

ENERGY INSURANCE MUTUAL 2005 ANNUAL REPORT





While the English were the first to settle the island now known as Barbados, it was the Portuguese who found the island, saw the Bearded Fig Tree, and named the island “Los Barbados” which means “The Bearded Ones.” The English dropped the “Los” and called the island Barbados. The Bearded Fig Tree, shown prominently on the Barbadian Coat of Arms, is illustrated on the cover and on the next several pages of this annual report.

Energy Insurance Mutual Limited, known as EIM,
was incorporated June 13, 1986, in Barbados, where it remains
domiciled. The Company wrote its initial policies for 17 founding Members
on July 1, 1986. Each of the 17 remains among the 175 Member Insureds
that EIM served at year-end 2005.

Since early 1988, the Company has had its operating
offices in Tampa, Florida.



Celebrating throughout the year 2006 the 20th Anniversary
of Energy Insurance Mutual, the Company recalls on the next several
pages its beginnings and salutes five individuals who were
instrumental in establishing and shaping EIM.



THE FIVE FOUNDING DIRECTORS RECALL THE BEGINNING OF ENERGY INSURANCE MUTUAL

Energy Insurance Mutual received its certificate of incorporation on June 13, 1986, in Barbados, and wrote its initial 17 policies on July 1, 1986. The Company is, thereby, celebrating its 20th anniversary throughout the year 2006, using the theme line, “20 years of remarkable service.”

The story of EIM begins in the spring of 1985 when very little, if any, affordable Directors and Officers coverage was available in the commercial markets. Irene Moszer, an execu-

tive at Virginia Power in Richmond, was among the many that were frustrated and concerned.



In this photograph, taken in 1986 in Barbados, are seated, from left, Tom Nunnally and Irene Moszer, and standing, from left, Harlan Dellis, Conrad Faulk, and Jerry Maloney.

Irene suggested to her CEO that the industry should explore the possibilities of putting a company together to provide excess liability and D&O, similar to what the industry had done already in respect of nuclear property. The CEO gave his approval.

I first mentioned to industry colleagues the idea of forming a mutual at my first NEIL board meeting, Irene said. I

chatted with a few people after making a short impromptu speech. The next step was writing a letter to 150, maybe 200, CEOs of U.S. electric utilities. The letter was signed by the chairman of Virginia Power, and it outlined the problem and said there would be further correspondence about having a meeting.



That meeting was held on June 25, in Chicago. There were over 90 people there who represented 67 electric utilities. By this time, the D&O situation was becoming an insurance crisis. Senior managements and board members were greatly concerned. The meeting ended with a vote to do a feasibility study.

The feasibility study steering committee that was formed included, among several others, EIM Founding Directors Harlan Dellsy, Conrad Faulk, Jerry Maloney, Irene Moszer, and Tom Nunnally. They and selected consultants did the work of putting the Company together, with all of the work being done outside the United States.

In a Company article published after Founding Director and First Chairman Irene Moszer had left the EIM board of directors, the other four founders all agreed: EIM was Irene's idea. She is the one who had the vision.

This is the story of EIM's founding, largely told in the words of the founders themselves, words taken from the Company's archives.

IRENE MOSZER

An academician with a Ph.D. in economics, Irene began her utility career in 1978 with Virginia Power, first as an analyst building forecasting models; later as a district manager. She speaks proudly of having driven trucks and climbed poles, especially of having bare-handed a 500-kv line. When she was elected vice president of administrative services in 1984, one of her responsibilities was insurance.

I knew absolutely nothing about insurance.

After the June 25 meeting, the CFOs of the 67 companies were asked to provide \$10,000 initially, with a second check later in the same amount if the feasibility study demonstrated sufficient promise. (The \$20,000 were returned in the summer of 1986 to those companies that had participated in the study whether they had joined EIM or not.)

The first meeting of the steering committee (there were 10 members) was in September 1985 in Toronto, Ontario, Canada. The steering committee met every four to six weeks, usually for two days and usually in Toronto.



Early on, Irene and several other members of the committee took their plans to Europe. They were seeking relationships that would later result in EIM having reinsurance soon after it began doing business.



Irene M. Moszer, Ph.D, was vice president, administrative services, Virginia Power, Richmond, when elected to the EIM Board and named the Company's first chairman and CEO. She chaired the Board for two terms, and she remained a member of the EIM Board and its executive committee until December 1994. She had retired early from Virginia Power that June and left the electric utility industry. Irene was CEO of General Resource Management, Inc., in Richmond from 1994 to 1997. After that, she was chief financial officer, first at Marietta College, Marietta, OH; and then at Pacific University, Forest, OR. In early 2005, she became vice president for business and finance at Alfred University, Alfred, NY.

We had nine presentations in five days in five different countries. It was an exhausting but exhilarating experience.

By April of the next year, we were ready to recommend the formation of a mutually owned excess insurance company. We made that announcement at a RIMS meeting.

EIM then stood for Electric Insurance Mutual. The membership base was broadened soon thereafter to include gas utilities, and thus the name became Energy Insurance Mutual.

By February, certainly March, it was clear that the Company location would be Barbados, not Bermuda. In that same time

frame, Trevor Carmichael and his firm were selected to be local legal counsel, an accounting firm was chosen, and potential sites for an office were visited.

From April to June, we put a company together; we worked like crazy. Sedgwick provided a general manager, and he hired or moved staff there to work exclusively for EIM in an office in downtown Bridgetown.

Our goal was to begin with \$75 million. On July 1, the day we did begin, we were \$3 million short, and the 17 original Members were only 96 percent covered for the first two weeks of the Company's existence. Fortunately, the 18th Member joined July 15, and we realized our financial goal of full coverage!

When leaving the EIM board, which was effective December 15, 1994, Irene said, *EIM*



has more than fulfilled my initial expectations. It absolutely was a once-in-a-lifetime experience.

JERRY MALONEY

I keenly and fondly remember 1986: the key decision to incorporate EIM in Barbados; the monthly 20-hour round trips; meetings in badly lit hotel conference rooms with noisy air conditioning units; fretting over the “big question,” which was whether EIM could achieve an adequate critical mass of participation in order to provide full coverage on July 1, 1986; and the gradual shrinkage of the initial feasibility study task force to the “group of five” which began to function as EIM’s board, management committee, underwriting and reinsurance committees, finance and audit committees, with a “rent-a-staff” group provided by Sedgwick.

And later that same year, the steady growth of the enterprise, gradual expansion of the board and other resources, and, finally, the initial analysis of the 1986 IRS amendments that led eventually to the move, in 1988, of EIM’s operations to Tampa.

It was an exciting and eventful year, and that’s been the pattern for EIM ever since—adapting to change and new challenges.



Gerald P. Maloney (Jerry) was senior vice president-finance, American Electric Power, when he joined the EIM Board in 1986. He became the Company’s third chairman and CEO, and he served for two terms, one beginning in April 1990 and the second in April 1991. His leadership as chairman of the Board’s investment committee was particularly valuable in the early years when the Board was determined to build the Company’s financial strength and reputation. When he left the EIM Board in 1999—the last of the founding directors who also had worked on the feasibility study in 1985-1986—Jerry was executive vice president and chief financial officer of AEP, a greatly expanded utility with its then recent acquisition of Central and South West.

CONRAD FAULK

Since day one, EIM has thought and worked as an organization dedicated to mutual interests and trust. Those characteristics also have been verified by those who count most—our Risk Manager Representatives, our Member Representatives, and our Member Brokers.



Conrad R. Faulk, who was the only founding director from the feasibility study who had been a risk manager, came to the EIM Board when he was vice president, risk management policy, MSU System Services, New Orleans, now Entergy Services. He took early retirement from Entergy on May 31, 1992. The directors asked him to remain on the EIM Board, and thereafter Conrad served two terms as chairman of the board and CEO, beginning in April 1993. He also was the Company's acting president and chief operating officer from April 1994 until September 1994. He did not stand for re-election in April 1995.



Harlan M. Dellsy served on the EIM Board of Directors from 1986 until 1996. Also, during that decade, he was a member of the executive committee and chaired the claims committee. He retired in February 1996 from ComEd, Chicago, as vice president. ComEd was then an operating unit of UNICOM Corporation, which has since been acquired by EIM Member Exelon Corporation. He continued after retirement to manage UNICOM's strategic planning as an independent consultant. Harlan also chaired briefly EIM's strategic planning task force, which soon thereafter became a standing committee of the Board of Directors.

We read that customer-driven organizations cannot be satisfied with just meeting expectations. They must exceed their customers' expectations. And they must never stop trying to improve. EIM's management, including the board of directors, embraces that philosophy and will continue to live it.

We always felt that EIM would be successful. We recognized the needs that presented themselves so clearly in 1985 and 1986, and we committed EIM to meeting those needs, not just immediately, but for the long-term. And the Company has been even more successful than first envisioned. Why? Because it has been a true team effort, and we've always set "stretch goals" and met them, usually even exceeded them.

HARLAN DELLSY

During his utility career, Harlan Dellsy also served on the board of several electric industry insurance captives, including Nuclear Electric Insurance Limited, where he was chairman from 1991-1995.

Initially, the driving factor that led to EIM's formation was the larger companies' inability to obtain D&O insurance. This was of particular concern to those companies in the nuclear business—but we quickly transcended that origin. EIM became a

successful organization servicing an entire industry, and we, therefore, had to be—and must remain—very market driven.



The two fundamental questions EIM will have to ask itself are: What will our Members ask of us, and why will companies want to deal with EIM rather than some other insurer?

TOM NUNNELLY

It all boils down to people helping each other and helping themselves. Volunteerism represents untold hours of time that are given without payment. And that brings me to Energy Insurance Mutual and its volunteer Risk Managers and Member Representatives.

We truly owe a great debt to those representatives of our Member Insureds who “run” our company. Having been involved from the days of the task force that led to EIM’s formation, I know firsthand the many, many hours the founding directors and officers provided.

Even now, with a first-rate staff of professionals taking care of the day-to-day business of EIM and its Policyholders, there’s the on-going work of the standing committees of the board. There are four board meetings each year, usually taking at least two days away from the directors’ paying jobs.

There is our hard-working Insurance Advisory Committee. Frequently, it is this group of risk managers, all of whom work, of course, for various Insureds, that lead the Board’s agenda, especially when it comes to improving our products and expanding our services. The IAC also meets four times annually.

The mutual concept is truly a business enterprise that moves forward on volunteerism.

I’m actually singing praises for ALL the volunteers who make Energy Insurance Mutual exactly what we want it to be: Our Company.



Thomas A. Nunnely (Tom), executive vice president, Southern Company Services, Atlanta, was EIM’s first president and second chairman of the board and CEO. He served as president from June 1986 to March 1988 when he was elected EIM chairman. The following year, Tom took early retirement from Southern Company. The EIM Board, however, asked him to stand for re-election as EIM chairman in 1989, and he continued to serve until April 1990. He served continuously as a member of the Board’s five-person executive committee.

AEGIS Insurance Services, Inc. ■ AGL Resources Inc. ■ Alabama Electric Cooperative, Inc. ■ Allegheny Energy, Inc. ■ ALLETE, Inc. ■ Alliant Energy Corporation ■ Ameren Corporation ■ American Electric Power Company, Inc. ■ American Transmission Company LLC ■ Anadarko Petroleum Corporation ■ Apache Corporation ■ Aquila, Inc. ■ Associated Electric Cooperative, Inc. ■ Atmos Energy Corporation ■ Avista Corporation ■ Basin Electric Power Cooperative ■ Black Hills Corporation ■ British Columbia Hydro and Power Authority ■ British Columbia Transmission Corporation ■ California Independent System Operator ■ Calpine Corp. ■ CenterPoint Energy, Inc. ■ Central Vermont Public Service Corporation ■ CenturyTel, Inc. ■ CH Energy Group, Inc. ■ Chesapeake Energy Corporation ■ Chugach Electric Association, Inc. ■ Cinergy Corp. ■ Citizens Gas & Coke Utility ■ City of Richmond, Department of Public Utilities ■ City Utilities of Springfield, MO ■ Cleco Corporation ■ CMS Energy Corporation ■ Colonial Pipeline Company ■ Complete Energy Holdings, LLC ■ Connecticut Yankee Atomic Power Company ■ Consolidated Edison Company of New York, Inc. ■ Constellation Energy Group, Inc. ■ Deseret Generation & Transmission Co-operative ■ Devon Energy Corporation ■ District of Columbia Water and Sewer Authority ■ Dominion Resources, Inc. ■ DPL Inc. ■ DTE Energy Company ■ Duke Energy ■ Duquesne Light Holdings, Inc. ■ Dynegy Inc. ■ E.ON AG ■ Edison International ■ El Paso Corporation ■ El Paso Electric Company ■ Electric Reliability Council of Texas, Inc. ■ Empire District Electric Company (The) ■ Enbridge Inc. ■ Energen Corporation ■ Energy Corporation of America ■ Energy East Corporation ■ EnergySouth, Inc. ■ Enron Corp. ■ Entergy Corporation ■ Enterprise Products Partners, L.P. ■ EOG Resources, Inc. ■ EPPIC (City of Anaheim) ■ EPPIC (Imperial Irrigation District) ■ EPPIC (Modesto Irrigation District) ■ EPPIC (Orlando Utilities Commission) ■ Equitable Resources ■ Exelon Corporation ■ Ferrellgas, L.P. ■ FirstEnergy Corp. ■ Florida Public Utilities Company ■ FPL Group, Inc. ■ Grand River Dam Authority ■ Great Plains Energy Incorporated ■ Great River Energy ■ Hawaiian Electric Industries, Inc. ■ Hydro One Inc. ■ Hydro-Quebec ■ IDACORP, Inc. ■ Independent Electricity System Operator ■ Inergy, LP ■ InterGen N.V. ■ Intermountain Industries, Inc. ■ ITC Holdings Corporation ■ IPALCO Enterprises, Inc. ■ Iroquois Gas Transmission System, LP ■ ISO New England Inc. ■ JEA and FPL d/b/a St. John's River Power Park ■ KeySpan Corporation ■ Kinder Morgan, Inc. ■ Laclede Group, Inc. (The) ■ Long Island Power Authority ■ Los Angeles Dept. of Water and Power ■ Massachusetts Water Resources Authority ■ MDU Resources Group, Inc. ■ Metropolitan Water District of Southern California ■ MGE Energy, Inc. ■ MidAmerican Energy Holdings Company ■ Midwest Independent Transmission System Operator ■ Mirant Corporation ■ Mountaineer Gas Company ■ National Energy & Gas Transmission, Inc. ■ National Fuel Gas Company ■ National Grid plc ■ National Grid USA ■ New Jersey Resources Corporation ■ New York Independent System Operator, Inc. ■ New York Power Authority ■ Nicor Inc. ■ NiSource Inc. ■ Northeast Utilities ■ Northern Border Pipeline Company ■ Northwest Natural Gas Company ■ NorthWestern Corporation ■ Noverco Inc. ■ NRG Energy, Inc ■ NSTAR ■ OGE Energy Corp. ■ Ohio Valley Electric Corporation ■ ONEOK, Inc. ■ Ontario Power Generation Inc. ■ Otter Tail Corporation ■ Peoples Energy Corporation ■ Pepco Holdings, Inc. ■ PG&E Corporation ■ Philadelphia Gas Works ■ Piedmont Natural Gas Company, Inc. ■ Pinnacle West Capital Corporation ■ PJM Interconnection, LLC ■ PNM Resources, Inc. ■ PPL Corporation ■ Progress Energy, Inc. ■ Public Service Enterprise Group Incorporated ■ Public Utility District No. 2 of Grant County, WA ■ Public Utility Risk Management Services Joint Self-Insurance Fund ■ Puget Energy, Inc. ■ Questar Corporation ■ Reliant Energy, Inc. ■ RGC Resources, Inc. ■ Sacramento Municipal Utility District ■ Salt River Project Agricultural Improvement and Power District ■ SCANA Corporation ■ Scottish Power plc ■ SEMCO Energy, Inc. ■ Seminole Electric Cooperative, Inc. ■ Sempra Energy ■ Sierra Pacific Resources ■ South Mississippi Electric Power Association ■ Southern Company ■ Southern Union Company ■ Southwest Gas Corporation ■ Suburban Propane Partners, LP ■ T. W. Phillips Gas and Oil Co. ■ Targa Resources Investments Inc. ■ TECO Energy, Inc. ■ Tennessee Valley Authority ■ Texas Genco LLC ■ Titan Propane LLC ■ Toronto Hydro Corporation ■ TransCanada PipeLines Limited ■ Transocean Inc. ■ Tri-State Generation and Transmission Association, Inc. ■ TXU Corp. ■ UGI Corporation ■ UIL Holdings Corporation ■ UniSource Energy Corporation ■ Vectren Corporation ■ Westar Energy, Inc. ■ Western Electricity Coordinating Council ■ Western Gas Resources, Inc. ■ WGL Holdings, Inc. ■ Williams Companies, Inc. (The) ■ Wisconsin Energy Corporation ■ WPS Resources Corporation ■ Xcel Energy Inc.



Energy Insurance Mutual, or EIM,
is a mutually owned insurance company that
provides its Members with substantial capacity on its
core products: Excess General Liability (EGL),
Excess Directors and Officers Liability (EDO), and
Excess Fiduciary Liability (EFL), each coverage for
losses in excess of at least \$25 million.

In addition, capacity is available on
Property risks for those Members who purchase
EGL and/or EDO coverage.

Membership in EIM is available to utilities and
organizations in the energy services industry.



CEO'S REVIEW OF THE YEAR 2005



In 2005 we:

- Paid claims of \$170.9 million
- Established new case reserves of over \$104 million

Our Financials yielded:

- Gross Written Premiums of \$213.4 million
- Net Investment Income of \$28.5 million
- Net Income of \$44.7 million
- Increase in unrealized appreciation of investments of \$14.3 million

all of which resulted in our ending the year with Surplus of over \$547.5 million, representing an increase from 2004 of \$59 million, or slightly over 12 percent.



Last year, I indicated that the Board and management were “firmly committed to re-instituting regular Distributions, and this will be a subject of continuing discussion during 2005.” It was, therefore, with great pleasure that I was able to announce in mid-December that EIM was declaring a \$10 million Distribution of Policyholders’ Surplus. This will bring the total amount returned to Policyholders up to in excess of \$157 million and will be our first Distribution since 2001. We will, of course, be looking at each year carefully, but I am hopeful that this will be the commencement of a regular series of Distributions.

Of course, the reason that we halted Distributions in 2002, was the unprecedented number of Directors and Officers Liability losses that we had received and reserved during that year. At the end of 2005, we had incurred (paid and specifically reserved) losses of almost \$311 million, and over the last 12 months, we saw considerable settlement activity that, no doubt, will be continuing in 2006. With the passage of time, we are obviously obtaining a much better grasp of the magnitude of these losses. I would be the first to admit that although we have probably not gotten it exactly right yet, we are a lot closer now than we were at the end of 2004.

A question that crops up with some degree of regularity is when are we going to start issuing multi-year policies once again. As a point of reference, EIM first started allowing for three-year policies to be issued on January 31, 1989, and this practice was discontinued on October 2, 2001. It was, therefore, not until late 2004 that we were able to complete the review of our book of business. Now that we know that the industry we serve can, at times, be much more volatile than we ever anticipated, we do believe that non-cancelable, multi-year programs are not coming back any time soon. We at EIM would like to think that we learn from our mistakes and accordingly correct any future actions. Having said that, I am sure that in the not too distant future someone will start offering multi-year deals, and pressure will be brought to bear on us to do likewise. We will resist in no uncertain terms.

In last year’s Annual Report, we advised everyone that some reinsurers were disputing certain losses, which fell in the 2002 and 2003 years. The three reinsurers that we were having a problem with were two Lloyd’s syndicates and a London company—none of which had an ongoing relationship with us. By year-end, we had concluded identical commutation agreements with all three entities. In addition, we were having collection problems with two domestic reinsurers, both of whom were in solvent run-off, but were able to collect the amounts due by the close of 2005. We, therefore, had no disputed reinsurance recoverables at the end of 2005. These types of situations are extremely time consuming and costly, let alone monumentally annoying. From everything that one reads and hears, disputes and the slowing down of the payment process are becoming more and more commonplace, and I can only lament this rather cynical approach to our business. Having said that, it appears to have become a fact of life in an insurance company’s dealings with their past reinsurers. I have always been a little old fashioned in that I do believe in long-term relationships and certainly bring that philosophy to the table in our relationships with our reinsurers. Although I have been disappointed that some of our past reinsurers have not shared my thoughts on the subject, I do believe that our existing group does, in fact, have similar views to mine.

The Property marketplace, having been hit with a devastating 2005 hurricane season, is understandably seeing rates firming across the board. In situations where there is potential hurricane exposure, the



rates will have to be adjusted upwards and terms amended to reflect that fact. With the estimated eventual payout by the insurance marketplace of something in excess of \$50 billion for Katrina, Rita, and Wilma, there is inevitably a ripple effect across other lines of business, which were not actually impacted by the storms.

The General Liability arena exhibited reasonable stability throughout 2005, and we would obviously like to see that trend continue for some time to come.

In the area of Directors and Officers Liability, we had seen what we regarded as irrational competition from insurers who were not hindered by legacy issues. A year later, we are seeing a leveling of pricing which we are hopeful will continue for a while.

Fiduciary Liability is the one area where we are seeing some modest premium increases, and there are some very real reasons why that class of business needs to be looked at a little more seriously than in the past—yes, you can have losses under a Fiduciary Liability policy.

We can only hope that we are now entering a period of relatively stable pricing across all lines. Of course that has been a long-held dream, which rarely lasts longer than one renewal cycle. Why is it that, as a matter of course, we expect to pay more for products and services from one year to the next, yet for the products that EIM provides, the presumption is normally that there will be a reduction? It is indeed a strange business that we are in.

During 2006, we are, of course, celebrating our 20th anniversary. It would be extremely easy to become pompous about the relative success of EIM and place that at the feet of the individuals who have been involved with the Company over the years. Although there is no doubt that EIM is a product of all the individuals who have ever been involved with the Company, there is an extremely important contributing factor that I can only refer to as good luck. From July 1, 1986 to December 31, 1999, or 13 and one half years, EIM actually paid out slightly under \$25 million, and then our luck ran out. From 2000 through 2005, or six years, EIM has paid out over \$563 million. The fact that we have seen this significant outflow of funds, yet our Surplus has grown, does attest to the financial resilience of EIM.

Our sole subsidiary, Energy Insurance Bermuda (EIB), had a number of issues during 2005 and consequently required considerably more of management's time than we would normally like. We found it necessary to move the auditing function to KPMG, and in this new world we live in, they have found it necessary to be extremely thorough. We also moved the management function over to International Advisory Services. We are monitoring the ongoing activities of EIB extremely closely, and if further remedial action needs to be taken, it will be.

Our Insurance Advisory Committee saw some changes during 2005 and early 2006, when Mike Hulsey of the City of Richmond and Donna Pederson-McGinnis of Dynegy resigned from the committee. I would like to offer my thanks to these individuals for their support and invaluable work over the years. We welcomed Bob Dillard of Kinder Morgan and Sandy Hart of Northwestern Natural Gas. We certainly look forward to working with these new members in the months and years to come.



Our Board saw little change in 2005 other than the fact that Mark Dodson, president and CEO of Northwest Natural Gas Company, and Chuck Shivery, chairman, president, and CEO of Northeast Utilities became the chairman and vice chairman, respectively, of EIM. I have known both of these individuals for quite some time now, have great respect for both of them, and look forward to working with them in their new roles at EIM.

It never ceases to amaze me that we can do what we do with so few people, that is of course, the day-to-day activities of running an insurance company. There are, in addition, another 20 people who offer advice and counsel to management whether we think we need it or not. I cannot overemphasize the importance of the Board and Insurance Advisory Committee (IAC) to EIM. The Board provides the necessary oversight to the activities of EIM, and the IAC keeps us fully up to date as to the changing needs of our Members. It is extremely gratifying to have this group of individuals who are prepared to share their expertise and time with us, and inadequate as it seems, I can only offer our thanks to each and every one of them.

Since our retention rate was 96 percent, I would like to thank our Members for their continued loyalty to EIM during 2005.

In looking at the Administrative Expense and comparing it to Gross Earned Premium, we continue to operate at what we believe to be an extremely efficient factor of 3.47 percent.

I would be the first to admit that I can be guilty of repeating myself, but having been employed by a small company for over 11 years with a handful of products, it becomes almost inevitable. The face of EIM, the heart and soul of EIM, are, of course, the other 17 individuals that comprise our staff. We do not always agree, but on a personal level, I find that disagreement fosters discussion which can prove enlightening. Who said you cannot teach an old dog new tricks?

We look forward to working with you in the months ahead.

A handwritten signature in black ink, appearing to read 'David L. Hadler', with a horizontal line underneath.

David L. Hadler
President and Chief Executive Officer
April 4, 2006



HIGHLIGHTS OF THE YEAR 2005

At year-end 2005, EIM had 175 Members, two more than at year-end 2004.

We gained nine new Members and lost seven, mainly due to policies being rolled into master policies. Our retention rate for 2005 was, therefore, an impressive 96 percent, although down from 2004's rate of 98.9 percent.

In 2005, gross premium earned reached \$215.0 million. The comparative number at the end of 2004 was \$215.8 million. A reduction came from the casualty business—almost \$182.4 million in 2005 compared to almost \$182.7 million in 2004. Property decreased somewhat, going from almost \$33.1 million in 2004 to more than \$32.6 million in 2005.

In 2005, the Company completed work on the new underwriting computer system, a system that allows us to e-mail indications, quotes, and binders. The EIM Policy Information Center (EPIC) was activated January 1, 2006, for all casualty business. As part of the document review, every EIM policy form was updated and now carries a 1/1/06 edition date. There were no changes to coverage.

This past year, EIM paid claims totaling \$170.9 million. Thus far, in the 21st century, the Company has paid losses of more than \$563 million. Fortunately, in the first 13^{1/2} years, total losses were just under \$25 million. Also, at year's end, EIM had loss reserves, including incurred but not reported, of over \$666 million.

The 2005 storm season brought EIM its first Excess General Liability notices due to hurricanes. To date, no EGL claims have been filed. 2005 was an active year for Property losses. The gross loss for Katrina, Rita, and Wilma has been estimated at \$12.6 million.

Despite losses for claims paid in recent years, Policyholders' Surplus has grown.

At year's end, Surplus had climbed to more than \$547.5 million, which is \$59 million more, or more than 12 percent, than the previous year's end.



In December, the EIM Board approved a \$10-million Distribution, which was the first Distribution since 2001, when Distributions were halted as the directors anticipated unprecedented losses and the need to build Surplus. The 2005 declaration means that the total amount returned to Policyholders since the first Distribution in 1988 is now more than \$157 million.

At December 31, 2005, the Company had invested assets of \$1,115.7 million.

The invested assets by class were: U.S. treasuries, \$24.0 million; municipals, \$304.5 million; corporates, \$66.6 million; mortgage backed, \$78.0 million; common equities, \$529.0 million; preferred stock, \$34.6 million; cash and cash equivalents, \$73.2 million; and accrued interest, \$5.8 million.

EIM's long-standing investment policy continued in 2005 to emphasize high quality, avoidance of concentration, and adequate liquidity. All asset allocations were within their respective drift ranges: U.S. equity, 30 to 45 percent; non-U.S. equity, 10 to 20 percent; and fixed income, 40 to 55 percent.

The Company's portfolio of \$1,115.7 million compares to \$1,003.7 million for the year before, and the 6.0-percent return follows a 9.2-percent return the previous year. The portfolio's three-year return was 10.9 percent; five-year, 4.8 percent; and seven-year, 4.9 percent.

In the IAC's annual Customer Satisfaction survey, 99 percent agreed or strongly agreed that EIM follows reasonable, prudent, and sound underwriting practices.

That was up from 98 percent in 2004. Also, 99 percent agreed or strongly agreed that EIM met Member expectations in level of service. On another significant measurement, 96 percent of the respondents indicated that EIM provides added value in the form of broad coverage, price stability, consistent limits, and financial strength.



EIM BOARD OF DIRECTORS



Richard H. Marsh (Rich)
Senior Vice President and
Chief Financial Officer
FirstEnergy Corp., Akron

Dudley C. Reynolds
President and Chief Operating Officer
Alabama Gas Corporation, Birmingham

Trevor A. Carmichael
Barrister at Law
Chancery Chambers,
Bridgetown, Barbados

David L. Hadler
President and Chief Executive Officer
Energy Insurance Mutual, Tampa

James R. Hatfield (Jim)
Senior Vice President and Chief
Financial Officer
OGE Energy Corp., Oklahoma City

Charles W. Shivery (Chuck)
Chairman, President, and Chief
Executive Officer
Northeast Utilities, Berlin, CT



Mark S. Dodson
President and Chief Executive Officer
Northwest Natural Gas Company,
Portland

Allen L. Leverett
Chief Financial Officer
Wisconsin Energy Corporation,
Milwaukee

Kimberly S. Greene (Kim)
Senior Vice President, Finance, and
Treasurer
Southern Company Services, Atlanta

J. Barry Mitchell
President
ComEd, Chicago

Bruce R. Worthington
Senior Vice President and
General Counsel
PG&E Corporation, San Francisco

Michael W. O'Donnell (Mike)
Executive Vice President and
Chief Financial Officer
NiSource Inc., Merrillville, IN



BOARD COMMITTEES

AUDIT COMMITTEE

James R. Hatfield (Chairman)
Charles W. Shivery (Vice Chairman)
Kimberly S. Greene
Allen L. Leverett
Michael W. O'Donnell
Dudley C. Reynolds

CLAIMS COMMITTEE

Bruce R. Worthington (Chairman)
Mark S. Dodson (Vice Chairman)
David L. Hadler
Dudley C. Reynolds

EXECUTIVE COMMITTEE

Mark S. Dodson (Chairman)
Charles W. Shivery (Vice Chairman)
David L. Hadler
Bruce R. Worthington

INSURANCE ADVISORY COMMITTEE

William R. Powell (Chairman)
George Schuitema (Vice Chairman)
Robert W. Dillard
Deborah S. Gaffney
James O. Hess, Jr.
John E. Luley
Robert J. Semet

Michael G. Whelan

Michael L. Wilson

INVESTMENT COMMITTEE

J. Barry Mitchell (Chairman)
James R. Hatfield (Vice Chairman)
Mark S. Dodson
Allen L. Leverett
Richard H. Marsh

NOMINATING COMMITTEE

Charles W. Shivery (Chairman)
Kimberly S. Greene
James R. Hatfield
J. Barry Mitchell

REINSURANCE COMMITTEE

Bruce R. Worthington (Chairman)
David L. Hadler
Richard H. Marsh
J. Barry Mitchell

STRATEGIC PLANNING COMMITTEE

Mark S. Dodson (Chairman)
David L. Hadler
J. Gary Meggs
Michael W. O'Donnell
William R. Powell
Dudley C. Reynolds
Charles W. Shivery



EIM OFFICERS



Charles W. Shivery
Vice Chairman of the Board

Mark S. Dodson
Chairman of the Board

Jill Dominguez
Vice President-Underwriting

Trevor A. Carmichael
Assistant Secretary

Samuel M. Garvin, Jr.
Vice President and CFO

Donna Dunlap
Secretary

David L. Hadler
President and CEO



INSURANCE ADVISORY COMMITTEE



IAC Chairman **William R. Powell**
Manager, Risk Management
Salt River Project, Phoenix



Michael L. Wilson
Director, Risk Management
Entergy Services, Inc., New Orleans



Robert J. Semet
Insurance Director
Exelon Corporation, Philadelphia



Robert W. Dillard
Director, Risk Management
Kinder Morgan, Inc., Houston



John E. Luley
Manager, Corporate Insurance
Pepco Holdings, Inc., Washington, D.C.



Michael G. Whelan
Director, Risk and Insurance
TXU Business Services, Dallas



Deborah S. Gaffney
Risk and Insurance Manager
Southern Company Services, Inc., Atlanta



James O. Hess, Jr.
Director, Liability and Financial Insurance
Duke Energy, Charlotte



IAC Vice Chairman **George Schuitema**
Director, Insurance and Claims
Peoples Energy Corporation, Chicago



THE PRODUCTS WE PROVIDE

GENERAL LIABILITY

EIM's Excess General Liability policy is written specifically to cover a Member's liability for bodily injury, property damage, and personal injury to third parties that may arise out of the Member's operations, including:

- Premises and operations hazards (world-wide)
- Automobile
- Products and completed operations
- Failure to supply
- Pollution
- Joint ventures

The EIM Excess General Liability policy is a following form policy that is written on a claims-made basis. In addition to the general coverages outlined above, the EGL policy can be endorsed to cover:

- Excess Employment Practices Liability
- Excess Professional Liability (subject to a \$65-million sub limit)
- Excess Worker's Compensation and Employer's Liability coverage

Often, policies underlying EIM place an annual aggregate on their limits. EIM's policy can be endorsed to drop down over eroded or exhausted aggregates in the underlying policies.

EIM offers capacity of up to \$100 million excess of at least \$35 million in underlying coverage.

D&O

The lack of Excess Directors and Officers Liability capacity was the very reason EIM was formed in mid-1986. There is no lack of capacity in the current market; it is simply a question of form and price.

In today's litigious society, Excess Directors and Officers Liability insurance is a critical coverage. Without such protection, many individual directors and officers would be unwilling to sit on corporate boards.

Up to \$50 million in D&O limits can be offered, which places EIM among the top capacity providers of this type of coverage to utilities and the energy services industry.

The policy is written on a claims-made basis. The minimum attachment point EIM will consider is \$35 million. The EIM policy is a following form policy, which in the majority of cases follows the AEGIS form. As such, the EIM policy can include an affirmative grant on nuclear coverage, no pollution exclusion, and optional enti-

ty coverage that can cover corporate entity securities claims. Excess General Partner Liability policies also are available.

FIDUCIARY

Fiduciary Liability settlements have continued to increase in number and in size. This trend began several years ago as fiduciary "tag-along" suits were routinely filed in conjunction with securities claims suits. These "tag-along" suits frequently result after an employer's stock, located in a company sponsored retirement benefit plan, suffers a loss in value resulting in a securities and fiduciary lawsuit. Plaintiff's attorneys now view fiduciary liability suits as an additional avenue to collect additional damages and legal fees. These suits have increased the exposure to plan fiduciaries, as it is still unresolved as to how far the courts and Congress will expand fiduciaries' liabilities under ERISA.

In addition to the "tag-along" suits, EIM's excess Fiduciary Liability policy may offer additional coverage protection for its Members in cases of claims being brought for other breaches of fiduciary duty, such as: funding issues in a defined benefit plan, changes in participant's benefits, cash benefit plan conversions, and administrative errors and omissions.

EIM continues to provide its Members \$25 million of Excess Fiduciary coverage capacity, which can attach above a minimum of \$35 million underlying coverage.

PROPERTY

EIM's property facility was established in 2001 as a direct response to the requests of our Members who were in need of capacity. Current capacity is \$20 million, up considerably from the original \$5 million. Coverage is written on a quota share basis and can be provided on a primary and/or excess basis.

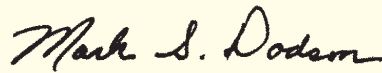
In 2005, EIM participated in an additional 10 Members' programs. The Company ended 2005 with Property policies in force for 63 Members, an all-time high. We continued to have our greatest success as a result of our Members directing their brokers to involve EIM in their placements. Despite the growth experienced in 2005, the market remained soft and premiums were basically flat.

EIM continues to have a healthy and dynamic relationship with Nuclear Electric Insurance Limited (NEIL) in terms of fronting for NEIL's non-nuclear property book of business.

As we look to the future, it is the Company's goal to increase existing participation on our Members' programs as well as participation on programs where we currently have no involvement.

Financials and Notes to the Financials

The financial statements in this Annual Report have been approved
by the Board of Directors of Energy Insurance Mutual.



Mark S. Dodson
Chairman of the Board

March 29, 2006

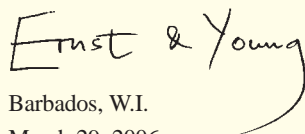
Report of Independent Auditors

To the Members of Energy Insurance Mutual Limited

We have audited the accompanying balance sheets of Energy Insurance Mutual Limited (the Company) as of December 31, 2005 and 2004, and the related statements of operations, policyholders' surplus and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for purposes of expressing an opinion of the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Energy Insurance Mutual Limited at December 31, 2005 and 2004, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States.



Ernst & Young

Barbados, W.I.
March 29, 2006

Balance Sheets

ENERGY INSURANCE MUTUAL LIMITED

(Expressed in Thousands of U.S. Dollars)

	December 31	
	<u>2005</u>	<u>2004</u>
ASSETS		
Investments, available-for-sale	\$ 1,036,746	\$ 942,482
Investment in subsidiary	1,234	1,757
Cash and cash equivalents	73,192	56,152
Reinsurance recoverable on unpaid and paid losses	233,473	318,623
Reinsurance premiums paid in advance	47,612	26,373
Accrued interest	5,778	5,071
Property and equipment, at cost, net of accumulated depreciation	1,214	905
Insurance balances receivable	1,627	1,905
Deferred acquisition costs	1,467	1,987
Income taxes recoverable	-	11,607
Prepaid expenses	333	435
	<u>1,402,676</u>	<u>1,367,297</u>
TOTAL ASSETS		
LIABILITIES AND POLICYHOLDERS' SURPLUS		
LIABILITIES		
Reserve for losses and loss adjustment expense	\$ 666,483	\$ 740,392
Unearned premiums	115,243	116,772
Amounts due to reinsurers	30,763	722
Deferred income taxes, net	27,252	16,055
Policyholders' distribution payable	10,000	-
Payable from purchase of investments	3,137	3,174
Accrued expenses	1,782	1,670
Income taxes payable	479	-
	<u>855,139</u>	<u>878,785</u>
TOTAL LIABILITIES		
POLICYHOLDERS' SURPLUS	<u>547,537</u>	<u>488,512</u>
TOTAL LIABILITIES AND POLICYHOLDERS' SURPLUS	<u>\$ 1,402,676</u>	<u>\$ 1,367,297</u>

See accompanying notes.

Statements of Operations

ENERGY INSURANCE MUTUAL LIMITED

(Expressed in Thousands of U.S. Dollars)

	Year Ended December 31	
	<u>2005</u>	<u>2004</u>
REVENUE		
Premiums		
Gross premiums written	\$ 206,811	\$ 214,297
Reinsurance premiums assumed	6,671	4,365
Decrease (increase) in unearned premiums	1,529	(2,824)
Reinsurance premiums ceded	<u>(90,128)</u>	<u>(89,578)</u>
Net premiums earned	124,883	126,260
Other underwriting income	3,775	1,259
Net gains on disposals of investments	198	2,687
Investment income, net	<u>28,523</u>	<u>27,628</u>
	<u>157,379</u>	<u>157,834</u>
EXPENSES		
Losses and loss adjustment expenses		
Gross losses and loss adjustment expenses incurred	87,226	121,796
Assumed losses and loss adjustment expenses	12,778	42,922
Reinsurance recoveries	<u>(25,903)</u>	<u>(7,530)</u>
	74,101	157,188
Other underwriting expenses, net of acquisition costs deferred	3,305	3,254
Administrative expenses	<u>7,471</u>	<u>7,073</u>
	<u>84,877</u>	<u>167,515</u>
Income (loss) before policyholders' distribution and income taxes	72,502	(9,681)
Policyholders' distribution	<u>(10,000)</u>	<u>—</u>
Income (loss) before income taxes	62,502	(9,681)
Income tax (expense) benefit:	(14,279)	5,116
Current	<u>(3,498)</u>	<u>3,635</u>
Deferred	<u>(17,777)</u>	<u>8,751</u>
NET INCOME (LOSS) FOR THE YEAR	<u>\$ 44,725</u>	<u>\$ (930)</u>

See accompanying notes.

Statements of Policyholders' Surplus

ENERGY INSURANCE MUTUAL LIMITED

(Expressed in Thousands of U.S. Dollars)

	Accumulated Other Comprehensive Income	Policyholders' Surplus	Total Policyholders' Surplus
	<hr/>	<hr/>	<hr/>
Balance at January 1, 2004	\$ 57,715	\$ 403,452	\$ 461,167
Net loss for the year	–	(930)	(930)
Change in net unrealized appreciation of investments, net of tax effect of \$15,226	28,275	–	<hr/> 28,275
Comprehensive income	<hr/>	<hr/>	<hr/> 27,345
Balance at December 31, 2004	\$ 85,990	\$ 402,522	\$ 488,512
Net income for the year	–	44,725	44,725
Change in net unrealized appreciation of investments, net of tax effect of \$7,699	14,300	–	<hr/> 14,300
Comprehensive income	<hr/>	<hr/>	<hr/> 59,025
Balance at December 31, 2005	<u>\$ 100,290</u>	<u>\$ 447,247</u>	<u>\$ 547,537</u>

See accompanying notes.

Statements of Cash Flows

ENERGY INSURANCE MUTUAL LIMITED

(Expressed in Thousands of U.S. Dollars)

Year Ended December 31

	2005	2004
OPERATING ACTIVITIES		
Net income (loss) for the year	\$ 44,725	\$ (930)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	180	69
Net gain from sale of investments	(198)	(2,687)
Deferred income taxes	3,498	(3,635)
Funds held by reinsurers	–	18,094
Equity in losses of subsidiary	523	51
Changes in operating assets and liabilities:		
Decrease in reinsurance recoverable on unpaid and paid losses	85,150	42,714
Increase in reinsurance premiums paid in advance	(21,239)	(18,390)
Increase in accrued interest	(707)	(479)
Decrease in insurance balances receivable	278	3,095
Decrease in deferred acquisition costs	520	130
Decrease (increase) in income taxes recoverable	11,607	(4,147)
Decrease (increase) in prepaid expenses	102	(83)
(Decrease) increase in reserve for losses and loss adjustment expense	(73,909)	52,278
(Decrease) increase in unearned premiums	(1,529)	2,824
Increase (decrease) in amounts due to reinsurers	30,041	(2,982)
Increase in Policyholders' distribution payable	10,000	–
Increase (decrease) in accrued expenses	112	(699)
Increase in income taxes payable	479	–
NET CASH PROVIDED BY OPERATING ACTIVITIES	89,633	85,223
INVESTING ACTIVITIES		
Cost of investments purchased	(477,584)	(311,133)
Proceeds from sales of investments	328,947	206,910
Proceeds from maturities of investments	76,570	45,695
Decrease in payable from purchase of investments	(37)	(830)
Purchases of property and equipment	(489)	(590)
NET CASH USED IN INVESTING ACTIVITIES	(72,593)	(59,948)
Net increase in cash and cash equivalents	17,040	25,275
Cash and cash equivalents at beginning of year	56,152	30,877
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 73,192	\$ 56,152
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid (received) during the year for income taxes	\$ 2,191	\$ (969)

See accompanying notes.

Notes to Financial Statements

1. INCORPORATION

Energy Insurance Mutual Limited (the Company, or EIM) was incorporated under the Companies Act of Barbados on June 13, 1986. It obtained a license to engage in exempt insurance business, in accordance with the provisions of the Exempt Insurance Act of Barbados, 1983. On August 12, 2003, it applied for, and was granted a license, to operate as a Qualifying Insurance Company under the Insurance Act 1992-2 of Barbados.

The Company is a mutual insurance company, and membership in the Company is available to any utility or member of the energy services industry that meets the underwriting standards established by the Company.

The Company provides directors and officers liability, general partner liability, and general liability coverages in excess of \$25,000,000, to members. Coverage is written on a “claims first made” basis. In addition, to a lesser extent, the Company writes property insurance, primarily excess all-risk coverage, for its members. The company does not have any other significant transactions with related parties.

2. ACCOUNTING PRINCIPLES AND SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The financial statements are prepared in accordance with accounting principles generally accepted in the United States.

Use of Estimates

The preparation of financial statements of insurance companies requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed herein.

Significant accounting policies are as follows:

Cash and Cash Equivalents

Cash and cash equivalents are short-term, highly liquid investments with an original maturity of three months or less.

Investments

Management determines the appropriate classification of debt and equity securities at the time of purchase, and reevaluates such designation as of each balance sheet date. The Company’s policy is to hold securities for investment purposes and, as such, has reported all securities as available-for-sale. Available-for-sale securities are carried at fair value, with the unrealized gains and losses, net of tax, reported in a separate component of policyholders’ surplus. Realized gains and losses and declines in value judged to be other than temporary on available-for-sale securities are included in net investment income. The cost of securities sold is based on the average cost method. Interest and dividends on securities classified as available-for-sale are included in investment income. Premiums and discounts on acquisition of debt securities are amortized over the life of the instrument using the effective interest rate method. The amortization of premiums and discounts is taken to the statement of operations.

Notes to Financial Statements

Reinsurance

In the normal course of business, the Company seeks to reduce the loss that may arise from catastrophes or other events that cause unfavorable underwriting results by reinsuring certain levels of risk in various areas of exposure with reinsurance companies. Reinsurance premiums, loss reimbursement and reserves related to reinsurance business are accounted for on a basis consistent with that used in accounting for the original policies issued and the terms of the reinsurance contracts. Reinsurance premiums written during 2005 and 2004 were \$111,367,000 and \$107,968,000, respectively.

The Company may receive a ceding commission in connection with ceded reinsurance, which is earned in a manner consistent with the premium and, to the extent that it represents a recovery of the reinsurer's share of the acquisition costs, is recorded in the statement of operations as a reduction in other underwriting expenses. Ceding commission which does not represent a recovery of acquisition costs is recorded as other underwriting income.

Deferred Acquisition Costs

Commissions and other costs of acquiring insurance which vary with, and are primarily related to, the production of new and renewal business are deferred and amortized over the life of the policy to which they relate. Ceding commissions received reduce acquisition costs incurred such that net acquisition costs are capitalized and charged to income in proportion to net revenue recognized. Amortization in 2005 and 2004 was \$3,305,000 and \$3,254,000, respectively, and is recorded as other underwriting expenses in the statement of operations.

Premiums

Premiums are generally recognized as revenue on a pro rata basis over the policy term. The portion of premiums that will be earned in the future is deferred and reported as unearned premiums. In addition, the Company may assume reinsurance premiums from ceding companies from whom a ceding commission or fee may be earned. Assumed reinsurance premiums and ceding commissions, recorded as other underwriting income in the statement of operations, are earned on the same basis as described above.

Investment in Subsidiary

In the early 1990's, the Company formed Energy Insurance (Bermuda) Ltd. (EIB), a wholly owned subsidiary, for the purpose of providing its members the vehicle to write specific risks that an individual utility might desire covered. As a result, EIB is able to write policies for its constituency through mutual business programs. As of December 31, 2005, EIB has assets (exclusive of assets held in mutual business programs) of approximately \$1.3 million, shareholder's equity of \$1.2 million, and a net loss of approximately \$523,000.

Reserve for Losses and Loss Adjustment Expenses

The losses and loss adjustment expense reserve represents the estimated ultimate gross cost of all reported and unreported losses incurred through December 31. Since the Company provides principally high level excess of loss coverage to its members, it is exposed to high value but infrequent claims. Therefore, standard actuarial methods, such as paid loss development, are inappropriate to use. Losses are determined based on projecting average loss and expected number of claims after reviewing historical known losses and claim

Notes to Financial Statements

counts, and understanding how exposures to loss have changed over policy periods. Aggregate expected losses are derived based on these estimates and a theoretical size of loss distribution.

Case reserves have been established on the notification of potential loss events for specific insurance policies. Case reserves are reviewed and updated continually. However, given the uncertainty regarding the extent of the Company's ultimate liability, a significant additional liability could develop. Although considerable variability is inherent in such estimates, particularly due to the limited number of claims to date, management believes that the reserve for losses and loss adjustment expense is adequate.

These estimates are periodically reviewed and adjusted as necessary as experience develops or new information becomes known; such adjustments are included in current operations.

Income Taxes

The Company utilizes the liability method in accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on temporary differences between the financial reporting and tax reporting bases of assets and liabilities. The differences are measured using the enacted tax rates and laws that are currently in effect for those periods when the differences are expected to reverse.

Reclassifications

Certain amounts reported in prior year's financial statements have been reclassified to conform to the presentation adopted in the current year. These reclassifications had no effect on the policyholders' surplus or the net loss for the year ended December 31, 2004.

3. INSURANCE OPERATIONS

The following table provides a reconciliation of the beginning and ending reserve balances for losses and loss adjustment expenses (LAE), net of reinsurance recoveries, for 2005 and 2004:

	Year Ended December 31	
	2005	2004
	<i>(In Thousands)</i>	
Reserve for losses and loss adjustment expense, net of reinsurance recoverables, at beginning of year	\$421,769	\$326,777
Add provision for claims, net of reinsurance:		
Provision for unpaid losses and loss adjustment expense for claims occurring in the current period, net of reinsurance	82,090	79,461
(Decrease) increase in estimated losses and loss adjustment expense for claims occurring in prior periods, net of reinsurance	(12,064)	87,807
Increase (decrease) in related tail coverage	4,075	(10,080)
	74,101	157,188
Less payments for losses and loss adjustment expenses relating to claims occurring in:		
the current period, net of reinsurance	892	956
prior periods, net of reinsurance	61,968	61,240
	62,860	62,196
Reserve for losses and loss adjustment expense, net of reinsurance recoverables, at end of year	\$433,010	\$421,769

Notes to Financial Statements

The foregoing reconciliation shows that a decrease of approximately \$12,064,000 in the December 31, 2004 reserve and an increase of approximately \$87,807,000 in the December 31, 2003 reserve emerged during 2005 and 2004, respectively.

The 2004 increase in incurred losses resulted principally from developments related to claims for which case reserves were increased to reflect new information or events that came to light in that year. The increase arose principally in respect of the 2002 underwriting year in which certain claims reserves were adjusted to levels, which in some cases were beyond the reinsurance cover available. In 2005, the level of incurred but not reported reserves was reduced principally as a result of the maturing, without further notification of losses, of many underwriting years and a less severe notification of new losses than had transpired in the prior financial year.

Additionally, an increase in tail coverage of approximately \$4,075,000 and a decrease of approximately \$10,080,000 emerged during 2005 and 2004, respectively. The decrease in 2004 is due to positive development related to unreported loss reserves as a result of a reduction in the actuary's assessment of the projected severity for contracts subject to tail coverage. The projected severity assumption increased in 2005.

The Company has carried reinsurance since 1986. In 2005, the Company purchased Excess of Loss coverage, which protects the Company from adverse frequency of losses, on the directors and officers, general partner, general liability and fiduciary liability book of business. After certain deductible or retentions have been satisfied, the maximum amount that could be recoverable under the reinsurance treaty is \$228,500,000 in respect of general liability and \$41,000,000 in respect of directors and officers, general partner and fiduciary liability.

On May 1, 2003, the Company entered into a new reinsurance arrangement with Nuclear Electric Insurance Limited (NEIL) whereby NEIL provides excess of loss reinsurance on the directors and officers and general partner book of business for 80% of \$20,000,000 excess of \$30,000,000.

The property book of business is primarily reinsured by Endurance Specialty Insurance Ltd., and/or NEIL. In addition, the Company also has an arrangement with NEIL whereby their non-nuclear property book of business can be fronted by EIM.

Reinsurance ceded contracts do not relieve the Company from its obligations to policyholders. The Company remains liable to its policyholders for the portion reinsured, to the extent that the reinsurer does not meet the obligations assumed under the reinsurance agreement. The reinsurance recoverable on paid and unpaid losses is substantially due from two reinsurers comprising 46% and 21%, respectively, of the balance at December 31, 2005 and 50% and 17%, respectively, at December 31, 2004. The remaining balance comprises amounts from various reinsurers, each not exceeding 6% (2004–8%) of the total.

During 2004, certain reinsurers disputed their assumed obligations of approximately \$52.7 million, which was included in reinsurance recoverable on unpaid and paid losses in the accompanying balance sheet. In 2005, the Company commuted the agreements in order to settle the dispute, and accepted an amount of approximately \$30.6 million as full settlement under the agreements and recognized a loss of \$22.1 million on the settlement. The loss is reflected as a reduction in loss recoveries in the statement of operations.

Notes to Financial Statements

4. INVESTMENTS

The cost and estimated fair value of investments, all of which are classified as available-for-sale, are as follows:

	2005			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	<i>(In Thousands)</i>			
U.S. Treasury securities and obligations of U.S. Government Agencies	\$ 24,176	\$ 37	\$ 234	\$ 23,979
U.S. state and municipal obligations	292,507	14,528	2,525	304,510
Corporate debt securities	67,601	743	1,758	66,586
Mortgage-backed securities	<u>77,625</u>	<u>696</u>	<u>258</u>	<u>78,063</u>
Total debt securities	461,909	16,004	4,775	473,138
Equities	<u>420,545</u>	<u>150,782</u>	<u>7,719</u>	<u>563,608</u>
Total investments	<u>\$ 882,454</u>	<u>\$ 166,786</u>	<u>\$ 12,494</u>	<u>\$1,036,746</u>

	2004			
	Cost or Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	<i>(In Thousands)</i>			
U.S. Treasury securities and obligations of U.S. Government Agencies	\$ 17,242	\$ 26	\$ 7	\$ 17,261
U.S. state and municipal obligations	262,948	15,992	679	278,261
Corporate debt securities	83,095	1,740	933	83,902
Mortgage-backed securities	<u>41,332</u>	<u>1,262</u>	<u>9</u>	<u>42,585</u>
Total debt securities	404,617	19,020	1,628	422,009
Equities	<u>405,572</u>	<u>122,537</u>	<u>7,636</u>	<u>520,473</u>
Total investments	<u>\$ 810,189</u>	<u>\$ 141,557</u>	<u>\$ 9,264</u>	<u>\$ 942,482</u>

These investments are in the custody of the Company's investment managers and custodial trustees.

The minimum requirement of the Company's investment guidelines is that no more than 5% of all debt securities may have a below investment-grade bond rating by at least one nationally recognized credit rating

Notes to Financial Statements

agency or the equivalent to the extent possible to determine. As of December 31, 2005 and 2004, the Company is in compliance with its investment guidelines.

The cost and estimated fair value of debt securities at December 31, 2005, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities have been aged by their respective maturity dates.

	<u>Cost</u>	<u>Estimated Fair Value</u>
	<i>(In Thousands)</i>	
Due in one year or less	\$ 12,362	\$ 12,108
Due after one year through five years	82,585	87,439
Due after five years through ten years	119,127	121,644
Due after ten years	<u>247,835</u>	<u>251,947</u>
	<u>\$ 461,909</u>	<u>\$ 473,138</u>

Proceeds from maturities of investments were approximately \$76,570,000 and \$45,695,000, and proceeds from sales of investments were approximately \$328,947,000 and \$206,910,000, during 2005 and 2004, respectively. Gross gains of approximately \$11,516,000 and \$15,688,000 and gross losses of \$11,318,000 and \$13,001,000 for 2005 and 2004, respectively, were realized on sales.

The composition of investment income is disclosed below:

	Year Ended December 31	
	<u>2005</u>	<u>2005</u>
	<i>(In Thousands)</i>	
Interest income	\$ 19,859	\$ 19,413
Dividend income	11,047	9,962
Loss from subsidiary	(523)	(51)
Other	50	56
Investment management fees	<u>(1,910)</u>	<u>(1,752)</u>
	<u>\$ 28,523</u>	<u>\$ 27,628</u>

Notes to Financial Statements

The following tables show gross unrealized losses and fair value of investments, aggregated by investment category, and the length of time that individual investments have been in a continuous unrealized loss position, at December 31, 2005 and 2004 (*in thousands*):

2005	Less than one year		One year or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	Description of securities					
U.S. Treasury & U.S. Government Agency	\$ 19,618	\$ 234	\$ -	\$ -	\$ 19,618	\$ 234
U.S. state and municipal obligations	100,395	1,327	27,932	1,198	128,327	2,525
Corporate debt securities	17,751	441	29,804	1,317	47,555	1,758
Mortgage-backed securities	47,781	251	16	7	47,797	258
Equities	<u>30,048</u>	<u>2,451</u>	<u>26,798</u>	<u>5,268</u>	<u>56,846</u>	<u>7,719</u>
Total temporarily impaired securities	<u>\$ 215,593</u>	<u>\$ 4,704</u>	<u>\$ 84,550</u>	<u>\$ 7,790</u>	<u>\$ 300,143</u>	<u>\$ 12,494</u>

2004	Less than one year		One year or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	Description of securities					
U.S. Treasury & U.S. Government Agency	\$ 1,283	\$ 7	\$ -	\$ -	\$ 1,283	\$ 7
U.S. state and municipal obligations	34,810	382	7,443	297	42,253	679
Corporate debt securities	45,568	815	3,067	118	48,635	933
Mortgage-backed securities	40	9	-	-	40	9
Equities	<u>50,872</u>	<u>5,312</u>	<u>17,121</u>	<u>2,324</u>	<u>67,993</u>	<u>7,636</u>
Total temporarily impaired securities	<u>\$ 132,573</u>	<u>\$ 6,525</u>	<u>\$ 27,631</u>	<u>\$ 2,739</u>	<u>\$ 160,204</u>	<u>\$ 9,264</u>

None of the 384 debt securities with unrealized losses have ever missed or been delinquent on a scheduled principle or interest payment. In addition, in excess of 90% of the balance of unrealized losses related to individual securities with losses representing 5% of cost, or less.

Notes to Financial Statements

Management is therefore of the belief that the unrealized losses are due to recent changes in interest rates and do not represent a significant impairment in the value of these securities that is other than temporary.

The Company's investment guidelines require it to invest in securities which would emulate the returns of the S & P 500. For this, and other reasons described below, unrealized losses arising on equity securities are believed to be temporary. Of the 214 securities with unrealized losses, 162, with losses of \$1.9 million, have been experiencing losses for 6 months or less and are believed to be temporary. Of the remaining 52 securities, 16 account for \$5.1 million of the remaining \$5.8 million. Of these 16, the largest single loss of \$1.7 million arises on a pharmaceutical company in which a patent for one of its products was challenged in the courts. Subsequent to year end, a favorable judgement lifted the challenge and, together with other positive factors, the stock price increased resulting in a substantial recovery of the unrealized loss. In addition, the Company holds preferred stock in a mortgage financing company with an unrealized loss of \$1.6 million as result of a lack of credibility by the market in top management. The value of the stock has been increasing over the last months of the financial year and, subsequent to year end, has continued its recovery following a change in management.

The balance of the 16 securities referred to above, together with the remaining 36 securities account for \$2.5 million of the losses, which include securities of companies who are participants in more volatile industries, such as the pharmaceutical and automobile industry. Based on an analysis of the individual securities, management is of the opinion that any impairment losses, which are other than temporary, are likely to be insignificant.

In determining whether or not an unrealized loss is other than temporary, the Company reviews factors such as:

- historical operating trends,
- business prospects,
- quality of management,
- analyst ratings on the issuer and sector,
- size of unrealized loss,
- the length of time the security has been in an unrealized loss position, and
- status of industry in which the company operates.

5. UNSETTLED INVESTMENT CONTRACTS

Unsettled investment contracts are purchases of securitized mortgage-backed securities for which the underlying investment has not been securitized, yet the price and settlement date are fixed. At December 31, 2005, unsettled investment contracts included open purchases of \$3,137,000. While the Company does not require any collateral relating to these contracts, all open sales are to the same brokers with whom the Company has an open purchase, yet at a lesser amount. Therefore, there is a limited credit risk to the Company.

Notes to Financial Statements

6. INCOME TAXES

A reconciliation between income taxes computed at the U.S. federal statutory rate and the provision for income taxes is shown below:

	December 31	
	<u>2005</u>	<u>2004</u>
	<i>(In Thousands)</i>	
Computed tax at current statutory rate	\$ 21,876	\$ (3,388)
Permanent differences relating to the following items:		
Tax-free investment income	(4,431)	(4,268)
Over-provision in respect of prior year	-	(1,074)
Other	<u>332</u>	<u>(21)</u>
Provision for income taxes	<u>\$ 17,777</u>	<u>\$ (8,751)</u>

At December 31, 2005, total deferred tax assets and deferred tax liabilities amounted to \$28,817,000 and \$56,069,000, respectively. At December 31, 2004, total deferred tax assets and deferred tax liabilities amounted to \$32,352,000 and \$48,407,000, respectively. Deferred taxes are provided on temporary differences in reporting income and expense for income tax and financial statement purposes.

The primary temporary differences result from discounting unpaid loss reserves for income tax purposes (\$22,020,000 and \$24,546,000 for 2005 and 2004, respectively), recognition of premium income for income tax purposes (\$4,734,000 and \$6,328,000 for 2005 and 2004, respectively), and net unrealized appreciation or depreciation of available-for-sale investments (\$54,002,000 and \$46,303,000 for 2005 and 2004, respectively).

The Company is in the tax jurisdiction of the United States and the state of Florida and therefore files both a United States and state of Florida corporate tax return.

Since the Company is licensed as a Qualifying Insurance Company under the Insurance Act 1992-2, it is liable for tax on its taxable income at a rate of 36%. As the Company's income is exclusively earned from foreign insurance business, it is eligible for a tax credit of 93%, the maximum allowable under section 12H of Barbados Income Tax Act Cap. 73, resulting in an effective tax rate of 2.1%. However, during 2003, the Company applied for, and was granted an exemption from tax by the Minister of Finance under the Duties, Taxes and Other Payment (Exemption) Act.

7. TRUST FUNDS AND DEPOSITS

The Company has established a trust fund with a federally insured depository. This trust fund serves as security for United States policyholders and third-party claimants to satisfy requirements of being listed as an alien surplus lines insurer by the National Association of Insurance Commissioners. The Company is required to maintain a minimum amount of the lesser of: \$60,000,000 or \$5,400,000, plus 30% for liabilities

Notes to Financial Statements

arising from business on or after January 1, 1998. At December 31, 2005, the required balance was \$60,000,000. In addition, the state of Florida has required the Company to deposit \$300,000 as security for the Company's policyholders or the Company's policyholders and creditors. The trust funds and deposit balances have been included in the accompanying balance sheet as available-for-sale investments, including both fixed income securities and equities.

8. AMOUNTS DUE TO REINSURERS

Amounts due to reinsurers include an amount of \$17,661,000 which represents the reinsurers' share of the subrogation recoveries on losses paid which have been collected by the Company and have not yet been paid to the reinsurer. The remainder of this balance, and the entire balance as at December 31, 2004, relate to reinsurance premiums payable.

9. POLICYHOLDERS' SURPLUS

Statement of Financial Accounting Standards No. 130, *Reporting Comprehensive Income*, establishes standards for the reporting and display of comprehensive income and its components in a full set of general-purpose financial statements. For the years ended December 31, 2005 and 2004, other comprehensive income consists of the following:

	2005		
	<u>Before-Tax Amount</u>	<u>Tax Expense</u>	<u>Net-of-Tax Amount</u>
	<i>(In Thousands)</i>		
Unrealized gains on securities:			
Net unrealized gains on available-for-sale securities	\$ 22,197	\$ 7,768	\$ 14,429
Less: reclassification adjustment for net gains realized in net income	<u>198</u>	<u>69</u>	<u>129</u>
Other comprehensive loss	<u>\$ 21,999</u>	<u>\$ 7,699</u>	<u>\$ 14,300</u>
	2004		
	<u>Before-Tax Amount</u>	<u>Tax Expense</u>	<u>Net-of-Tax Amount</u>
	<i>(In Thousands)</i>		
Unrealized gains on securities:			
Net unrealized gains on available-for-sale securities	\$ 46,188	\$ 16,166	\$ 30,022
Plus: reclassification adjustment for net losses realized in net income	<u>2,687</u>	<u>940</u>	<u>1,747</u>
Other comprehensive income	<u>\$ 43,501</u>	<u>\$ 15,226</u>	<u>\$ 28,275</u>

Notes to Financial Statements

10. FAIR VALUE OF FINANCIAL INSTRUMENTS

The methods and assumptions used to estimate the fair value of each class of financial instruments for which it is practical to estimate a value are as follows:

Cash and cash equivalents: The carrying value of these assets is a reasonable estimate of their fair value because of the short maturity of these instruments.

Available-for-sale investments: Fair values are based on quoted market or dealer quotes.

Other financial assets and liabilities: The carrying value of these assets and liabilities is a reasonable estimate of their fair value. Other financial assets include reinsurance recoverable on paid losses, accrued interest and insurance balances receivable. Other financial liabilities include amounts due to reinsurers, payable from purchase of investments and accrued expenses.

11. COMMITMENTS AND CONTINGENCIES

It is management's position that the Company is not currently affected by any significant contingent liabilities, nor has it obligated itself in respect of any significant commitments as at December 31, 2005.

12. MARGIN OF SOLVENCY

In order to meet the requirements of the Qualifying Insurance Company under the Insurance Act 1992-2 of Barbados, the Company must have contributed reserves of approximately \$13,035,000. The policyholders' surplus provided an excess margin of solvency of approximately \$534,502,000 at December 31, 2005, that is available for the payment of dividends.

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