,499) | (96,404) | (15,095) |
| Total incurred losses and loss expenses | 920,442 | 292,303 | 628,139 |
| Paid losses and loss expenses: | | | |
| Current year | 101,827 | 16,685 | 85,142 |
| Prior years | 740,744 | 117,605 | 623,139 |
| Total paid losses and loss expenses | 842,571 | 134,290 | 708,281 |
| Effects of foreign exchange rate changes | 11,546 | 1,671 | 9,875 |
| Reserve at December 31 | $2,993,698 | 875,910 | $2,117,788 |
| Amounts currently due from reinsurers | | 39,034 | |
| *Due from reinsurers* | | $ 914,944 | |

For the years ended December 31, 2013 and 2012, changes in actuarial estimates of insured events in prior years have resulted in a net decrease to the reserve for losses and loss expenses of $62,066 and $15,095, respectively. The net decrease in 2013 was largely driven by an increase in ultimate losses and current year estimates of the cession across the Company's existing reinsurance programs for property, casualty and London lines of business. The net decreases in 2012 were primarily attributable to favorable loss development in certain lines of casualty business, offset by reserve strengthening for pollution business.

### ENVIRONMENTAL-RELATED CLAIMS

Included in the reserve for losses and loss expenses are amounts held for losses relating to manufactured gas plant cleanup costs and losses related to exposure to asbestos. In estimating amounts to be provided, management considers various information, including the number of reported claims, the continually evolving legal environment in each jurisdiction and the trends in remediation and medical costs. Management believes that the reserve for such losses is adequate; however, uncertainties exist as to the extent of coverage, the existence of other potentially responsible parties, the likelihood of the Company being liable, and the share of the ultimate cost, if any, that the Company will bear. Management periodically reviews this reserve as new information becomes available and as the legal environment changes; however, these exposures are difficult to predict.

### REINSURANCE

The Company cedes a portion of its risk by utilizing various reinsurance contracts in order to provide additional capacity for future growth and limit the maximum net loss potential arising from large risks. These contracts do not relieve the Company from its obligation to policyholders. The amounts recoverable from reinsurers are estimated in a manner consistent with the reserve for losses associated with the related reinsurance contracts.

The Company regularly evaluates the financial condition of its reinsurers and monitors credit risk with respect to amounts recoverable under these contracts. Failure of reinsurers to honor their obligations could result in losses to the Company; consequently, allowances are established for amounts deemed uncollectible. In order to minimize this credit risk, the Company seeks to cede business to reinsurers generally rated "A-" or better by accredited rating agencies such as A.M. Best. The Company considers reinsurers that are not rated or do not fall within the prescribed rating categories and may grant exceptions to the general policy on a case-by-case basis. As of December 31, 2013 and 2012, 95 and 96 percent, respectively, of the total reinsurance exposure was due from reinsurers rated "A-" or better.

To estimate the allowances for uncollectible reinsurance, the Company performs a default analysis consisting of a number of factors, including the amounts of ceded losses recoverable from the reinsurer and the credit rating of the reinsurer. As of December 31, 2013 and 2012, such allowances were approximately $28,261 and $23,967, respectively. There were no write-offs of ceded losses for the years ended December 31, 2013 or 2012. As of December 31, 2013 and 2012, current reinsurance recoverables had $3,373 and $1,804, respectively, overdue from reinsurers for 90 days or more.

(Expressed in thousands of U.S. dollars)

At December 31, 2013 and 2012, ceded losses recoverable with a carrying value of approximately $151,016 and $146,637, respectively, were associated with a single reinsurer. Also at December 31, 2013 and 2012, ceded losses recoverable with a carrying value of approximately $288,703 and $212,483, respectively, were associated with Underwriters at Lloyd's of London.

## 7. INCOME TAXES

The Company has received an undertaking from Bermuda that it will be exempt from any local profits, income or capital gains taxes until the year 2035. No such taxes are presently imposed in Bermuda.

The Company files U.S. and Canadian federal income tax returns. Furthermore, certain U.K. subsidiaries are required to file U.K. income tax returns, and a U.K. subsidiary files U.S. tax returns under Internal Revenue Code Section 953 (d).

The provision for income taxes for the years ended December 31, 2013 and 2012 is as follows:

| | 2013 | 2012 |
|---|---|---|
| Current (benefit) provision | $ (2,585) | $ 42,823 |
| Deferred provision (benefit) relating to: | | |
| Loss reserves | 7,544 | 4,323 |
| Net operating loss carryforwards | 7,039 | (45,387) |
| Capital loss carryforwards | 1,412 | 18,767 |
| Change in fair value of insurance and reinsurance contracts | 22,434 | 2,388 |
| Unearned premiums | (4,185) | 2,028 |
| Tax credit carryforwards | (2,032) | — |
| Basis difference in investments | (13,539) | 1,225 |
| Change in valuation allowance | (4) | (82) |
| Deferred foreign earnings | 30,742 | 689 |
| Policy acquisition costs | 689 | (4,076) |
| U.K. branch | 7,433 | (11,428) |
| Fixed assets basis difference | (942) | (714) |
| Other expenses | (10,318) | (12,395) |
| Claims equalization reserve | 1,220 | 9,762 |
| Effects of foreign exchange rates | 73 | 1,232 |
| Total deferred provision (benefit) | 47,566 | (33,668) |
| *Total income tax provision* | $ 44,981 | $ 9,155 |

The reconciliation between the Company's effective tax rate and the statutory tax rate is as follows:

| | TAX EFFECT 2013 | PERCENT OF PRE-TAX INCOME | TAX EFFECT 2012 | PERCENT OF PRE-TAX INCOME |
|---|---|---|---|---|
| U.S. federal income tax at statutory rate | $47,115 | 35.0% | $10,063 | 35.0% |
| Adjustments: | | | | |
| Tax-exempt interest | (338) | (0.3%) | (4,740) | (16.5%) |
| Foreign tax credit utilized | 1,058 | 0.8% | 1,068 | 3.7% |
| Change in valuation allowance | (4) | 0.0% | (82) | (0.3%) |
| Return to provision permanent | (2,687) | (2.0%) | 2,071 | 7.2% |
| Other permanent items | (163) | (0.1%) | 775 | 2.7% |
| *Total income tax provision* | $44,981 | 33.4% | $ 9,155 | 31.8% |

Deferred income taxes as of December 31, 2013 and 2012 relate to the following:

| | 2013 | 2012 |
|---|---|---|
| Deferred tax assets: | | |
| Loss reserves | $ 60,568 | $ 68,112 |
| Net operating loss carryforwards | 212,410 | 219,449 |
| Capital loss carryforwards | 24 | 1,436 |
| Unearned premiums | 19,988 | 15,803 |
| Tax credits | 18,932 | 16,900 |
| Basis difference in investments | 9,129 | — |
| Policy acquisition costs | 1,217 | 1,906 |
| U.K. branch | 22,713 | 12,394 |
| Other | 50,094 | 57,528 |
| Gross deferred tax assets | 395,075 | 393,528 |
| Less: Valuation allowance | (4,000) | (4,004) |
| *Deferred tax assets* | 391,075 | 389,524 |
| Deferred tax liabilities: | | |
| Unrealized investment gains on securities, net | (21,519) | (39,633) |
| Change in fair value of insurance and reinsurance contracts | (58,854) | (36,420) |
| Deferred foreign earnings | (54,156) | (23,414) |
| Fixed asset basis difference | (5,594) | (6,536) |
| Basis difference in investments | — | (4,410) |
| Claims equalization reserve | (10,982) | (9,762) |
| *Deferred tax liabilities* | (151,105) | (120,175) |
| Effects of foreign exchange rate changes | (4) | (24) |
| *Net deferred tax asset* | $239,966 | $269,325 |

The Company has $604,876 of net operating losses that are available to offset taxable income in future years. These net operating losses will begin to expire in 2019 and will fully expire in 2033. The Company has $13,247 of alternative minimum tax credits, which will not expire, and $5,687 and $3,653 of foreign tax credits as of December 31, 2013 and 2012, respectively. The foreign tax credits will expire between 2017 and 2023.

Management believes that based on its historical pattern of taxable income, the Company will more likely than not produce sufficient taxable income in the future to realize its deferred tax assets, after consideration of the valuation allowance.

At December 31, 2013 and 2012, the Company had no uncertain tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within the next 12 months.

On December 4, 2012, the Company received notice that one of its subsidiaries would be audited by the State of New Jersey for the 2008 - 2011 tax years. The audit was conducted and concluded in 2013 without significant income tax adjustments. On February 28, 2013, the Company received notice that the same subsidiary would be audited by the Internal Revenue Service for the 2011 tax year. The examination was concluded in 2013 without significant income tax adjustments.

The Company's consolidated financial statements are subject to routine audits by the Internal Revenue Service and other taxing authorities; however, there are currently no audits for any tax periods in progress.

## 8. POLICYHOLDERS' LIABILITY

The liability of each policyholder of the Company is limited to any unpaid premiums due to the Company from such policyholders and for premiums, if any, relating to the Company's retrospective premium plans.

Retrospective premium plans were retroactively discontinued for all policies incepting on or after January 1, 1988. Management is unaware of any events that would cause the application of any of the retrospective premium plans remaining in effect.

## 9. CONTINGENCIES

The Company is subject to legal proceedings, claims and other regulatory inquiries that arise in the ordinary course of its business. The Company provides for such activity through the establishment of reserves for losses and loss expenses. At the present time, management does not believe that the outcome of any of those matters will have a material adverse effect on the Company's financial position, operating results or cash flows.

The Company leases office space and equipment under various operating lease arrangements, which expire at various dates through 2021. Rent expense for the years ended December 31, 2013 and 2012 was $4,755 and $4,413, respectively. Aggregate minimum rental commitments of the Company as of December 31, 2013 are approximately $3,670 for 2014, $3,763 for 2015, $4,042 for 2016, 2017, and 2018 and $9,838 for all years thereafter until 2021.

## 10. SUBSEQUENT EVENTS

AEGIS has evaluated events subsequent to December 31, 2013, and through the consolidated financial statements issuance date of April 11, 2014.

## 11. DIVIDEND RESTRICTIONS AND MARGIN OF SOLVENCY

At December 31, 2013, there were no significant restrictions on the payment of dividends from the AEGIS Energy Syndicate to AEGIS London Holding.

The Company is registered under the Bermuda Insurance Act of 1978 and related regulations, which require that the Company maintain a minimum solvency margin of approximately $186 million for solvency and liquidity. The policyholders' surplus provided an excess margin of solvency of approximately $626 million at December 31, 2013.

## 12. OPERATING RESULTS BY LINE OF BUSINESS

Continuity credits, when declared by the Board of Directors of AEGIS, are earned by members based upon their individual proportionate shares of premiums and surplus attributable to the Company's General Liability and Directors & Officers Liability lines of business, as defined in the Company's bylaws. General Liability includes excess liability, fiduciary and employee benefits liability, professional liability and excess workers' compensation insurance. Directors & Officers Liability includes directors and officers liability and general partner liability insurance. Operating expenses directly attributable to a given line of business are charged correspondingly; the remainder is allocated based upon gross written premiums. Investment results and the results from all other lines of business are allocated to each line of business based upon its proportionate share of unearned premiums, reserve for losses and loss expenses, and total surplus.

Total surplus supports all insurance policies issued by the Company, regardless of type. The amounts of total surplus allocated by line of business are presented solely for informational purposes.

| | GENERAL LIABILITY | | DIRECTORS & OFFICERS LIABILITY | | TOTAL | |
|---|---|---|---|---|---|---|
| | 2013 | 2012 | 2013 | 2012 | 2013 | 2012 |
| Revenue: | | | | | | |
| Net premiums earned | $ 585,408 | $ 583,284 | $220,065 | $ 219,405 | $ 805,473 | $ 802,689 |
| Net investment income | 72,105 | 98,485 | 38,959 | 47,987 | 111,064 | 146,472 |
| Change in fair value of insurance and reinsurance contracts | 38,420 | (17,291) | — | — | 38,420 | (17,291) |
| *Total revenue* | 695,933 | 664,478 | 259,024 | 267,392 | 954,957 | 931,870 |
| Expenses: | | | | | | |
| Losses and loss expenses incurred | 464,099 | 540,726 | 108,116 | 87,413 | 572,215 | 628,139 |
| Commission expense | 63,860 | 76,476 | 33,913 | 36,906 | 97,773 | 113,382 |
| Other underwriting expenses | 81,604 | 91,408 | 33,208 | 36,028 | 114,812 | 127,436 |
| *Total expenses* | 609,563 | 708,610 | 175,237 | 160,347 | 784,800 | 868,957 |
| Income (loss) before continuity and other premium credits and income taxes | 86,370 | (44,132) | 83,787 | 107,045 | 170,157 | 62,913 |
| Continuity and other premium credits | 7,223 | 8,110 | 28,321 | 26,053 | 35,544 | 34,163 |
| *Income (loss) before income taxes* | 79,147 | (52,242) | 55,466 | 80,992 | 134,613 | 28,750 |
| Income tax (benefit) provision | 27,972 | (21,422) | 17,009 | 30,577 | 44,981 | 9,155 |
| *Net income (loss)* | 51,175 | (30,820) | 38,457 | 50,415 | 89,632 | 19,595 |
| Other comprehensive (loss) income | (22,052) | 20,544 | (11,587) | 10,110 | (33,639) | 30,654 |
| Total surplus, beginning of year | 254,349 | 264,625 | 845,841 | 785,316 | 1,100,190 | 1,049,941 |
| *Total surplus, end of year* | $ 283,472 | $ 254,349 | $872,711 | $ 845,841 | $1,156,183 | $1,100,190 |

# Independent Auditors' Report

Deloitte.

To the Members of Associated Electric & Gas Insurance Services Limited:

We have audited the accompanying consolidated financial statements of Associated Electric & Gas Insurance Services Limited (the "Company"), which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of income and comprehensive income, changes in surplus, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

### MANAGEMENT'S RESPONSIBILITY FOR THE CONSOLIDATED FINANCIAL STATEMENTS

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

### AUDITORS' RESPONSIBILITY

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits 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 consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### OPINION

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Associated Electric & Gas Insurance Services Limited as of December 31, 2013 and 2012, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

April 11, 2014
Parsippany, New Jersey

## Offices

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## 2014 AEGIS Meetings

**ANNUAL MEETING**

The Annual General Meeting of Members of the Company will be held in Charleston, SC, on October 30, 2014. Notice of the Meeting and the form of proxy will be issued to voting Members in late September 2014.

**POLICYHOLDERS' CONFERENCE**

The annual AEGIS Policyholders' Conference will be held July 28 – 31, 2014, in San Diego, CA. Registration information will be e-mailed and posted to our website in May 2014.

**OTHER MEETINGS AND SEMINARS**

AEGIS will also host a series of regional member and broker meetings, Claims Roundtable seminars, and a number of underwriting, claims and loss control seminars and webinars throughout 2014. Please visit aegislink.com for details.

*Associated Electric & Gas Insurance Services Limited ("AEGIS") was incorporated in Bermuda in 1971 and commenced underwriting activities in 1975. AEGIS is registered as a Class 2 non-assessable mutual insurance company in Bermuda.*

*AEGIS is an eligible surplus lines insurer in all jurisdictions of the United States. It is subject to United States federal income taxes, files the required tax returns and maintains a United States trust fund in excess of $150,000,000. AEGIS is also a licensed foreign insurance company in all provinces and territories of Canada and on the general register of foreign reinsurers in Mexico.*

*AEGIS' operations are supported by its wholly owned managing general agent, AEGIS Insurance Services, Inc. ("AEGIS Services"), which provides AEGIS and its affiliates with professional staff and services.*

*AEGIS Energy Syndicate 1225 at Lloyd's of London ("AES 1225") commenced operations in 1999. AES 1225 operations are supported by AEGIS Managing Agency Limited, also known as AEGIS London, which provides professional staff and services for AES 1225. AEGIS Electric & Gas International Services Limited ("AEGIS International") is a corporate member of Lloyd's and the sole capital provider of AES 1225. Both AMAL and AEGIS International are subsidiaries of AEGIS through AEGIS Holding Inc.*

AEGIS