

ERIE INDEMNITY CO
Form 10-Q
July 26, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2018

Commission file number 0-24000

ERIE INDEMNITY COMPANY
(Exact name of registrant as specified in its charter)
PENNSYLVANIA 25-0466020
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification No.)

100 Erie Insurance Place, Erie, Pennsylvania 16530
(Address of principal executive offices) (Zip Code)

(814) 870-2000
(Registrant's telephone number, including area code)
Not applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

(Do not check if a smaller reporting company)

Smaller reporting company Emerging growth company

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If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange

Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The number of shares outstanding of the registrant's Class A Common Stock as of the latest practicable date, with no par value and a stated value of \$0.0292 per share, was 46,189,068 at July 13, 2018.

The number of shares outstanding of the registrant's Class B Common Stock as of the latest practicable date, with no par value and a stated value of \$70 per share, was 2,542 at July 13, 2018.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

ERIE INDEMNITY COMPANY
 STATEMENTS OF OPERATIONS (UNAUDITED)
 (dollars in thousands, except per share data)

| | Three months ended | | Six months ended | |
|--|--------------------|------------|------------------|------------|
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Operating revenue | | | | |
| Management fee revenue - policy issuance and renewal services, net | \$454,572 | \$441,319 | \$860,550 | \$833,377 |
| Management fee revenue - administrative services, net | 13,299 | — | 26,373 | — |
| Administrative services reimbursement revenue | 146,507 | — | 292,470 | — |
| Service agreement revenue | 7,080 | 7,245 | 14,225 | 14,503 |
| Total operating revenue | 621,458 | 448,564 | 1,193,618 | 847,880 |
| Operating expenses | | | | |
| Cost of operations - policy issuance and renewal services | 379,628 | 365,116 | 728,258 | 697,492 |
| Cost of operations - administrative services | 146,507 | — | 292,470 | — |
| Total operating expenses | 526,135 | 365,116 | 1,020,728 | 697,492 |
| Operating income | 95,323 | 83,448 | 172,890 | 150,388 |
| Investment income | | | | |
| Net investment income | 7,104 | 6,239 | 13,924 | 12,220 |
| Net realized investment (losses) gains | (32) |) 124 | (497) |) 640 |
| Net impairment losses recognized in earnings | (646) |) (61) |) (646) |) (182) |
| Equity in (losses) earnings of limited partnerships | (219) |) 149 | (411) |) 362 |
| Total investment income | 6,207 | 6,451 | 12,370 | 13,040 |
| Interest expense, net | 602 | 257 | 1,155 | 423 |
| Other income (expense) | 58 | (407) |) 102 | (816) |
| Income before income taxes | 100,986 | 89,235 | 184,207 | 162,189 |
| Income tax expense | 21,280 | 30,708 | 38,743 | 55,786 |
| Net income | \$79,706 | \$58,527 | \$145,464 | \$106,403 |
| Net income per share | | | | |
| Class A common stock – basic | \$1.71 | \$1.26 | \$3.12 | \$2.28 |
| Class A common stock – diluted | \$1.52 | \$1.12 | \$2.78 | \$2.03 |
| Class B common stock – basic | \$257 | \$189 | \$469 | \$343 |
| Class B common stock – diluted | \$257 | \$188 | \$468 | \$343 |
| Weighted average shares outstanding – Basic | | | | |
| Class A common stock | 46,188,705 | 46,180,852 | 46,188,309 | 46,184,666 |
| Class B common stock | 2,542 | 2,542 | 2,542 | 2,542 |
| Weighted average shares outstanding – Diluted | | | | |

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| | | | | |
|------------------------------|------------|------------|------------|------------|
| Class A common stock | 52,312,849 | 52,299,395 | 52,311,741 | 52,355,214 |
| Class B common stock | 2,542 | 2,542 | 2,542 | 2,542 |
| Dividends declared per share | | | | |
| Class A common stock | \$0.8400 | \$0.7825 | \$1.6800 | \$1.5650 |
| Class B common stock | \$126.000 | \$117.375 | \$252.000 | \$234.750 |

See accompanying notes to Financial Statements. See Note 11, "Accumulated Other Comprehensive Income (Loss)", for amounts reclassified out of accumulated other comprehensive income (loss) into the Statements of Operations.

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ERIE INDEMNITY COMPANY
 STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)
 (in thousands)

| | Three months ended | | Six months ended | |
|--|--------------------|----------|------------------|-----------|
| | June 30, | | June 30, | |
| | 2018 | 2017 | 2018 | 2017 |
| Net income | \$79,706 | \$58,527 | \$145,464 | \$106,403 |
| Other comprehensive (loss) income, net of tax | | | | |
| Change in unrealized holding (losses) gains on available-for-sale securities | (551 |) 1,092 | (5,978 |) 2,613 |
| Comprehensive income | \$79,155 | \$59,619 | \$139,486 | \$109,016 |

See accompanying notes to Financial Statements. See Note 11, "Accumulated Other Comprehensive Income (Loss)", for amounts reclassified out of accumulated other comprehensive income (loss) into the Statements of Operations.

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

| | June 30, 2018 (Unaudited) | December 31, 2017 |
|---|---------------------------------|----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$198,412 | \$215,721 |
| Available-for-sale securities | 107,369 | 71,190 |
| Receivables from Erie Insurance Exchange and affiliates | 445,211 | 418,328 |
| Prepaid expenses and other current assets | 45,426 | 34,890 |
| Federal income taxes recoverable | 0 | 29,900 |
| Note receivable from Erie Family Life Insurance Company | 25,000 | 25,000 |
| Accrued investment income | 6,647 | 6,853 |
| Total current assets | 828,065 | 801,882 |
| Available-for-sale securities | 598,059 | 687,523 |
| Equity securities | 12,488 | — |
| Limited partnership investments | 39,651 | 45,122 |
| Fixed assets, net | 94,651 | 83,149 |
| Deferred income taxes, net | 31,527 | 19,390 |
| Other assets | 47,834 | 28,793 |
| Total assets | \$1,652,275 | \$1,665,859 |
| Liabilities and shareholders' equity | | |
| Current liabilities: | | |
| Commissions payable | \$253,328 | \$228,124 |
| Agent bonuses | 56,482 | 122,528 |
| Accounts payable and accrued liabilities | 97,139 | 104,533 |
| Dividends payable | 39,119 | 39,116 |
| Contract liability | 33,137 | — |
| Deferred executive compensation | 8,801 | 15,605 |
| Federal income taxes payable | 8,933 | 0 |
| Current portion of long-term borrowings | 925 | 0 |
| Total current liabilities | 497,864 | 509,906 |
| Defined benefit pension plans | 145,667 | 207,530 |
| Employee benefit obligations | 194 | 423 |
| Contract liability | 17,452 | — |
| Deferred executive compensation | 11,688 | 14,452 |
| Long-term borrowings | 98,800 | 74,728 |
| Other long-term liabilities | 422 | 1,476 |
| Total liabilities | 772,087 | 808,515 |
| Shareholders' equity | | |
| Class A common stock, stated value \$0.0292 per share; 74,996,930 shares authorized; 68,299,200 shares issued; 46,189,068 shares outstanding | 1,992 | 1,992 |

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| | | |
|--|--------------|--------------|
| Class B common stock, convertible at a rate of 2,400 Class A shares for one Class B share, stated value \$70 per share; 3,070 shares authorized; 2,542 shares issued and outstanding | 178 | 178 |
| Additional paid-in-capital | 16,459 | 16,470 |
| Accumulated other comprehensive loss | (162,037) | (156,059) |
| Retained earnings | 2,169,686 | 2,140,853 |
| Total contributed capital and retained earnings | 2,026,278 | 2,003,434 |
| Treasury stock, at cost; 22,110,132 shares held | (1,156,999) | (1,155,668) |
| Deferred compensation | 10,909 | 9,578 |
| Total shareholders' equity | 880,188 | 857,344 |
| Total liabilities and shareholders' equity | \$1,652,275 | \$1,665,859 |

See accompanying notes to Financial Statements.

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ERIE INDEMNITY COMPANY
 STATEMENTS OF CASH FLOWS (UNAUDITED)
 (in thousands)

| | Six months ended | |
|--|------------------|------------|
| | June 30, | |
| | 2018 | 2017 |
| Cash flows from operating activities | | |
| Management fee received | \$859,694 | \$806,129 |
| Administrative services reimbursements received | 298,056 | — |
| Service agreement fee received | 14,225 | 14,503 |
| Net investment income received | 17,279 | 15,022 |
| Limited partnership distributions | 3,037 | 1,339 |
| Decrease in reimbursements collected from affiliates | — | (5,633) |
| Commissions paid to agents | (413,880) | (386,400) |
| Agents bonuses paid | (126,594) | (115,056) |
| Salaries and wages paid | (102,601) | (95,462) |
| Pension contribution and employee benefits paid | (99,334) | (33,737) |
| General operating expenses paid | (111,381) | (113,122) |
| Administrative services expenses paid | (295,635) | — |
| Income taxes paid | (208) | (47,767) |
| Interest paid | (1,065) | (325) |
| Net cash provided by operating activities | 41,593 | 39,491 |
| Cash flows from investing activities | | |
| Purchase of investments: | | |
| Available-for-sale securities | (114,848) | (184,803) |
| Equity securities | (1,035) | — |
| Limited partnerships | (215) | (325) |
| Proceeds from investments: | | |
| Available-for-sale securities sales | 76,387 | 57,851 |
| Available-for-sale securities maturities/calls | 69,674 | 100,042 |
| Equity securities | 1,157 | — |
| Limited partnerships | 2,682 | 4,344 |
| Net purchase of fixed assets | (18,121) | (9,972) |
| Net distributions on agent loans | (21,334) | (3,083) |
| Net cash used in investing activities | (5,653) | (35,946) |
| Cash flows from financing activities | | |
| Dividends paid to shareholders | (78,235) | (72,883) |
| Net proceeds from long-term borrowings | 24,986 | 24,975 |
| Net cash used in financing activities | (53,249) | (47,908) |
| Net decrease in cash and cash equivalents | (17,309) | (44,363) |
| Cash and cash equivalents, beginning of period | 215,721 | 189,072 |
| Cash and cash equivalents, end of period | \$198,412 | \$144,709 |

See accompanying notes to Financial Statements.

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NOTES TO FINANCIAL STATEMENTS (UNAUDITED)

Note 1. Nature of Operations

Erie Indemnity Company ("Indemnity", "we", "us", "our") is a publicly held Pennsylvania business corporation that has since its incorporation in 1925 served as the attorney-in-fact for the subscribers (policyholders) at the Erie Insurance Exchange ("Exchange"). The Exchange, which also commenced business in 1925, is a Pennsylvania-domiciled reciprocal insurer that writes property and casualty insurance. We function solely as the management company and all insurance operations are performed by the Exchange.

Our primary function as attorney-in-fact is to perform policy issuance and renewal services on behalf of the subscribers at the Exchange. We also act as attorney-in-fact on behalf of the Exchange with respect to all claims handling and investment management services, as well as the service provider for all claims handling, life insurance, and investment management services for its insurance subsidiaries, collectively referred to as "administrative services". Acting as attorney-in-fact in these two capacities is done in accordance with a subscriber's agreement (a limited power of attorney) executed individually by each subscriber (policyholder), which appoints us as their common attorney-in-fact to transact certain business on their behalf. Pursuant to the subscriber's agreement for acting as attorney-in-fact in these two capacities, we earn a management fee calculated as a percentage of the direct and assumed premiums written by the Exchange.

The policy issuance and renewal services we provide to the Exchange are related to the sales, underwriting and issuance of policies. The sales related services we provide include agent compensation and certain sales and advertising support services. Agent compensation includes scheduled commissions to agents based upon premiums written as well as additional commissions and bonuses to agents, which are earned by achieving targeted measures. The underwriting services we provide include underwriting and policy processing. The remaining services we provide include customer service and administrative support. We also provide information technology services that support all the functions listed above. Included in these expenses are allocations of costs for departments that support these policy issuance and renewal functions.

By virtue of its legal structure as a reciprocal insurer, the Exchange does not have any employees or officers. Therefore, it enters into contractual relationships by and through an attorney-in-fact. Indemnity serves as the attorney-in-fact on behalf of the Exchange with respect to its administrative services. The Exchange's insurance subsidiaries also utilize Indemnity for these services in accordance with the service agreements between each of the subsidiaries and Indemnity. Claims handling services include costs incurred in the claims process, including the adjustment, investigation, defense, recording and payment functions. Life insurance management services include costs incurred in the management and processing of life insurance business. Investment management services are related to investment trading activity, accounting and all other functions attributable to the investment of funds. Included in these expenses are allocations of costs for departments that support these administrative functions. The amounts incurred for these services are reimbursed to Indemnity at cost in accordance with the subscriber's agreement and the service agreements. State insurance regulations require that intercompany service agreements and any material amendments be approved in advance by the state insurance department.

Our results of operations are tied to the growth and financial condition of the Exchange. If any events occurred that impaired the Exchange's ability to grow or sustain its financial condition, including but not limited to reduced financial strength ratings, disruption in the independent agency relationships, significant catastrophe losses, or products not meeting customer demands, the Exchange could find it more difficult to retain its existing business and attract new business. A decline in the business of the Exchange almost certainly would have as a consequence a decline in the total premiums paid and a correspondingly adverse effect on the amount of the management fees we receive. We also have an exposure to a concentration of credit risk related to the unsecured receivables due from the Exchange for its

management fee. See Note 12, "Concentrations of Credit Risk".

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Note 2. Significant Accounting Policies

Basis of presentation

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. For further information, refer to the financial statements and footnotes included in our Form 10-K for the year ended December 31, 2017 as filed with the Securities and Exchange Commission on February 22, 2018.

Use of estimates

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

Recently adopted accounting standards

We adopted Accounting Standards Codification 606, "Revenue from Contracts with Customers" ("ASC 606") on January 1, 2018, using the modified retrospective method applied to all contracts. We recognized the cumulative effect of initially adopting ASC 606 as an adjustment to the opening balance of retained earnings at January 1, 2018. The comparative information for periods preceding January 1, 2018 has not been restated and continues to be reported under the accounting standards in effect for those periods.

Under ASC 606, we determined that we have two performance obligations under the subscriber's agreement. The first performance obligation is providing policy issuance and renewal services. The second performance obligation is acting as the attorney-in-fact on behalf of the Exchange, as well as the service provider for its insurance subsidiaries, with respect to all administrative services. Therefore, upon adoption of ASC 606 beginning January 1, 2018, the management fee earned per the subscriber's agreement, currently 25% of all direct and assumed premiums written by the Exchange, will be allocated between the two performance obligations. Prior to the adoption of ASC 606, the entire management fee was allocated to the policy issuance and renewal services. Additionally, the expenses we incur and related reimbursements we receive related to the administrative services will be presented gross in our Statement of Operations effective January 1, 2018. There was no significant impact to service agreement revenue upon adoption of ASC 606.

Revenue allocated to the policy issuance and renewal services continues to be recognized at the time of policy issuance or renewal because it is at the time of policy issuance or renewal when the economic benefits of the service Indemnity provides (i.e. the substantially completed policy issuance or renewal service) and the control of the promised asset (i.e. the executed insurance policy) transfers to the customer. A significant portion of the management fee is currently allocated to this performance obligation and therefore, the related revenue recognition pattern for the vast majority of our revenues will remain unchanged.

The revenue allocated to the second performance obligation will be recognized over several years in correlation with the costs incurred because the economic benefit of the services provided (i.e. management of the administrative services) transfers to the customer over a period of time. The amounts incurred for these services are reimbursed to Indemnity at cost in accordance with the subscriber's agreement and the service agreements. On January 1, 2018, we established a contract liability of \$48.5 million representing the portion of revenue not yet earned related to the administrative services to be provided in subsequent years. We recorded a related deferred tax asset of \$10.2 million and a cumulative effect adjustment that reduced retained earnings by \$38.3 million. The adoption of ASC 606 changed the presentation of our Statement of Cash Flows, but had no net impact to our cash flows.

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The cumulative effect of the changes made to our Statement of Financial Position at January 1, 2018 were as follows:

| (in thousands) | Balance at Adjustments | | Balance December due to ASC at January 1, 2018 |
|----------------------------------|------------------------|-----------|--|
| | 31, 2017 | 606 | |
| Statement of Financial Position: | | | |
| Assets | | | |
| Deferred tax asset | \$ 19,390 | \$ 10,188 | \$ 29,578 |
| Liabilities | | | |
| Contract liability | — | 48,514 | 48,514 |
| Equity | | | |
| Retained earnings | 2,140,853 | (38,326) | 2,102,527 |

The impact of adoption on our Statement of Financial Position at June 30, 2018 was as follows:

| (in thousands) | June 30, 2018 | | |
|----------------------------------|-------------------------------|--------------------------------|---------------------------------------|
| | As Reported (Unaudited) | Balances without ASC 606 | Impact of Change Higher/(Lower) |
| Statement of Financial Position: | | | |
| Assets | | | |
| Deferred tax asset | \$31,527 | \$20,903 | \$ 10,624 |
| Liabilities | | | |
| Contract liability | 50,589 | — | 50,589 |
| Equity | | | |
| Retained earnings | 2,169,688 | 2,209,651 | (39,965) |

The impact of adoption on our Statement of Operations at June 30, 2018 was as follows:

| (in thousands) | Three months ended | | | Six months ended | | |
|---|-------------------------------|--------------------------------|---------------------------------------|-------------------------------|--------------------------------|---------------------------------------|
| | As Reported (Unaudited) | Balances without ASC 606 | Impact of Change Higher/(Lower) | As Reported (Unaudited) | Balances without ASC 606 | Impact of Change Higher/(Lower) |
| Statement of Operations: | | | | | | |
| Management fee revenue allocated to policy issuance and renewal services, gross | \$456,896 | \$471,999 | \$ (15,103) | \$864,132 | \$892,698 | \$ (28,566) |
| Less: change in allowance for management fee returned on cancelled policies | (2,324) | (2,400) | 76 | (3,582) | (3,700) | 118 |
| Management fee revenue allocated to policy issuance and renewal services, net | \$454,572 | \$469,599 | \$ (15,027) | \$860,550 | \$888,998 | \$ (28,448) |
| Management fee revenue allocated to administrative services, gross | \$13,313 | \$— | \$ 13,313 | \$26,401 | \$— | \$ 26,401 |
| Less: change in allowance for management fee returned on cancelled policies | (14) | — | (14) | (28) | — | (28) |
| Management fee revenue allocated to administrative services, net | 13,299 | — | 13,299 | 26,373 | — | 26,373 |

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| | | | | | | |
|--|------------|-----|------------|------------|-----|------------|
| Administrative services reimbursement revenue | 146,507 | — | 146,507 | 292,470 | — | 292,470 |
| Total revenue allocated to administrative services | \$ 159,806 | \$— | \$ 159,806 | \$ 318,843 | \$— | \$ 318,843 |
| Administrative services expenses | \$ 146,507 | \$— | \$ 146,507 | \$ 292,470 | \$— | \$ 292,470 |

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In March 2017, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2017-07, "Compensation-Retirement Benefits", which requires the service cost component of net benefit costs to be reported with other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit costs are required to be presented separately from the service cost component and outside of income from operations on a retrospective basis. This amendment also allows only the service cost component to be eligible for capitalization, when applicable, prospectively after the effective date. ASU 2017-07 is effective for interim and annual periods beginning after December 15, 2017. We adopted this guidance effective January 1, 2018 and have included the other components of net benefit costs in "Other income (expense)" in the Statements of Operations and conformed the prior-period presentation. The adoption of this guidance did not have a material impact on the presentation of our financial statements or related disclosures.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments-Overall". ASU 2016-01 revises the accounting related to the classification and measurement of investments in equity securities and the presentation of certain fair value changes for financial liabilities measured at fair value. ASU 2016-01 is effective for interim and annual reporting periods beginning after December 15, 2017. We adopted this guidance on a prospective basis effective January 1, 2018. The adoption of this guidance resulted in reclassifying unrealized losses, net of tax, on equity securities from accumulated other comprehensive loss to retained earnings, which reduced retained earnings by \$0.1 million at January 1, 2018. As of January 1, 2018, equity securities are presented separately in our Statement of Financial Position. Our disclosures were prepared in accordance with this guidance.

Recently issued accounting standards

In June 2016, the FASB issued ASU 2016-13, "Financial Instruments-Credit Losses", which requires financial assets measured at amortized cost to be presented at the net amount expected to be collected through the use of a new forward-looking expected loss model and credit losses relating to available-for-sale debt securities to be recognized through an allowance for credit losses. ASU 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2019. Early adoption for interim and annual periods beginning after December 15, 2018 is permitted. We have evaluated the impact of this guidance on our invested assets. Our investments are not measured at amortized cost, and therefore do not require the use of a new expected loss model. Our available-for-sale debt securities will continue to be monitored for credit losses which would be reflected as an allowance for credit losses rather than a reduction of the carrying value of the asset. The other material financial assets subject to this guidance include our receivables from Erie Insurance Exchange and its subsidiaries. Given the financial strength of the Exchange, demonstrated by its strong surplus position and industry ratings, it is unlikely these receivables would have significant, if any, credit loss exposure. Accordingly, we do not expect a material impact on our financial statements or related disclosures as a result of this guidance.

In February 2016, the FASB issued ASU 2016-02, "Leases", which requires lessees to recognize assets and liabilities arising from operating leases on the statement of financial position and to disclose key information about leasing arrangements. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Currently ASU 2016-02 requires leases to be recognized and measured at the beginning of the earliest period presented using a modified retrospective approach. In January 2018, the FASB issued a proposed ASU that would allow entities to recognize the cumulative effect adjustment in the year of adoption rather than the earliest period presented. Under existing guidance, we recognize lease expense as a component of operating expenses in the Statements of Operations. We are evaluating our lease contracts to determine those that qualify for treatment as leases under the new guidance and the impact to our financial statements and disclosures.

Recognition of management fee revenue

We earn management fees from the Exchange under the subscriber's agreement for services provided. Pursuant to the subscriber's agreement, we may retain up to 25% of all direct and assumed premiums written by the Exchange. The management fee rate is set at least annually by our Board of Directors. The management fee revenue is calculated by

multiplying the management fee rate by the direct and assumed premiums written by the Exchange. Upon adoption of ASC 606 beginning January 1, 2018, we determined we have two performance obligations under the subscriber's agreement. The first performance obligation is to provide policy issuance and renewal services. The second performance obligation is acting as the attorney-in-fact with respect to the administrative services. Beginning January 1, 2018, our management fee revenue is allocated to these two performance obligations. Prior to the adoption of ASC 606, the entire management fee was allocated to the policy issuance and renewal services.

Management fee revenue allocated to the policy issuance and renewal services is recognized at the time of policy issuance or renewal, because it is at the time of policy issuance or renewal when the economic benefit of the service we provide (the substantially completed policy issuance or renewal service) and the control of the promised asset (the executed insurance policy) transfers to the customer.

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Management fee revenue allocated to the second performance obligation relates to us acting as the attorney-in-fact on behalf of the Exchange, as well as the service provider for its insurance subsidiaries, with respect to the administrative services and is recognized over a four-year period representing the time over which the economic benefit of the services provided (i.e. management of the administrative services) transfers to the customer.

Administrative services

By virtue of its legal structure as a reciprocal insurer, the Exchange does not have any employees or officers. Therefore, it enters into contractual relationships by and through an attorney-in-fact. Indemnity serves as the attorney-in-fact on behalf of the Exchange with respect to its administrative services in accordance with the subscriber's agreement. The Exchange's insurance subsidiaries also utilize Indemnity for these services in accordance with the service agreements between each of the subsidiaries and Indemnity. Claims handling services include costs incurred in the claims process, including the adjustment, investigation, defense, recording and payment functions. Life insurance management services include costs incurred in the management and processing of life insurance business. Investment management services are related to investment trading activity, accounting and all other functions attributable to the investment of funds. Included in these expenses are allocations of costs for departments that support these administrative functions. Common overhead expenses and certain service department costs incurred by us on behalf of the Exchange and its insurance subsidiaries are reimbursed by the proper entity based upon appropriate utilization statistics (employee count, square footage, vehicle count, project hours, etc.) specifically measured to accomplish proportional allocations, which we believe are reasonable. Prior to the adoption of ASC 606, we recorded the reimbursements we receive for the administrative services expenses as receivables from the Exchange and its subsidiaries with a corresponding reduction to our expenses. Upon adoption of ASC 606 on January 1, 2018, the expenses we incur and related reimbursements we receive for administrative services are presented gross in our Statement of Operations. Reimbursements are settled on a monthly basis. The amounts incurred for these services are reimbursed to Indemnity at cost in accordance with the subscriber's agreement and the service agreements. State insurance regulations require that intercompany service agreements and any material amendments be approved in advance by the state insurance department.

Reclassifications

Certain amounts previously reported in the 2017 financial statements have been reclassified for comparative purposes to conform to the current period's presentation. Such reclassifications resulted from new accounting guidance and only affected the Statements of Operations. Most notably, "Commissions", "Salaries and employee benefits", and "All other operating expenses" have been combined within "Cost of operations - policy issuance and renewal services" in the Statements of Operations (See Note 3, "Revenue"). These reclassifications had no effect on previously reported net income.

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Note 3. Revenue

The majority of our revenue is derived from the subscriber's agreement between us and the subscribers (policyholders) at the Exchange. Pursuant to the subscriber's agreement, we earn a management fee calculated as a percentage, not to exceed 25%, of all direct and assumed written premiums of the Exchange. We account for management fee revenue earned under the subscriber's agreement in accordance with ASC 606, which we adopted on January 1, 2018, using the modified retrospective method. See Note 2, "Significant Accounting Policies" for further discussion of the adoption, including the impact on our financial statements.

We allocate a portion of our management fee revenue, currently 25% of the direct and assumed written premiums of the Exchange, between the two performance obligations we have under the subscriber's agreement. The first performance obligation is to provide policy issuance and renewal services to the subscribers (policyholders) at the Exchange, and the second is to act as attorney-in-fact on behalf of the Exchange, as well as the service provider for its insurance subsidiaries, with respect to all administrative services. The transaction price, including management fee revenue and administrative service reimbursement revenue, is allocated based on the estimated standalone selling prices developed using industry information and other available information for similar services.

The first performance obligation is to provide policy issuance and renewal services that result in executed insurance policies between the Exchange or one of its insurance subsidiaries and the subscriber (policyholder). Our customer, the subscriber (policyholder), receives economic benefits when substantially all the policy issuance or renewal services are complete and an insurance policy is issued or renewed by the Exchange or one of its insurance subsidiaries. It is at the time of policy issuance or renewal that the allocated portion of revenue is recognized.

The Exchange, by virtue of its legal structure as a reciprocal insurer, does not have any employees or officers. Therefore, it enters into contractual relationships by and through an attorney-in-fact. Indemnity serves as the attorney-in-fact on behalf of the Exchange with respect to its administrative services in accordance with the subscriber's agreement. The Exchange's insurance subsidiaries also utilize Indemnity for these services in accordance with the service agreements between each of the subsidiaries and Indemnity. Collectively, these services represent a second performance obligation under the subscriber's agreement and the service agreements. The revenue allocated to this performance obligation is recognized over time as these services are provided. The portion of revenue not yet earned is recorded as a contract liability in the Statement of Financial Position. We recorded a contract liability of \$48.5 million at January 1, 2018, upon adoption of ASC 606. The management fee revenue recognized as earned for these services for the six months ended June 30, 2018 was \$26.4 million. Beginning with the adoption of ASC 606 on January 1, 2018, the administrative services expenses we incur and the related reimbursements we receive are recorded gross in the Statement of Operations.

Indemnity records a receivable from the Exchange for management fee revenue when the premium is written or assumed by the Exchange. Indemnity collects the management fee from the Exchange when the Exchange collects the premiums from the subscribers (policyholders). As the Exchange issues policies with annual terms only, cash collections generally occur within one year.

A constraining estimate exists around the management fee received as consideration related to the potential for management fee to be returned if a policy were to be cancelled mid-term. Management fees are returned to the Exchange when policyholders cancel their insurance coverage mid-term and unearned premiums are refunded to them. We maintain an estimated allowance to reduce the management fee to its estimated net realizable value to account for the potential of mid-term policy cancellations based on historical cancellation rates. This estimated allowance has been allocated between the two performance obligations consistent with the revenue allocation proportions.

The following table disaggregates revenue by our two performance obligations:

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| (in thousands) | Three months ended June 30, | | Six months ended June 30, | |
|---|--------------------------------|-----------|------------------------------|-----------|
| | 2018 | 2017 | 2018 | 2017 |
| Management fee revenue - policy issuance and renewal services | \$454,572 | \$441,319 | \$860,550 | \$833,377 |
| Management fee revenue - administrative services | 13,299 | — | 26,373 | — |
| Administrative services reimbursement revenue | 146,507 | — | 292,470 | — |
| Total administrative services | \$159,806 | \$— | \$318,843 | \$— |

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Note 4. Earnings Per Share

Class A and Class B basic earnings per share and Class B diluted earnings per share are calculated under the two-class method. The two-class method allocates earnings to each class of stock based upon its dividend rights. Class B shares are convertible into Class A shares at a conversion ratio of 2,400 to 1. See Note 10, "Capital Stock".

Class A diluted earnings per share are calculated under the if-converted method, which reflects the conversion of Class B shares to Class A shares. Diluted earnings per share calculations include the dilutive effect of assumed issuance of stock-based awards under compensation plans that have the option to be paid in stock using the treasury stock method.

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

| (dollars in thousands, except per share data) | Three months ended June 30, 2018 | | | 2017 | | |
|--|---|-------------------------------------|---------------------|---|-------------------------------------|---------------------|
| | Allocated net income (numerator) | Weighted shares (denominator) | Per-share amount | Allocated net income (numerator) | Weighted shares (denominator) | Per-share amount |
| Class A – Basic EPS: | | | | | | |
| Income available to Class A stockholders | \$79,053 | 46,188,705 | \$ 1.71 | \$58,048 | 46,180,852 | \$ 1.26 |
| Dilutive effect of stock-based awards | 0 | 23,344 | — | 0 | 17,743 | — |
| Assumed conversion of Class B shares | 653 | 6,100,800 | — | 479 | 6,100,800 | — |
| Class A – Diluted EPS: | | | | | | |
| Income available to Class A stockholders on Class A equivalent shares | \$79,706 | 52,312,849 | \$ 1.52 | \$58,527 | 52,299,395 | \$ 1.12 |
| Class B – Basic EPS: | | | | | | |
| Income available to Class B stockholders | \$653 | 2,542 | \$ 257 | \$479 | 2,542 | \$ 189 |
| Class B – Diluted EPS: | | | | | | |
| Income available to Class B stockholders | \$653 | 2,542 | \$ 257 | \$479 | 2,542 | \$ 188 |
| | | | | | | |
| (dollars in thousands, except per share data) | Six months ended June 30, 2018 | | | 2017 | | |
| | Allocated net income (numerator) | Weighted shares (denominator) | Per-share amount | Allocated net income (numerator) | Weighted shares (denominator) | Per-share amount |
| Class A – Basic EPS: | | | | | | |
| Income available to Class A stockholders | \$144,273 | 46,188,309 | \$ 3.12 | \$105,532 | 46,184,666 | \$ 2.28 |
| Dilutive effect of stock-based awards | 0 | 22,632 | — | 0 | 69,748 | — |
| Assumed conversion of Class B shares | 1,191 | 6,100,800 | — | 871 | 6,100,800 | — |
| Class A – Diluted EPS: | | | | | | |
| Income available to Class A stockholders on Class A equivalent shares | \$145,464 | 52,311,741 | \$ 2.78 | \$106,403 | 52,355,214 | \$ 2.03 |
| Class B – Basic EPS: | | | | | | |
| Income available to Class B stockholders | \$1,191 | 2,542 | \$ 469 | \$871 | 2,542 | \$ 343 |
| Class B – Diluted EPS: | | | | | | |
| Income available to Class B stockholders | \$1,191 | 2,542 | \$ 468 | \$871 | 2,542 | \$ 343 |

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Note 5. Fair Value

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

Valuation techniques used to derive the fair value of our available-for-sale debt securities and equity securities are based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources. Unobservable inputs reflect our own assumptions regarding fair market value for these securities. Although virtually all of our prices are obtained from third party sources, we also perform an internal pricing review on outliers, which include securities with price changes inconsistent with current market conditions. Financial instruments are categorized based upon the following characteristics or inputs to the valuation techniques:

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

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

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

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

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

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

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

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The following tables present our fair value measurements on a recurring basis by asset class and level of input:

| (in thousands) | At June 30, 2018 | | | |
|---|------------------|--|---------------------------|-----------------------------|
| | Total | Quoted prices in active markets for identical assets Level 1 | Observable inputs Level 2 | Unobservable inputs Level 3 |
| Fair value measurements using: | | | | |
| Available-for-sale securities: | | | | |
| U.S. treasury | \$36,442 | \$ 0 | \$ 36,442 | \$ 0 |
| States & political subdivisions | 258,491 | 0 | 258,491 | 0 |
| Foreign government securities | 499 | 0 | 499 | 0 |
| Corporate debt securities | 282,006 | 0 | 270,886 | 11,120 |
| Residential mortgage-backed securities | 21,869 | 0 | 21,869 | 0 |
| Commercial mortgage-backed securities | 32,276 | 0 | 32,276 | 0 |
| Collateralized debt obligations | 70,976 | 0 | 70,976 | 0 |
| Other debt securities | 2,869 | 0 | 2,869 | 0 |
| Total available-for-sale securities | 705,428 | 0 | 694,308 | 11,120 |
| Equity securities: | | | | |
| Nonredeemable preferred stock - financial services sector | 12,488 | 1,973 | 10,515 | 0 |
| Total equity securities | 12,488 | 1,973 | 10,515 | 0 |
| Other investments ⁽¹⁾ | 3,752 | — | — | — |
| Total | \$721,668 | \$ 1,973 | \$ 704,823 | \$ 11,120 |

| (in thousands) | At December 31, 2017 | | | |
|---|----------------------|--|---------------------------|-----------------------------|
| | Total | Quoted prices in active markets for identical assets Level 1 | Observable inputs Level 2 | Unobservable inputs Level 3 |
| Fair value measurements using: | | | | |
| Available-for-sale securities: | | | | |
| U.S. treasury | \$11,734 | \$ 0 | \$ 11,734 | \$ 0 |
| States & political subdivisions | 259,264 | 0 | 259,264 | 0 |
| Foreign government securities | 503 | 0 | 503 | 0 |
| Corporate debt securities | 346,523 | 0 | 338,644 | 7,879 |
| Residential mortgage-backed securities | 25,571 | 0 | 25,571 | 0 |
| Commercial mortgage-backed securities | 32,804 | 0 | 32,804 | 0 |
| Collateralized debt obligations | 58,034 | 0 | 55,834 | 2,200 |
| Other debt securities | 11,528 | 0 | 11,528 | 0 |
| Total fixed maturities | 745,961 | 0 | 735,882 | 10,079 |
| Nonredeemable preferred stock - financial services sector | 11,659 | 2,015 | 9,644 | 0 |

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| | | | | |
|--|-----------|----------|------------|-----------|
| Nonredeemable preferred stock - utilities sector | 1,093 | 0 | 1,093 | 0 |
| Total available-for-sale securities | 758,713 | 2,015 | 746,619 | 10,079 |
| Other investments ⁽¹⁾ | 4,816 | — | — | — |
| Total | \$763,529 | \$ 2,015 | \$ 746,619 | \$ 10,079 |

(1) Other investments measured at fair value represent real estate funds included on the balance sheet as limited partnership investments that are reported under the fair value option using the net asset value practical expedient. These amounts are not required to be categorized in the fair value hierarchy. The investments can never be redeemed with the funds. Instead, distributions are received when liquidation of the underlying assets of the funds occur. It is estimated that the underlying assets will generally be liquidated between 5 and 10 years from the inception of the funds. The fair value of these investments is based on the net asset value (NAV) information provided by the general partner. Fair value is based on our proportionate share of the NAV based on the most recent partners' capital statements received from the general partners, which is generally one quarter prior to our balance sheet date. These values are then analyzed to determine if the NAV represents fair value at our balance sheet date, with adjustment being made where appropriate. We consider observable market data and perform a review validating the appropriateness of the NAV at each balance sheet date. It is likely that all of the investments will be redeemed at a future date for an amount different than the NAV of our ownership interest in partners' capital as of June 30, 2018 and December 31, 2017. During the six months ended June 30, 2018, no contributions were made and distributions totaling \$0.7 million were received from these investments. During the year ended December 31, 2017, no contributions were made and distributions totaling \$0.5 million were received from these investments. There were no unfunded commitments related to the investments as of June 30, 2018 and December 31, 2017.

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We review the fair value hierarchy classifications each reporting period. Transfers between hierarchy levels may occur due to changes in available market observable inputs. Transfers into and out of level classifications in 2017 are reported as having occurred at the beginning of the quarter in which the transfers occurred. Effective January 1, 2018, we changed our policy to recognize transfers as occurring at the end of the quarter in which the transfers occurred. This change is applied prospectively due to the immaterial impact on prior year disclosures.

There were no transfers between Level 1 and Level 2 for the three and six months ended June 30, 2018 and 2017.

Level 3 Assets – 2018 Quarterly Change:

| (in thousands) | Beginning balance at March 31, 2018 | Included in earnings ⁽¹⁾ | Included in other comprehensive income | Purchases | Sales | Transfers into Level 3 ⁽²⁾ | Transfers out of Level 3 ⁽²⁾ | Ending balance at June 30, 2018 |
|---|-------------------------------------|-------------------------------------|--|-----------|---------|---------------------------------------|---|---------------------------------|
| Available-for-sale securities: | | | | | | | | |
| Corporate debt securities | \$ 6,309 | \$ 10 | \$ (53) | \$ 3,047 | \$(472) | \$ 5,370 | \$(3,091) | \$ 11,120 |
| Total Level 3 available-for-sale securities | \$ 6,309 | \$ 10 | \$ (53) | \$ 3,047 | \$(472) | \$ 5,370 | \$(3,091) | \$ 11,120 |

Level 3 Assets – 2018 Year-to-Date Change:

| (in thousands) | Beginning balance at December 31, 2017 | Included in earnings ⁽¹⁾ | Included in other comprehensive income | Purchases | Sales | Transfers into Level 3 ⁽²⁾ | Transfers out of Level 3 ⁽²⁾ | Ending balance at June 30, 2018 |
|---|--|-------------------------------------|--|-----------|---------|---------------------------------------|---|---------------------------------|
| Available-for-sale securities: | | | | | | | | |
| Corporate debt securities | \$ 7,879 | \$ 1 | \$ (48) | \$ 3,047 | \$(965) | \$ 7,782 | \$(6,576) | \$ 11,120 |
| Collateralized debt obligations | 2,200 | 0 | 7 | 0 | 0 | 0 | (2,207) | 0 |
| Total Level 3 available-for-sale securities | \$ 10,079 | \$ 1 | \$ (41) | \$ 3,047 | \$(965) | \$ 7,782 | \$(8,783) | \$ 11,120 |

Level 3 Assets – 2017 Quarterly Change:

| (in thousands) | Beginning balance at March 31, 2017 | Included in earnings ⁽¹⁾ | Included in other comprehensive income | Purchases | Sales | Transfers into Level 3 ⁽²⁾ | Transfers out of Level 3 ⁽²⁾ | Ending balance at June 30, 2017 |
|---|-------------------------------------|-------------------------------------|--|-----------|-----------|---------------------------------------|---|---------------------------------|
| Available-for-sale securities: | | | | | | | | |
| Corporate debt securities | \$ 9,803 | \$ 29 | \$ (23) | \$ 2,110 | \$(1,283) | \$ 3,626 | \$(4,967) | \$ 9,295 |
| Total Level 3 available-for-sale securities | \$ 9,803 | \$ 29 | \$ (23) | \$ 2,110 | \$(1,283) | \$ 3,626 | \$(4,967) | \$ 9,295 |

Level 3 Assets – 2017 Year-to-Date Change:

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| (in thousands) | Beginning balance at December 31, 2016 | Included in earnings ⁽¹⁾ | Included in other comprehensive income | Purchases | Sales | Transfers into Level 3 ⁽²⁾ | Transfers out of Level 3 ⁽²⁾ | Ending balance at June 30, 2017 |
|---|--|---|---|-----------|-----------|--|--|---|
| Available-for-sale securities: | | | | | | | | |
| Corporate debt securities | \$ 9,352 | \$ (21) | \$ (48) | \$ 3,981 | \$(3,132) | \$ 5,811 | \$(6,648) | \$ 9,295 |
| Total Level 3 available-for-sale securities | \$ 9,352 | \$ (21) | \$ (48) | \$ 3,981 | \$(3,132) | \$ 5,811 | \$(6,648) | \$ 9,295 |

(1) These amounts are reported in the Statements of Operations as net investment income and net realized investment gains (losses) for the each of the periods presented above.

(2) Transfers into and/or (out) of Level 3 are primarily attributable to the availability of market observable information and the re-evaluation of the observability of pricing inputs.

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Quantitative and Qualitative Disclosures about Unobservable Inputs

When a non-binding broker quote was the only input available, the security was classified within Level 3. Use of non-binding broker quotes totaled \$11.1 million at June 30, 2018. The unobservable inputs are not reasonably available to us.

The following table presents our fair value measurements on a recurring basis by pricing source:

| (in thousands) | At June 30, 2018 | | | |
|---|------------------|---------|-----------|----------|
| | Total | Level 1 | Level 2 | Level 3 |
| Available-for-sale securities priced via pricing services | \$705,428 | \$0 | \$694,308 | \$11,120 |
| Equity securities priced via pricing services | 12,488 | 1,973 | 10,515 | 0 |
| Other investments priced via unobservable inputs ⁽¹⁾ | 3,752 | — | — | — |
| Total | \$721,668 | \$1,973 | \$704,823 | \$11,120 |

(1) Other investments measured at fair value represent real estate funds included on the balance sheet as limited partnership investments that are reported under the fair value option using the NAV practical expedient. These amounts are not required to be categorized in the fair value hierarchy. The fair value of these investments is based on the NAV information provided by the general partner.

There were no assets measured at fair value on a nonrecurring basis during the six months ended June 30, 2018.

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Note 6. Investments

Available-for-sale securities

The following tables summarize the cost and fair value of our available-for-sale securities. See also Note 5, "Fair Value" for additional fair value disclosures.

| (in thousands) | At June 30, 2018 | | | |
|--|------------------|-------------|-------------------|----------------------|
| | Amortized cost | Gross gains | unrealized losses | Estimated fair value |
| Available-for-sale securities: | | | | |
| U.S. treasury | \$36,769 | \$ 0 | \$ 327 | \$36,442 |
| States & political subdivisions | 257,498 | 3,443 | 2,450 | 258,491 |
| Foreign government securities | 500 | 0 | 1 | 499 |
| Corporate debt securities | 285,639 | 663 | 4,296 | 282,006 |
| Residential mortgage-backed securities | 21,739 | 374 | 244 | 21,869 |
| Commercial mortgage-backed securities | 32,878 | 5 | 607 | 32,276 |
| Collateralized debt obligations | 71,009 | 103 | 136 | 70,976 |
| Other debt securities | 2,863 | 6 | 0 | 2,869 |
| Total available-for-sale securities | \$708,895 | \$ 4,594 | \$ 8,061 | \$705,428 |

| (in thousands) | At December 31, 2017 | | | |
|---|----------------------|-------------|-------------------|----------------------|
| | Amortized cost | Gross gains | unrealized losses | Estimated fair value |
| Available-for-sale securities: | | | | |
| U.S. treasury | \$11,873 | \$ 0 | \$ 139 | \$11,734 |
| States & political subdivisions | 254,533 | 5,351 | 620 | 259,264 |
| Foreign government securities | 501 | 2 | 0 | 503 |
| Corporate debt securities | 346,759 | 1,688 | 1,924 | 346,523 |
| Residential mortgage-backed securities | 25,324 | 371 | 124 | 25,571 |
| Commercial mortgage-backed securities | 33,475 | 26 | 697 | 32,804 |
| Collateralized debt obligations | 57,838 | 237 | 41 | 58,034 |
| Other debt securities | 11,496 | 32 | 0 | 11,528 |
| Total fixed maturities | 741,799 | 7,707 | 3,545 | 745,961 |
| Nonredeemable preferred stock - financial services sector | 11,719 | 15 | 75 | 11,659 |
| Nonredeemable preferred stock - utilities sector | 1,118 | 0 | 25 | 1,093 |
| Total available-for-sale securities | \$754,636 | \$ 7,722 | \$ 3,645 | \$758,713 |

The amortized cost and estimated fair value of available-for-sale securities at June 30, 2018, are shown below by remaining contractual term to maturity. Mortgage-backed securities are allocated based upon stated maturity dates. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (in thousands) | At June 30, 2018 | |
|---------------------------------------|------------------|----------------------|
| | Amortized cost | Estimated fair value |
| Due in one year or less | \$94,467 | \$94,408 |
| Due after one year through five years | 241,546 | 242,016 |

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| | | |
|--|-----------|-----------|
| Due after five years through ten years | 249,068 | 246,058 |
| Due after ten years | 123,814 | 122,946 |
| Total available-for-sale securities | \$708,895 | \$705,428 |

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

| (dollars in thousands) | At June 30, 2018 | | | | | | |
|---|---------------------|-------------------|---------------------|-------------------|------------|-------------------|-----------------|
| | Less than 12 months | | 12 months or longer | | Total | | No. of holdings |
| | Fair value | Unrealized losses | Fair value | Unrealized losses | Fair value | Unrealized losses | |
| Available-for-sale securities: | | | | | | | |
| U.S. treasury | \$34,969 | \$ 278 | \$ 1,474 | \$ 49 | \$36,443 | \$ 327 | 5 |
| States & political subdivisions | 99,153 | 1,763 | 13,871 | 687 | 113,024 | 2,450 | 57 |
| Foreign government securities | 499 | 1 | 0 | 0 | 499 | 1 | 1 |
| Corporate debt securities | 194,322 | 3,740 | 28,430 | 556 | 222,752 | 4,296 | 516 |
| Residential mortgage-backed securities | 4,526 | 98 | 5,416 | 146 | 9,942 | 244 | 12 |
| Commercial mortgage-backed securities | 15,500 | 301 | 8,930 | 306 | 24,430 | 607 | 22 |
| Collateralized debt obligations | 28,250 | 136 | 0 | 0 | 28,250 | 136 | 20 |
| Other debt securities | 210 | 0 | 0 | 0 | 210 | 0 | 1 |
| Total available-for-sale securities | \$377,429 | \$ 6,317 | \$ 58,121 | \$ 1,744 | \$435,550 | \$ 8,061 | 634 |
| Quality breakdown of available-for-sale securities: | | | | | | | |
| Investment grade | \$269,062 | \$ 3,554 | \$ 54,423 | \$ 1,577 | \$323,485 | \$ 5,131 | 187 |
| Non-investment grade | 108,367 | 2,763 | 3,698 | 167 | 112,065 | 2,930 | 447 |
| Total available-for-sale securities | \$377,429 | \$ 6,317 | \$ 58,121 | \$ 1,744 | \$435,550 | \$ 8,061 | 634 |

| (dollars in thousands) | At December 31, 2017 | | | | | | |
|---|----------------------|-------------------|---------------------|-------------------|------------|-------------------|-----------------|
| | Less than 12 months | | 12 months or longer | | Total | | No. of holdings |
| | Fair value | Unrealized losses | Fair value | Unrealized losses | Fair value | Unrealized losses | |
| Available-for-sale securities: | | | | | | | |
| U.S. treasury | \$10,237 | \$ 110 | \$ 1,497 | \$ 29 | \$11,734 | \$ 139 | 4 |
| States & political subdivisions | 52,553 | 288 | 14,361 | 332 | 66,914 | 620 | 33 |
| Corporate debt securities | 171,154 | 1,585 | 31,113 | 339 | 202,267 | 1,924 | 331 |
| Residential mortgage-backed securities | 4,156 | 29 | 7,064 | 95 | 11,220 | 124 | 11 |
| Commercial mortgage-backed securities | 10,836 | 85 | 11,984 | 612 | 22,820 | 697 | 19 |
| Collateralized debt obligations | 21,598 | 41 | 0 | 0 | 21,598 | 41 | 12 |
| Other debt securities | 1,499 | 0 | 0 | 0 | 1,499 | 0 | 1 |
| Total fixed maturities | 272,033 | 2,138 | 66,019 | 1,407 | 338,052 | 3,545 | 411 |
| Nonredeemable preferred stock - financial services sector | 9,644 | 75 | 0 | 0 | 9,644 | 75 | 5 |
| Nonredeemable preferred stock - utilities sector | 1,093 | 25 | 0 | 0 | 1,093 | 25 | 1 |
| Total available-for-sale securities | \$282,770 | \$ 2,238 | \$ 66,019 | \$ 1,407 | \$348,789 | \$ 3,645 | 417 |
| Quality breakdown of fixed maturities: | | | | | | | |
| Investment grade | \$214,586 | \$ 1,064 | \$ 62,193 | \$ 985 | \$276,779 | \$ 2,049 | 158 |
| Non-investment grade | 57,447 | 1,074 | 3,826 | 422 | 61,273 | 1,496 | 253 |
| Total fixed maturities | \$272,033 | \$ 2,138 | \$ 66,019 | \$ 1,407 | \$338,052 | \$ 3,545 | 411 |

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

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Net investment income

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

| (in thousands) | Three months ended June 30, | | Six months ended June 30, | |
|------------------------------------|-----------------------------|---------|---------------------------|----------|
| | 2018 | 2017 | 2018 | 2017 |
| Fixed maturities ⁽¹⁾ | \$6,263 | \$6,220 | \$12,373 | \$12,124 |
| Equity securities | 142 | 17 | 284 | 49 |
| Cash equivalents and other | 1,026 | 395 | 2,034 | 916 |
| Total investment income | 7,431 | 6,632 | 14,691 | 13,089 |
| Less: investment expenses | 327 | 393 | 767 | 869 |
| Investment income, net of expenses | \$7,104 | \$6,239 | \$13,924 | \$12,220 |

(1) Includes interest earned on note receivable from Erie Family Life Insurance Company ("EFL") of \$0.4 million and \$0.8 million for the three and six months ended June 30, 2018 and 2017, respectively.

Realized investment gains (losses)

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

| (in thousands) | Three months ended June 30, | | Six months ended June 30, | |
|--|-----------------------------|--------|---------------------------|---------|
| | 2018 | 2017 | 2018 | 2017 |
| Available-for-sale securities: | | | | |
| Gross realized gains | \$235 | \$507 | \$575 | \$1,087 |
| Gross realized losses | (301) | (381) | (986) | (539) |
| Net realized (losses) gains on available-for-sale securities | (66) | 126 | (411) | 548 |
| Equity securities | (68) | — | (188) | — |
| Miscellaneous | 102 | (2) | 102 | 92 |
| Net realized investment (losses) gains | \$(32) | \$124 | \$(497) | \$640 |

The portion of net unrealized losses recognized during the reporting period, related to equity securities still held at the reporting date, is calculated as follows:

| (in thousands) | Three months ended June 30, | | Six months ended June 30, | |
|--|-----------------------------|------|---------------------------|------|
| | 2018 | 2017 | 2018 | 2017 |
| Equity securities: | | | | |
| (1) | | | | |
| Total net realized losses | \$ (68) | \$ — | \$ (188) | \$ — |
| Less: net losses realized on securities sold | 0 | — | (34) | — |
| Net unrealized losses recognized | \$ (68) | \$ — | \$ (154) | \$ — |

during the period
on securities held
at reporting date

(1) With the adoption of ASU 2016-01, effective January 1, 2018, changes in unrealized gains and losses on equity securities are included in net realized investment gains (losses) in the Statement of Operations. The adoption of this guidance resulted in a reclassification of net unrealized losses of \$0.1 million from accumulated other comprehensive loss to retained earnings at January 1, 2018.

Other-than-temporary impairments on available-for-sale securities recognized in earnings were \$0.6 million and \$0.1 million for the quarters ended June 30, 2018 and 2017, respectively, and \$0.6 million and \$0.2 million for the six months ended June 30, 2018 and 2017, respectively. We have the intent to sell all credit-impaired available-for-sale debt securities; therefore, the entire amount of the impairment charges were included in earnings and no non-credit impairments were recognized in other comprehensive income.

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Limited partnerships

The majority of our limited partnership holdings are considered investment companies where the general partners record assets at fair value. These limited partnerships are recorded using the equity method of accounting and are generally reported on a one-quarter lag; therefore, our year-to-date limited partnership results through June 30, 2018 are comprised of partnership financial results for the fourth quarter of 2017 and first quarter of 2018. Given the lag in reporting, our limited partnership results do not reflect the market conditions of the second quarter of 2018. We also own some real estate limited partnerships that do not meet the criteria of an investment company. These partnerships prepare audited financial statements on a cost basis. We have elected to report these limited partnerships under the fair value option, which is based on the NAV from our partner's capital statement reflecting the general partner's estimate of fair value for the fund's underlying assets. Fair value provides consistency in the evaluation and financial reporting for these limited partnerships and limited partnerships accounted for under the equity method. Cash contributions made to and distributions received from the partnerships are recorded in the period in which the transaction occurs.

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|-----------------------------|-------|---------------------------|-------|
| (in thousands) | 2018 | 2017 | 2018 | 2017 |
| Equity in (losses) earnings of limited partnerships accounted for under the equity method | \$(216) | \$149 | \$(21) | \$399 |
| Change in fair value of limited partnerships accounted for under the fair value option | (3) | 0 | (390) | (37) |
| Equity in (losses) earnings of limited partnerships | \$(219) | \$149 | \$(411) | \$362 |

The following table summarizes limited partnership investments by sector:

| (in thousands) | At June 30, 2018 | At December 31, 2017 |
|---------------------------------------|------------------|----------------------|
| Private equity | \$30,501 | \$ 31,663 |
| Mezzanine debt | 2,916 | 3,516 |
| Real estate | 2,482 | 5,127 |
| Real estate - fair value option | 3,752 | 4,816 |
| Total limited partnership investments | \$39,651 | \$ 45,122 |

See also Note 13, "Commitments and Contingencies" for investment commitments related to limited partnerships.

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Note 7. Borrowing Arrangements

Bank line of credit

As of June 30, 2018, we have access to a \$100 million bank revolving line of credit with a \$25 million letter of credit sublimit that expires on November 3, 2020. As of June 30, 2018, a total of \$99.1 million remains available under the facility due to \$0.9 million outstanding letters of credit, which reduce the availability for letters of credit to \$24.1 million. We had no borrowings outstanding on our line of credit as of June 30, 2018. Bonds with a fair value of \$108.1 million were pledged as collateral on the line at June 30, 2018. The securities pledged as collateral have no trading restrictions and are reported as available-for-sale securities in the Statements of Financial Position as of June 30, 2018. The banks require compliance with certain covenants, which include leverage ratios and debt restrictions, for our line of credit. We are in compliance with all covenants at June 30, 2018.

Term loan credit facility

In 2016, we entered into a credit agreement for a \$100 million senior secured draw term loan credit facility ("Credit Facility") for the acquisition of real property and construction of an office building that will serve as part of our principal headquarters. Under the agreement, \$25 million was drawn on December 1, 2016, June 1, 2017, and December 1, 2017. The final \$25 million was completed on June 1, 2018, for a total drawn amount of \$100 million. During the draw period from December 1, 2016 through December 31, 2018, we will make monthly interest payments under the Credit Facility. Upon the expiration of the draw period, the Credit Facility converts to a fully-amortized term loan with monthly payments of principal and interest over a period of 28 years, commencing on January 1, 2019. Borrowings under the Credit Facility bear interest at a fixed rate of 4.35%. In addition, we are required to pay a quarterly commitment fee of 0.08% on the unused portion of the Credit Facility during the draw period. Bonds with a fair value of \$108.3 million were pledged as collateral for the facility and are reported as available-for-sale securities in the Statements of Financial Position as of June 30, 2018. The bank requires compliance with certain covenants, which include leverage ratios, debt restrictions and minimum net worth, for our Credit Facility. We are in compliance with all covenants at June 30, 2018.

Amounts drawn from the Credit Facility are reported at carrying value on our Statements of Financial Position, net of unamortized loan origination and commitment fees. The estimated fair value of this borrowing at June 30, 2018 was \$94.3 million. The estimated fair value was determined using estimates based upon interest rates and credit spreads and are classified as Level 3 in the fair value hierarchy as of June 30, 2018.

The scheduled maturity of the \$100 million Credit Facility begins on January 1, 2019 with annual principal payments of \$1.9 million in 2019, \$2.0 million in 2020, \$2.0 million in 2021, \$2.1 million in 2022, \$2.2 million in 2023 and \$89.8 million thereafter.

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Note 8. Postretirement Benefits

Pension plans

Our pension plans consist of a noncontributory defined benefit pension plan covering substantially all employees and an unfunded supplemental employee retirement plan for certain members of executive and senior management. Although we are the sponsor of these postretirement plans and record the funded status of these plans, the Exchange and its subsidiaries reimburse us for approximately 59% of the annual benefit expense of these plans, which represents pension benefits for employees performing administrative services and their allocated share of costs for employees in departments that support the administrative functions.

An accelerated contribution of \$40 million was made to the defined benefit pension plan in the first quarter of 2018, and an additional \$40 million contribution was made in April 2018.

Prior to 2003, the employee pension plan purchased annuities from EFL for certain plan participants that were receiving benefit payments under the pension plan. These are nonparticipating annuity contracts under which EFL has unconditionally contracted to provide specified benefits to beneficiaries; however, the pension plan remains the primary obligor to the beneficiaries. A contingent liability of \$18.3 million at June 30, 2018 exists in the event EFL does not honor the annuity contracts.

The cost of our pension plans are as follows:

| (in thousands) | Three months ended June 30, | | Six months ended June 30, | |
|--------------------------------------|-----------------------------|----------|---------------------------|----------|
| | 2018 | 2017 | 2018 | 2017 |
| Service cost for benefits earned | \$9,513 | \$7,776 | \$19,026 | \$15,553 |
| Interest cost on benefits obligation | 8,845 | 8,568 | 17,691 | 17,137 |
| Expected return on plan assets | (12,814) | (10,316) | (25,629) | (20,633) |
| Prior service cost amortization | 338 | 218 | 676 | 436 |
| Net actuarial loss amortization | 3,202 | 2,325 | 6,404 | 4,650 |
| Pension plan cost ⁽¹⁾ | \$9,084 | \$8,571 | \$18,168 | \$17,143 |

(1) The components of pension plan costs other than the service cost component are included in the line item "Other income (expense)" in the Statements of Operations after reimbursements from the Exchange and its subsidiaries.

Note 9. Income Taxes

The effective tax rate may differ from the statutory federal tax rate primarily due to permanent differences for tax exempt interest income.

Income tax amounts are estimates based on our initial analysis and current interpretation of the Tax Cuts and Jobs Act enacted in 2017. Given the complexity of the legislation, anticipated guidance from the U.S. Treasury, and the potential for additional guidance from the Securities and Exchange Commission or the FASB, these estimates may be adjusted during 2018.

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Note 10. Capital Stock

Class A and B common stock

Holders of Class B shares may, at their option, convert their shares into Class A shares at the rate of 2,400 Class A shares per Class B share. There were no shares of Class B common stock converted into Class A common stock during the six months ended June 30, 2018 and the year ended December 31, 2017. There is no provision for conversion of Class A shares to Class B shares, and Class B shares surrendered for conversion cannot be reissued.

Stock repurchases

In 2011, our Board of Directors approved a continuation of the current stock repurchase program of \$150 million, with no time limitation. There were no shares repurchased under this program during the six months ended June 30, 2018 and the year ended December 31, 2017. We had approximately \$17.8 million of repurchase authority remaining under this program at June 30, 2018.

During the six months ended June 30, 2018, we purchased 22,247 shares of our outstanding Class A nonvoting common stock outside of our publicly announced share repurchase program at a total cost of \$2.6 million. Of this amount, we purchased 5,830 shares for \$0.7 million, or \$117.39 per share, for stock-based awards in conjunction with our equity compensation plan, for which the shares were delivered to plan participants in January and May 2018. We purchased 4,576 shares for \$0.5 million, or \$115.69 per share, to fund the rabbi trust for the outside director deferred stock compensation plan. The shares were transferred to the rabbi trust in March and May 2018. The remaining 11,841 shares were purchased at a total cost of \$1.4 million, or \$119.14 per share, to fund the rabbi trust for the incentive compensation deferral plan. The shares were transferred to the rabbi trust in March and May 2018.

During the year ended December 31, 2017, we purchased 60,332 shares of our outstanding Class A nonvoting common stock outside of our publicly announced share repurchase program at a total cost of \$7.3 million. Of this amount, we purchased 3,785 shares for \$0.4 million, or \$111.55 per share, for stock-based awards in conjunction with our equity compensation plan. We purchased 9,663 shares for \$1.2 million, or \$121.85 per share, to fund the rabbi trust for the outside director deferred stock compensation plan. The remaining 46,884 shares were purchased at a total cost of \$5.7 million, or \$122.40 per share, for stock-based awards in conjunction with our long-term incentive plan. These shares were delivered in 2017.

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Note 11. Accumulated Other Comprehensive Income (Loss)

Changes in accumulated other comprehensive income ("AOCI") (loss) by component, including amounts reclassified to other comprehensive income ("OCI") (loss) and the related line item in the Statements of Operations where net income is presented, are as follows:

| (in thousands) | Three months ended June 30, 2018 | | | Three months ended June 30, 2017 | | |
|---|-------------------------------------|------------------------------|-------------|-------------------------------------|------------------------------|-------------|
| | Before Tax | Income Tax ⁽¹⁾ | Net | Before Tax | Income Tax ⁽¹⁾ | Net |
| Investment securities: | | | | | | |
| AOCI (loss), beginning of period | \$(3,460) | \$(727) | \$(2,733) | \$6,293 | \$2,202 | \$4,091 |
| OCI (loss) before reclassifications | (1,409) | (296) | (1,113) | 1,746 | 611 | 1,135 |
| Realized investment losses (gains) | 66 | 14 | 52 | (126) | (44) | (82) |
| Impairment losses | 646 | 136 | 510 | 61 | 22 | 39 |
| OCI (loss) | (697) | (146) | (551) | 1,681 | 589 | 1,092 |
| AOCI (loss), end of period | \$(4,157) | \$(873) | \$(3,284) | \$7,974 | \$2,791 | \$5,183 |
| Pension and other postretirement plans: ⁽²⁾ | | | | | | |
| AOCI (loss), beginning of period | \$(200,954) | \$(42,201) | \$(158,753) | \$(190,695) | \$(66,744) | \$(123,951) |
| AOCI (loss), end of period | \$(200,954) | \$(42,201) | \$(158,753) | \$(190,695) | \$(66,744) | \$(123,951) |
| Total | | | | | | |
| AOCI (loss), beginning of period | \$(204,414) | \$(42,928) | \$(161,486) | \$(184,402) | \$(64,542) | \$(119,860) |
| Investment securities | (697) | (146) | (551) | 1,681 | 589 | 1,092 |
| Pension and other postretirement plans | 0 | 0 | 0 | 0 | 0 | 0 |
| OCI (loss) | (697) | (146) | (551) | 1,681 | 589 | 1,092 |
| AOCI (loss), end of period | \$(205,111) | \$(43,074) | \$(162,037) | \$(182,721) | \$(63,953) | \$(118,768) |
| Investment securities: | | | | | | |
| AOCI, beginning of period | \$3,410 | \$716 | \$2,694 | \$3,954 | \$1,384 | \$2,570 |
| OCI (loss) before reclassifications | (8,539) | (1,793) | (6,746) | 4,386 | 1,535 | 2,851 |
| Realized investment losses (gains) | 411 | 86 | 325 | (548) | (192) | (356) |
| Impairment losses | 646 | 136 | 510 | 182 | 64 | 118 |
| Cumulative effect of adopting ASU 2016-01 ⁽³⁾ | (85) | (18) | (67) | — | — | — |
| OCI (loss) | (7,567) | (1,589) | (5,978) | 4,020 | 1,407 | 2,613 |
| AOCI (loss), end of period | \$(4,157) | \$(873) | \$(3,284) | \$7,974 | \$2,791 | \$5,183 |
| Pension and other postretirement plans: ⁽²⁾ | | | | | | |
| AOCI (loss), beginning of period | \$(200,954) | \$(42,201) | \$(158,753) | \$(190,695) | \$(66,744) | \$(123,951) |
| AOCI (loss), end of period | \$(200,954) | \$(42,201) | \$(158,753) | \$(190,695) | \$(66,744) | \$(123,951) |
| Total | | | | | | |
| AOCI (loss), beginning of period | \$(197,544) | \$(41,485) | \$(156,059) | \$(186,741) | \$(65,360) | \$(121,381) |
| Investment securities | (7,567) | (1,589) | (5,978) | 4,020 | 1,407 | 2,613 |
| Pension and other postretirement plans | 0 | 0 | 0 | 0 | 0 | 0 |

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| | | | | | | | | | |
|----------------------------|-------------|------------|-------------|-------------|------------|-------------|-------|-------|-------|
| OCI (loss) | (7,567 |) | (1,589 |) | (5,978 |) | 4,020 | 1,407 | 2,613 |
| AOCI (loss), end of period | \$(205,111) | \$(43,074) | \$(162,037) | \$(182,721) | \$(63,953) | \$(118,768) | | | |

- (1) Deferred taxes were recognized at the corporate rate of 21% for the three and six months ended June 30, 2018 and 35% for the three and six months ended June 30, 2017.
- (2) There are no comprehensive income items or amounts reclassified out of accumulated other comprehensive loss related to postretirement plan items during interim periods.
- (3) ASU 2016-01 required a reclassification of unrealized losses of equity securities from AOCI to retained earnings at January 1, 2018. See Note 2, "Significant Accounting Policies".

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Note 12. Concentrations of Credit Risk

Financial instruments could potentially expose us to concentrations of credit risk, including unsecured receivables from the Exchange. A large majority of our revenue and receivables are from the Exchange and its subsidiaries. See also Note 1, "Nature of Operations". Management fee amounts and other reimbursements due from the Exchange and its subsidiaries were \$445.2 million and \$418.3 million at June 30, 2018 and December 31, 2017, respectively.

Note 13. Commitments and Contingencies

We have contractual commitments to invest up to \$13.9 million related to our limited partnership investments at June 30, 2018. These commitments are split among private equity securities of \$5.5 million, mezzanine debt securities of \$8.1 million, and real estate activities of \$0.3 million. These commitments will be funded as required by the limited partnership agreements.

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

We believe that our accruals for legal proceedings are appropriate and, individually and in the aggregate, are not expected to be material to our financial condition, results of operations, or cash flows.

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

Note 14. Subsequent Events

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

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

The following discussion of financial condition and results of operations highlights significant factors influencing Erie Indemnity Company ("Indemnity", "we", "us", "our"). This discussion should be read in conjunction with the historical financial statements and the related notes thereto included in Part I, Item 1. "Financial Statements" of this Quarterly Report on Form 10-Q, and with Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" for the year ended December 31, 2017, as contained in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 22, 2018.

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CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

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

Statements contained herein that are not historical fact are forward-looking statements and, as such, are subject to risks and uncertainties that could cause actual events and results to differ, perhaps materially, from those discussed herein. Forward-looking statements relate to future trends, events or results and include, without limitation, statements and assumptions on which such statements are based that are related to our plans, strategies, objectives, expectations, intentions, and adequacy of resources. Examples of forward-looking statements are discussions relating to premium and investment income, expenses, operating results, and compliance with contractual and regulatory requirements. Forward-looking statements are not guarantees of future performance and involve risks and uncertainties that are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Among the risks and uncertainties, in addition to those set forth in our filings with the Securities and Exchange Commission, that could cause actual results and future events to differ from those set forth or contemplated in the forward-looking statements include the following:

- dependence upon our relationship with the Exchange and the management fee under the agreement with the subscribers at the Exchange;

- dependence upon our relationship with the Exchange and the growth of the Exchange, including:

- general business and economic conditions;
- factors affecting insurance industry competition;
- dependence upon the independent agency system; and
- ability to maintain our reputation for customer service;

- dependence upon our relationship with the Exchange and the financial condition of the Exchange, including:

- the Exchange's ability to maintain acceptable financial strength ratings;
- factors affecting the quality and liquidity of the Exchange's investment portfolio;

changes in government regulation of the insurance industry;
emerging claims and coverage issues in the industry; and
severe weather conditions or other catastrophic losses, including terrorism;
costs of providing policy issuance and renewal services to the Exchange under the subscriber's agreement;
credit risk from the Exchange;
ability to attract and retain talented management and employees;
ability to ensure system availability and effectively manage technology initiatives;
difficulties with technology or data security breaches, including cyber attacks;
ability to maintain uninterrupted business operations;
factors affecting the quality and liquidity of our investment portfolio;

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our ability to meet liquidity needs and access capital; and
outcome of pending and potential litigation.

A forward-looking statement speaks only as of the date on which it is made and reflects our analysis only as of that date. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events, changes in assumptions, or otherwise.

RECENTLY ADOPTED ACCOUNTING STANDARDS

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Codification (ASC) 606, "Revenue from Contracts with Customers". ASC 606 requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. (See Part I, Item 1. "Financial Statements - Note 2, Significant Accounting Policies, of Notes to Financial Statements" contained within this report.) We adopted ASC 606 as of January 1, 2018 using the modified retrospective method.

Under ASC 606, we determined that we are acting as the attorney-in-fact for the subscribers at the Exchange in two capacities pursuant to the subscriber's agreement. The first is providing policy issuance and renewal services. The second is acting as the attorney-in-fact on behalf of the Exchange, as well as the service provider for its insurance subsidiaries, with respect to all claims handling, life insurance, and investment management services, collectively referred to as "administrative services". Beginning January 1, 2018, the management fee, currently 25% of all direct and assumed premiums written by the Exchange, will be allocated between the two performance obligations. Prior to the adoption of ASC 606, the entire management fee was allocated to the policy issuance and renewal services. Additionally, the expenses we incur and related reimbursements we receive for administrative services are presented gross in our Statement of Operations effective January 1, 2018.

A significant portion of the management fee will be allocated to the policy issuance and renewal services and recognized at a point in time, i.e. the time of policy issuance or renewal. Therefore, the related revenue recognition pattern for the vast majority of our revenues remains unchanged. The management fee allocated to the administrative services will be recognized as revenue over a four-year period in correlation to costs incurred. Upon adoption at January 1, 2018, we established a contract liability related to the administrative services of \$48.5 million, a deferred tax asset of \$10.2 million, and recorded a cumulative effect adjustment that reduced shareholders' equity by \$38.3 million. If ASC 606 had been effective in 2017, based on current estimates our revenue would have been reduced by approximately \$1.9 million for the six months ended June 30, 2017, and reduced by approximately \$2.8 million for the year ended December 31, 2017.

RECENT ACCOUNTING STANDARDS

See Part I, Item 1. "Financial Statements - Note 2, Significant Accounting Policies, of Notes to Financial Statements" contained within this report for a discussion of other recently adopted as well as recently issued accounting standards and the impact on our financial statements if known.

OPERATING OVERVIEW

Overview

We serve as the attorney-in-fact for the subscribers (policyholders) at the Exchange, a reciprocal insurer that writes property and casualty insurance. Our primary function as attorney-in-fact is to perform policy issuance and renewal

services on behalf of the subscribers at the Exchange. We also act as attorney-in-fact on behalf of the Exchange, as well as the service provider for its insurance subsidiaries, with respect to all administrative services.

The Exchange is a reciprocal insurance exchange, which is an unincorporated association of individuals, partnerships and corporations that agree to insure one another. Each applicant for insurance to the Exchange signs a subscriber's agreement, which contains an appointment of Indemnity as their attorney-in-fact to transact the business of the Exchange on their behalf. Pursuant to the subscriber's agreement for acting as attorney-in-fact in these two capacities, we earn a management fee calculated as a percentage of the direct and assumed premiums written by the Exchange.

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Our earnings are primarily driven by the management fee revenue generated for the services we provide to the Exchange. The policy issuance and renewal services we provide to the Exchange are related to the sales, underwriting and issuance of policies. The sales related services we provide include agent compensation and certain sales and advertising support services. Agent compensation includes scheduled commissions to agents based upon premiums written as well as additional commissions and bonuses to agents, which are earned by achieving targeted measures. Agent compensation generally comprises approximately two-thirds of our policy issuance and renewal expenses. The underwriting services we provide include underwriting and policy processing. The remaining services we provide include customer service and administrative support. We also provide information technology services that support all the functions listed above. Included in these expenses are allocations of costs for departments that support these policy issuance and renewal functions.

By virtue of its legal structure as a reciprocal insurer, the Exchange does not have any employees or officers. Therefore, it enters into contractual relationships by and through an attorney-in-fact. Indemnity serves as the attorney-in-fact on behalf of the Exchange with respect to its administrative services. The Exchange's insurance subsidiaries also utilize Indemnity for these services in accordance with the service agreements between each of the subsidiaries and Indemnity. Claims handling services include costs incurred in the claims process, including the adjustment, investigation, defense, recording and payment functions. Life insurance management services include costs incurred in the management and processing of life insurance business. Investment management services are related to investment trading activity, accounting and all other functions attributable to the investment of funds. Included in these expenses are allocations of costs for departments that support these administrative functions. The amounts incurred for these services are reimbursed to Indemnity at cost in accordance with the subscriber's agreement and the service agreements. State insurance regulations require that intercompany service agreements and any material amendments be approved in advance by the state insurance department.

Our results of operations are tied to the growth and financial condition of the Exchange as the Exchange is our sole customer, and our earnings are largely generated from management fees based on the direct and assumed premiums written by the Exchange. The Exchange generates revenue by insuring preferred and standard risks, with personal lines comprising 71% of the 2017 direct and assumed written premiums and commercial lines comprising the remaining 29%. The principal personal lines products are private passenger automobile and homeowners. The principal commercial lines products are commercial multi-peril, commercial automobile and workers compensation.

Financial Overview

| (dollars in thousands, except per share data) | Three months ended June 30, | | | Six months ended June 30, | | |
|---|-----------------------------|----------|----------|---------------------------|-----------|----------|
| | 2018 | 2017 | % Change | 2018 | 2017 | % Change |
| | (Unaudited) | | | (Unaudited) | | |
| Operating income | \$95,323 | \$83,448 | 14.2 % | \$172,890 | \$150,388 | 15.0 % |
| Total investment income | 6,207 | 6,451 | (3.8) | 12,370 | 13,040 | (5.1) |
| Interest expense, net | 602 | 257 | NM | 1,155 | 423 | NM |
| Other income (expense) | 58 | (407) | NM | 102 | (816) | NM |
| Income before income taxes | 100,986 | 89,235 | 13.2 | 184,207 | 162,189 | 13.6 |
| Income tax expense | 21,280 | 30,708 | (30.7) | 38,743 | 55,786 | (30.6) |
| Net income | \$79,706 | \$58,527 | 36.2 % | \$145,464 | \$106,403 | 36.7 % |
| Net income per share - diluted | \$1.52 | \$1.12 | 36.2 % | \$2.78 | \$2.03 | 36.8 % |

NM = not meaningful

Operating income increased in both the second quarter and six months ended June 30, 2018, compared to the same periods in 2017, as the growth in total operating revenue outpaced the growth in total operating expenses. Management fee revenue for policy issuance and renewal services increased \$13.3 million in the second quarter of 2018 and \$27.2 million for the six months ended June 30, 2018, compared to the same periods in 2017. Management fee revenue allocated to administrative services was \$13.3 million in the second quarter of 2018 and \$26.4 million for the six months ended June 30, 2018. No management fee revenue was allocated to administrative services in the second quarter or six months ended June 30, 2017. Management fee revenue is based upon the management fee rate we charge, and the direct and assumed premiums written by the Exchange. The management fee rate was 25% for both 2018 and 2017. The direct and assumed premiums written by the Exchange increased 6.5% to \$1.9 billion in the second quarter of 2018 and 6.7% to \$3.6 billion for the six months ended June 30, 2018, compared to the same periods in 2017. The administrative services reimbursement revenue and corresponding cost of operations increased both total operating revenue and total operating expenses by \$146.5 million for the second quarter of 2018 and \$292.5 million for the six months ended June 30, 2018, but had no net impact on operating income.

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Cost of operations for policy issuance and renewal services increased 4.0% and 4.4% in the three and six months ended June 30, 2018, respectively, compared to the same periods in 2017, due to higher commissions and higher underwriting and policy processing costs driven by direct written premium growth.

Total investment income decreased \$0.2 million in the second quarter of 2018 and \$0.7 million for the six months ended June 30, 2018, compared to the same periods in 2017, primarily driven by net realized losses and impairments on investments.

Income before income taxes increased \$11.8 million in the second quarter and \$22.0 million for the six months ended June 30, 2018, while income tax expense decreased \$9.4 million in the second quarter and \$17.0 million for the six months ended June 30, 2018, due to the lower income tax rate of 21% which became effective January 1, 2018.

General Conditions and Trends Affecting Our Business

Economic conditions

Unfavorable changes in economic conditions, including declining consumer confidence, inflation, high unemployment, and the threat of recession, among others, may lead the Exchange's customers to modify coverage, not renew policies, or even cancel policies, which could adversely affect the premium revenue of the Exchange, and consequently our management fee. Further, unanticipated increased inflation costs including medical cost inflation, construction and auto repair cost inflation, and tort issues may impact the estimated loss reserves and future premium rates. If any of these items impacted the financial condition or continuing operations of the Exchange, it could have an impact on our financial results.

Financial market volatility

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

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RESULTS OF OPERATIONS

Management fee revenue

On January 1, 2018, we adopted ASC 606, "Revenue from Contracts with Customers". Upon adoption, we determined we have two performance obligations in the subscriber's agreement, providing policy issuance and renewal services and acting as attorney-in-fact for the Exchange, as well as the service provider for its insurance subsidiaries, with respect to all administrative services. We earn management fees for acting as the attorney-in-fact for the subscribers at the Exchange in these two capacities. Upon adoption of ASC 606, we are required to allocate our revenues between our performance obligations. Prior to the adoption of ASC 606, the entire management fee was allocated to the policy issuance and renewal services.

The management fee is calculated by multiplying all direct and assumed premiums written by the Exchange by the management fee rate, which is determined by our Board of Directors at least annually. The management fee rate was set at 25%, the maximum rate, for both 2018 and 2017. Changes in the management fee rate can affect our revenue and net income significantly.

The following table presents the allocation and disaggregation of revenue for our two performance obligations:

| (dollars in thousands) | Three months ended June 30, | | | Six months ended June 30, | | |
|--|-----------------------------|--------------|----------|---------------------------|--------------|----------|
| | 2018 (Unaudited) | 2017 | % Change | 2018 (Unaudited) | 2017 | % Change |
| Policy issuance and renewal services | | | | | | |
| Direct and assumed premiums written by the Exchange | \$ 1,887,999 | \$ 1,772,877 | 6.5 % | \$ 3,570,793 | \$ 3,345,908 | 6.7 % |
| Management fee rate | 24.2 | % 25.0 | % | 24.2 | % 25.0 | % |
| Management fee revenue | 456,896 | 443,219 | 3.1 | 864,132 | 836,477 | 3.3 |
| Change in allowance for management fee returned on cancelled policies ⁽¹⁾ | (2,324) | (1,900) | NM | (3,582) | (3,100) | NM |
| Management fee revenue - policy issuance and renewal services, net ⁽²⁾ | \$ 454,572 | \$ 441,319 | 3.0 % | \$ 860,550 | \$ 833,377 | 3.3 % |
| Administrative services | | | | | | |
| Direct and assumed premiums written by the Exchange | \$ 1,887,999 | \$ — | N/A % | \$ 3,570,793 | \$ — | N/A % |
| Management fee rate | 0.8 | % — | | 0.8 | % — | |
| Management fee revenue | 15,104 | — | N/A | 28,566 | — | N/A |
| Change in contract liability ⁽³⁾ | (1,791) | N/A | N/A | (2,165) | N/A | N/A |
| Change in allowance for management fee returned on cancelled policies ⁽¹⁾ | (14) | N/A | N/A | (28) | N/A | N/A |
| Management fee revenue - administrative services, net | 13,299 | — | N/A | 26,373 | — | N/A |
| Administrative services reimbursement revenue | 146,507 | — | N/A | 292,470 | — | N/A |
| Total revenue from administrative services | \$ 159,806 | \$ — | N/A % | \$ 318,843 | \$ — | N/A % |

NM = not meaningful

N/A = not applicable

(1)

Management fees are returned to the Exchange when policies are cancelled mid-term and unearned premiums are refunded. We record an estimated allowance for management fees returned on mid-term policy cancellations. This estimated allowance has been allocated between the two performance obligations consistent with the revenue allocation proportion.

(2) The allocation of management fee revenue between the two performance obligations beginning January 1, 2018, caused the growth in management fee revenue - policy issuance and renewal services to not correspond directly with the growth in direct and assumed premiums written by the Exchange in the second quarter and six months ended June 30, 2018 compared to same respective periods in 2017.

(3) With the adoption of ASC 606 effective January 1, 2018, management fee revenue - administrative services is recognized over time as the services are performed. See Part I, Item 1. "Financial Statements - Note 2, Significant Accounting Policies and Note 3, Revenue, of Notes to Financial Statements" contained within this report.

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Direct and assumed premiums written by the Exchange

Direct and assumed premiums include premiums written directly by the Exchange and premiums assumed from its wholly owned property and casualty subsidiaries. Direct and assumed premiums written by the Exchange increased 6.5% to \$1.9 billion in the second quarter of 2018 compared to the second quarter of 2017, driven by increases in both policies in force and average premium per policy. Year-over-year policies in force for all lines of business increased 3.5% in the second quarter of 2018 as the result of continuing strong policyholder retention and an increase in new policies written, compared to 3.2% in the second quarter of 2017. The year-over-year average premium per policy for all lines of business increased 2.8% at June 30, 2018, compared to 2.7% at June 30, 2017.

Premiums generated from new business increased 7.0% to \$236 million in the second quarter of 2018, compared to an increase of 10.4% to \$221 million in the second quarter of 2017. Underlying the trend in new business premiums was a 0.1% increase in new business policies written in the second quarter of 2018, compared to a 6.3% increase in the second quarter of 2017, while the year-over-year average premium per policy on new business increased 5.3% at June 30, 2018, compared to 4.2% at June 30, 2017. Premiums generated from renewal business increased 6.4% to \$1.7 billion in the second quarter of 2018, compared to an increase of 5.1% to \$1.6 billion in the second quarter of 2017. Underlying the trend in renewal business premiums was an increase in year-over-year average premium per policy of 2.5% at June 30, 2018 and steady policy retention ratios. Year-over-year average premium per policy increased 2.5% at June 30, 2017.

Personal lines – Total personal lines premiums written increased 6.3% to \$1.3 billion in the second quarter of 2018, compared to 6.8% in the second quarter of 2017, driven by an increase of 3.7% in total personal lines policies in force and an increase of 3.1% in the total personal lines year-over-year average premium per policy.

Commercial lines – Total commercial lines premiums written increased 7.1% to \$549 million in the second quarter of 2018, from \$513 million in the second quarter of 2017, driven by a 2.6% increase in total commercial lines policies in force and a 2.8% increase in the total commercial lines year-over-year average premium per policy.

Future trends-premium revenue – The Exchange plans to continue its efforts to grow premiums and improve its competitive position in the marketplace. Expanding the size of its agency force through a careful agency selection process and increased market penetration in our existing operating territories is expected to contribute to future growth as existing and new agents build their books of business.

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

Policy issuance and renewal services

| (dollars in thousands) | Three months ended June 30, | | | Six months ended June 30, | | |
|--|-----------------------------|-----------|----------|---------------------------|-----------|----------|
| | 2018 | 2017 | % Change | 2018 | 2017 | % Change |
| | (Unaudited) | | | (Unaudited) | | |
| Management fee revenue - policy issuance and renewal services, net | \$454,572 | \$441,319 | 3.0 % | \$860,550 | \$833,377 | 3.3 % |
| Service agreement revenue | 7,080 | 7,245 | (2.3) | 14,225 | 14,503 | (1.9) |
| | 461,652 | 448,564 | 2.9 | 874,775 | 847,880 | 3.2 |
| Cost of policy issuance and renewal services | 379,628 | 365,116 | 4.0 | 728,258 | 697,492 | 4.4 |
| Operating income - policy issuance and renewal services | \$82,024 | \$83,448 | (1.7) % | \$146,517 | \$150,388 | (2.6) % |

Policy issuance and renewal services

We allocate a portion of the management fee, which currently equates to 24.2% of the direct and assumed premiums written by the Exchange, for providing policy issuance and renewal services. This portion of the management fee is recognized as revenue when the policy is issued or renewed because it is at that time that the services we provide are substantially complete and the executed insurance policy is transferred to the customer. The increase in management fee revenue for policy issuance and renewal services was driven by the increase in the direct and assumed premiums written by the Exchange discussed previously.

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Service agreement revenue

Service agreement revenue includes service charges we collect from subscribers/policyholders for providing extended payment terms on policies written and assumed by the Exchange, and late payment and policy reinstatement fees. The service charges are fixed dollar amounts per billed installment. Despite the growth in policies in force, the decrease in service agreement revenue reflects the continued shift to payment plans that do not incur service charges or offer a premium discount for certain payment methods. The shift to these plans is driven by the consumers' desire to avoid paying service charges and to take advantage of the discount.

Cost of policy issuance and renewal services

| (dollars in thousands) | Three months ended June 30, | | | Six months ended June 30, | | |
|--|-----------------------------|-----------|----------|---------------------------|-----------|----------|
| | 2018 | 2017 | % Change | 2018 | 2017 | % Change |
| | (Unaudited) | | | (Unaudited) | | |
| Commissions: | | | | | | |
| Total commissions | \$261,573 | \$251,383 | 4.1 % | \$495,667 | \$471,861 | 5.0 % |
| Non-commission expense: | | | | | | |
| Underwriting and policy processing | \$38,732 | \$36,642 | 5.7 % | \$77,326 | \$72,055 | 7.3 % |
| Information technology | 34,900 | 35,387 | (1.4) | 68,849 | 70,162 | (1.9) |
| Sales and advertising | 16,463 | 17,073 | (3.6) | 31,235 | 30,653 | 1.9 |
| Customer service | 8,247 | 6,943 | 18.8 | 16,492 | 13,578 | 21.5 |
| Administrative and other | 19,713 | 17,688 | 11.4 | 38,689 | 39,183 | (1.3) |
| Total non-commission expense | 118,055 | 113,733 | 3.8 | 232,591 | 225,631 | 3.1 |
| Total cost of policy issuance and renewal services | \$379,628 | \$365,116 | 4.0 % | \$728,258 | \$697,492 | 4.4 % |

Commissions – Commissions increased \$10.2 million in the second quarter of 2018 and \$23.8 million for the six months ended June 30, 2018, compared to the same respective periods in 2017. The increases were driven by increases in direct and assumed premiums written by the Exchange of 6.5% for the second quarter and 6.7% for the six months ended June 30, 2018, slightly offset by lower agent incentive costs related to less profitable growth, compared to the same respective periods in 2017. The estimated agent incentive payout at June 30, 2018 is based on actual underwriting results for the two prior years and current year-to-date actual results and forecasted results for the remainder of 2018. Therefore, fluctuations in the current quarter underwriting results can impact the estimated incentive payout on a quarter-to-quarter basis.

Non-commission expense – Non-commission expense increased \$4.3 million in the second quarter of 2018 compared to the same period in 2017. Underwriting and policy processing costs increased \$2.1 million primarily due to increased underwriting report costs. Customer service costs increased \$1.3 million primarily due to increased personnel costs and credit card processing fees. Administrative and other expenses increased \$2.0 million primarily due to a sales and use tax refund recorded in the second quarter of 2017.

Non-commission expense increased \$7.0 million for the six months ended June 30, 2018 compared to the same period in 2017. Underwriting and policy processing costs increased \$5.3 million primarily due to increased personnel costs and underwriting report costs. Information technology costs decreased \$1.3 million primarily due to lower professional fees and hardware and software costs, somewhat offset by higher personnel costs. Customer service costs increased \$2.9 million primarily due to increased personnel costs and credit card processing fees. Personnel costs in all expense categories were impacted by additional bonuses of approximately \$4.8 million awarded to all employees as a result of tax savings realized from the lower corporate income tax rate that became effective January 1, 2018. These increased personnel costs were somewhat offset by lower estimated costs for incentive plan awards related to underwriting performance.

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Administrative services

| (dollars in thousands) | Three months ended June 30, | | | Six months ended June 30, | | |
|---|--------------------------------|------------------|-----|------------------------------|------------------|-----|
| | 2018 (Unaudited) | 2017 % Change | % | 2018 (Unaudited) | 2017 % Change | % |
| Management fee revenue - administrative services, net | \$ 13,299 | \$ -N/A | % | \$ 26,373 | \$ -N/A | % |
| Administrative services reimbursement revenue | 146,507 | — | N/A | 292,470 | — | N/A |
| Total revenue allocated to administrative services | 159,806 | — | N/A | 318,843 | — | N/A |
| Administrative services expenses | | | | | | |
| Claims handling services | 127,544 | — | N/A | 255,649 | — | N/A |
| Investment management services | 8,485 | — | N/A | 16,773 | — | N/A |
| Life management services | 10,478 | — | N/A | 20,048 | — | N/A |
| Operating income - administrative services | \$ 13,299 | \$ -N/A | % | \$ 26,373 | \$ -N/A | % |

N/A = not applicable

Administrative services

We allocate a portion of the management fee, which currently equates to 0.8% of the direct and assumed premiums written by the Exchange, to the administrative services. This portion of the management fee is recognized as revenue over a four-year period representing the time over which the services are provided. We also report reimbursed costs as revenues, which are recognized monthly as services are provided. Beginning with the adoption of ASC 606 on January 1, 2018, the administrative services expenses we incur and the related reimbursements we receive are recorded gross in the Statement of Operations.

Cost of administrative services

By virtue of its legal structure as a reciprocal insurer, the Exchange does not have any employees or officers. Therefore, it enters into contractual relationships by and through an attorney-in-fact. Indemnity serves as the attorney-in-fact on behalf of the Exchange with respect to its administrative services in accordance with the subscriber's agreement. The Exchange's insurance subsidiaries also utilize Indemnity for these services in accordance with the service agreements between each of the subsidiaries and Indemnity. The amounts incurred for these services are reimbursed to Indemnity at cost in accordance with the subscriber's agreement and the service agreements. We record these reimbursements due from the Exchange and its insurance subsidiaries as a receivable.

Total investment income

A summary of the results of our investment operations is as follows:

| (dollars in thousands) | Three months ended June 30, | | | Six months ended June 30, | | |
|---|--------------------------------|----------|----------|---------------------------|-----------|----------|
| | 2018 (Unaudited) | 2017 | % Change | 2018 (Unaudited) | 2017 | % Change |
| Net investment income | \$ 7,104 | \$ 6,239 | 13.9 % | \$ 13,924 | \$ 12,220 | 13.9 % |
| Net realized investment (losses) gains | (32) | 124 | NM | (497) | 640 | NM |
| Net impairment losses recognized in earnings | (646) | (61) | NM | (646) | (182) | NM |
| Equity in (losses) earnings of limited partnerships | (219) | 149 | NM | (411) | 362 | NM |
| Total investment income | \$ 6,207 | \$ 6,451 | (3.8) % | \$ 12,370 | \$ 13,040 | (5.1) % |

NM = not meaningful

Net investment income

Net investment income primarily includes interest and dividends on our fixed maturity and equity security portfolios, net of investment expenses.

Net investment income increased by \$0.9 million in the second quarter of 2018, compared to the second quarter of 2017, and increased by \$1.7 million for the six months ended June 30, 2018, compared to the six months ended June 30, 2017. The increase in net investment income in both periods was primarily due to an increase in income from cash and cash equivalents driven by an increase in rates. Additionally, preferred stock income increased due to higher invested balances and bond income increased due to higher yields.

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Net realized investments (losses) gains

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

| | Three months ended June 30, | | Six months ended June 30, | |
|--|-----------------------------|--------|---------------------------|--------|
| (in thousands) | 2018 | 2017 | 2018 | 2017 |
| Securities sold: | (Unaudited) | | (Unaudited) | |
| Fixed maturities | \$(66) | \$271 | \$(411) | \$693 |
| Equity securities | 0 | (145) | (59) | (145) |
| Equity securities decreases in fair value ⁽¹⁾ | (68) | 0 | (129) | 0 |
| Miscellaneous | 102 | (2) | 102 | 92 |
| Net realized investment (losses) gains ⁽²⁾ | \$(32) | \$124 | \$(497) | \$640 |

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

(2) See Part I, Item 1. "Financial Statements - Note 6, Investments, of Notes to Financial Statements" contained within this report for additional disclosures regarding net realized investment (losses) gains.

The second quarter of 2018 losses from sales of fixed maturity securities and decreases in fair value of equity securities were somewhat offset by miscellaneous gains. Net realized gains during the second quarter of 2017 from sales of fixed maturity securities were partially offset by losses from sales of equity securities. Net realized losses of \$0.5 million for the six months ended June 30, 2018 were primarily driven by losses from sales of securities coupled with decreases in fair value of equity securities. Net realized gains of \$0.6 million for the six months ended June 30, 2017 were primarily driven by gains from sales of fixed maturity securities partially offset by losses from sales of equity securities.

Net impairment losses recognized in earnings

Net impairment losses in the second quarter of 2018 were \$0.6 million compared to \$0.1 million in the second quarter of 2017. Net impairment losses were \$0.6 million and \$0.2 million for the six months ended June 30, 2018 and 2017, respectively. Impairments were primarily related to securities in an unrealized loss position where we determined the loss was other-than-temporary based on credit factors. Impairments in both years also included securities in an unrealized loss position with intent to sell prior to expected recovery of our amortized cost basis.

Equity in (losses) earnings of limited partnerships

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

| | Three months ended June 30, | | Six months ended June 30, | |
|---|-----------------------------|---------|---------------------------|--------|
| (in thousands) | 2018 | 2017 | 2018 | 2017 |
| Private equity | \$(270) | \$(323) | \$66 | \$228 |
| Mezzanine debt | 27 | 33 | 105 | (113) |
| Real estate | 24 | 439 | (582) | 247 |
| Total equity in (losses) earnings of limited partnerships | \$(219) | \$149 | \$(411) | \$362 |

Limited partnership earnings pertain to investments in U.S. and foreign private equity, mezzanine debt, and real estate partnerships. Valuation adjustments are recorded to reflect the changes in fair value of the underlying investments held by the limited partnerships. These adjustments are recorded as a component of equity in earnings of limited partnerships in the Statements of Operations.

Limited partnership earnings tend to be cyclical based upon market conditions, the age of the partnership, and the nature of the investments. Generally, limited partnership earnings are recorded on a quarter lag from financial statements we receive from our general partners. As a consequence, earnings from limited partnerships reported at June 30, 2018 reflect investment valuation changes resulting from the financial markets and the economy in the fourth quarter of 2017 and the first quarter of 2018.

Limited partnership investments generated losses of \$0.2 million and \$0.4 million in the second quarter and year to date 2018, respectively compared to earnings of \$0.1 million and \$0.4 million in the second quarter and year to date periods of 2017, respectively. The real estate sector generated lower earnings in the second quarter and losses in the six months ended June 30, 2018.

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Financial condition of Erie Insurance Exchange

Serving in the capacity of attorney-in-fact for the Exchange, we are dependent on the growth and financial condition of the Exchange, who is our sole customer. The strength of the Exchange and its wholly owned subsidiaries is rated annually by A.M. Best Company. Higher ratings of insurance companies generally indicate financial stability and a strong ability to pay claims. The ratings are generally based upon factors relevant to policyholders and are not directed toward return to investors. The Exchange and each of its property and casualty subsidiaries are rated A+ "Superior". On June 18, 2018, the outlook for the financial strength rating was affirmed as stable. According to A.M. Best, this second highest financial strength rating category is assigned to those companies that, in A.M. Best's opinion, have achieved superior overall performance when compared to the standards established by A.M. Best and have a superior ability to meet obligations to policyholders over the long term. As of December 31, 2017, only approximately 12% of insurance groups are rated A+ or higher, and the Exchange is included in that group.

The financial statements of the Exchange are prepared in accordance with statutory accounting principles prescribed by the Commonwealth of Pennsylvania. Financial statements prepared under statutory accounting principles focus on the solvency of the insurer and generally provide a more conservative approach than under GAAP. Statutory direct written premiums of the Exchange and its wholly owned property and casualty subsidiaries grew 6.7% to \$3.6 billion for the six months ended June 30, 2018 from \$3.3 billion for the six months ended June 30, 2017. These premiums, along with investment income, are the major sources of cash that support the operations of the Exchange. Policyholders' surplus, determined under statutory accounting principles, was \$8.8 billion at June 30, 2018 and December 31, 2017, and \$8.1 billion at June 30, 2017. The Exchange and its wholly owned property and casualty subsidiaries' year-over-year policy retention ratio continues to be high at 89.8% at June 30, 2018 and 89.6% at December 31, 2017 and June 30, 2017.

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FINANCIAL CONDITION

Investments

Our investment portfolio is managed with the objective of maximizing after-tax returns on a risk-adjusted basis.

Distribution of investments

| (dollars in thousands) | Carrying value at June 30, 2018 (Unaudited) | | Carrying value at December 31, 2017 | |
|---|---|------------|--|------------|
| | | % to total | | % to total |
| Fixed maturities | \$705,428 | 93 % | \$ 745,961 | 93 % |
| Equity securities: | | | | |
| Preferred stock | 12,488 | 2 | 12,752 | 2 |
| Limited partnerships: | | | | |
| Private equity | 30,501 | 4 | 31,663 | 4 |
| Mezzanine debt | 2,916 | 0 | 3,516 | 0 |
| Real estate | 6,234 | 1 | 9,943 | 1 |
| Real estate mortgage loans ⁽¹⁾ | 95 | 0 | 136 | 0 |
| Total investments | \$757,662 | 100 % | \$ 803,971 | 100 % |

(1) Real estate mortgage loans are included with Other assets in the Statements of Financial Position.

We continually review our investment portfolio to evaluate positions that might incur other-than-temporary declines in value. We record impairment write-downs on investments in instances where the fair value of the investment is substantially below cost, and we conclude that the decline in fair value is other-than-temporary, which includes consideration for intent to sell. For all investment holdings, general economic conditions and/or conditions specifically affecting the underlying issuer or its industry, including downgrades by the major rating agencies, are considered in evaluating impairment in value. In addition to specific factors, other factors considered in our review of investment valuation are the length of time the fair value is below cost and the amount the fair value is below cost.

We individually analyze all positions with emphasis on those that have, in management's opinion, declined significantly below cost. In compliance with impairment guidance for debt securities, we perform further analysis to determine if a credit-related impairment has occurred. Some of the factors considered in determining whether a debt security is credit impaired include potential for the default of interest and/or principal, level of subordination, collateral of the issue, compliance with financial covenants, credit ratings and industry conditions. We have the intent to sell all credit-impaired debt securities; therefore, the entire amount of the impairment charges are included in earnings and no impairments are recorded in other comprehensive income. We believe our investment valuation philosophy and accounting practices result in appropriate and timely measurement of fair value and recognition of impairment.

Fixed maturities

Under our investment strategy, we maintain a fixed maturity portfolio that is of high quality and well diversified within each market sector. This investment strategy also achieves a balanced maturity schedule. Our fixed maturity portfolio is managed with the goal of achieving reasonable returns while limiting exposure to risk. Our municipal bond portfolio accounts for \$258.5 million, or 37%, of the total fixed maturity portfolio at June 30, 2018. The overall credit rating of the municipal portfolio without consideration of the underlying insurance is AA+.

Fixed maturities classified as available-for-sale are carried at fair value with unrealized gains and losses, net of deferred taxes, included in shareholders' equity. Net unrealized losses on fixed maturities, net of deferred taxes, amounted to \$2.7 million at June 30, 2018, compared to net unrealized gains of \$3.3 million at December 31, 2017.

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The following table presents a breakdown of the fair value of our fixed maturity portfolio by sector and rating: ⁽¹⁾

| Industry Sector | At June 30, 2018 | | | | | Fair value |
|--------------------------------------|------------------|-----------|----------|----------|----------------------|------------|
| | AAA | AA | A | BBB | Non-investment grade | |
| (in thousands) | (Unaudited) | | | | | |
| Basic materials | \$0 | \$0 | \$0 | \$0 | \$15,308 | \$15,308 |
| Communications | 0 | 1,963 | 1,998 | 3,784 | 26,050 | 33,795 |
| Consumer | 0 | 1,028 | 2,461 | 27,324 | 43,820 | 74,633 |
| Diversified | 0 | 0 | 0 | 0 | 710 | 710 |
| Energy | 0 | 995 | 0 | 4,006 | 15,792 | 20,793 |
| Financial | 0 | 3,964 | 22,262 | 32,427 | 18,295 | 76,948 |
| Government-municipal | 100,546 | 144,029 | 13,916 | 0 | 0 | 258,491 |
| Healthcare | 0 | 0 | 0 | 0 | 500 | 500 |
| Industrial | 0 | 0 | 4,916 | 1,018 | 23,822 | 29,756 |
| Structured securities ⁽²⁾ | 59,139 | 41,335 | 13,895 | 7,285 | 6,336 | 127,990 |
| Technology | 0 | 996 | 2,029 | 6,482 | 13,540 | 23,047 |
| U.S. treasury | 0 | 36,442 | 0 | 0 | 0 | 36,442 |
| Utilities | 0 | 0 | 0 | 3,986 | 3,029 | 7,015 |
| Total | \$159,685 | \$230,752 | \$61,477 | \$86,312 | \$167,202 | \$705,428 |

(1) Ratings are supplied by S&P, Moody's, and Fitch. The table is based upon the lowest rating for each security.

(2) Structured securities include residential mortgage-backed securities, commercial mortgage-backed securities, collateralized debt obligations, and asset-backed securities.

Equity Securities

Our equity securities consist of nonredeemable preferred stock and are carried at fair value in the Statements of Financial Position with all changes in unrealized gains and losses reflected in the Statements of Operations, effective January 1, 2018 with the adoption of ASU 2016-01. Previously, changes in unrealized gains and losses were reflected in Other Comprehensive Income, net of deferred taxes.

The following table presents an analysis of the fair value of our preferred stock securities by sector:

| Industry Sector | At June 30, | At |
|-----------------|-------------|-------------------|
| | 2018 | December 31, 2017 |
| | (Unaudited) | |
| Financial | \$ 12,488 | \$ 11,659 |
| Utilities | 0 | 1,093 |
| Total | \$ 12,488 | \$ 12,752 |

Limited partnerships

At June 30, 2018, investments in limited partnerships decreased from the investment levels at December 31, 2017. Changes in partnership values are a function of contributions and distributions, adjusted for market value changes in the underlying investments. The decrease in limited partnership investments was primarily due to net distributions received from the partnerships. We have made no new limited partnership commitments since 2006, and the balance of limited partnership investments is expected to decline over time as additional distributions are received. The results

from our limited partnerships are based upon financial statements received from our general partners, which are generally received on a quarter lag. As a result, the market values and earnings recorded during 2018 reflect the partnership activity experienced in the fourth quarter of 2017 and the first quarter of 2018.

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LIQUIDITY AND CAPITAL RESOURCES

Sources and Uses of Cash

Liquidity is a measure of a company's ability to generate sufficient cash flows to meet the short- and long-term cash requirements of its business operations and growth needs. Our liquidity requirements have been met primarily by funds generated from management fee revenue and income from investments. Cash provided from these sources is used primarily to fund the costs of our management operations including commissions, salaries and wages, pension plans, share repurchases, dividends to shareholders, and the purchase and development of information technology. We expect that our operating cash needs will be met by funds generated from operations.

Volatility in the financial markets presents challenges to us as we do occasionally access our investment portfolio as a source of cash. Some of our fixed income investments, despite being publicly traded, are illiquid. Volatility in these markets could impair our ability to sell certain of our fixed income securities or cause such securities to sell at deep discounts. Additionally, our limited partnership investments are significantly less liquid. We believe we have sufficient liquidity to meet our needs from sources other than the liquidation of securities.

Cash flow activities

The following table provides condensed cash flow information for the six months ended June 30:

| (in thousands) | 2018 | 2017 |
|---|-------------|------------|
| | (Unaudited) | |
| Net cash provided by operating activities | \$41,593 | \$39,491 |
| Net cash used in investing activities | (5,653) | (35,946) |
| Net cash used in financing activities | (53,249) | (47,908) |
| Net decrease in cash and cash equivalents | \$(17,309) | \$(44,363) |

Net cash provided by operating activities was \$41.6 million in the first six months of 2018, compared to \$39.5 million in the first six months of 2017. Increased cash from operating activities for the first six months of 2018 was primarily due to an increase in management fee revenue received driven by the increase in direct and assumed premiums written by the Exchange along with a decrease in income taxes paid due to the lower corporate income tax rate effective January 1, 2018, compared to the first six months of 2017. Somewhat offsetting the increase in cash from operating activities was higher pension contributions and commissions and bonuses paid to agents, compared to the first six months of 2017. Our Board approved an \$80 million accelerated pension contribution. We contributed \$40 million in January 2018 and \$40 million in April 2018. In the first six months of 2017, we contributed \$19.0 million to our pension plan. We are reimbursed approximately 59% of the net periodic benefit cost of the pension plans from the Exchange and its subsidiaries, which includes pension benefits for employees performing administrative services and their allocated share of costs for employees in departments that support the administrative functions. Cash paid for agent commissions and bonuses increased \$39.0 million to \$540.5 million in the first six months of 2018 due to higher scheduled commissions driven by premium growth and higher bonus award payments resulting from profitable underwriting results.

At June 30, 2018, we recorded a net deferred tax asset of \$31.5 million. The Tax Cuts and Jobs Act reduced the corporate income tax rate from 35% to 21% effective January 1, 2018. There was no deferred tax valuation allowance recorded at June 30, 2018.

Net cash used in investing activities totaled \$5.7 million in the first six months of 2018, compared to \$35.9 million in the first six months of 2017. The decrease in cash used for the first six months of 2018, compared to the first six months of 2017, was driven by lower purchases of available-for-sale securities somewhat offset by increased loans made to our independent agents. Also impacting our future investing activities are limited partnership commitments,

which totaled \$13.9 million at June 30, 2018, and will be funded as required by the partnerships' agreements. Of this amount, the total remaining commitment to fund limited partnerships that invest in private equity securities was \$5.5 million, mezzanine debt securities was \$8.1 million and real estate activities was \$0.3 million. Additionally, we have committed to incur future costs related to the construction of the building that will serve as part of our principal headquarters, which is expected to cost \$100 million and is being funded by the senior secured draw term loan credit facility of the same amount. As of June 30, 2018, \$39.0 million of costs have been incurred related to this project.

Net cash used in financing activities totaled \$53.2 million in the first six months of 2018, compared to \$47.9 million in the first six months of 2017. The increase in cash used was primarily due to dividends paid to shareholders. We increased both our Class A and Class B shareholder regular quarterly dividends by 7.3% for 2018, compared to 2017. There are no regulatory

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restrictions on the payment of dividends to our shareholders. Financing activities were also impacted by the final scheduled draw of \$25 million on June 1, 2018 on the senior secured draw term loan credit facility. Future financing activities will include the principal payments due under the senior secured draw term loan credit facility, which will not commence until 2019.

There were no repurchases of our Class A nonvoting common stock in the first six months of 2018 and 2017 in conjunction with our stock repurchase program. In 2011, our Board of Directors approved a continuation of the current stock repurchase program of \$150 million with no time limitation. This repurchase authority includes, and is not in addition to, any unspent amounts remaining under the prior authorization. We had approximately \$17.8 million of repurchase authority remaining under this program at June 30, 2018, based upon trade date.

In the first six months of 2018, we purchased 22,247 shares of our outstanding Class A nonvoting common stock outside of our publicly announced share repurchase program at a total cost of \$2.6 million. Of this amount, we purchased 5,830 shares for \$0.7 million, or \$117.39 per share, for stock-based awards in conjunction with our equity compensation plan, for which the shares were delivered to plan participants in January and May 2018. We purchased 4,576 shares for \$0.5 million, or \$115.69 per share, to fund the rabbi trust for the outside director deferred stock compensation plan. The shares were transferred to the rabbi trust in March and May 2018. The remaining 11,841 shares were purchased at a total cost of \$1.4 million, or \$119.14 per share, to fund the rabbi trust for the incentive compensation deferral plan. The shares were transferred to the rabbi trust in March and May 2018.

In the first six months of 2017, we purchased 55,935 shares of our outstanding Class A nonvoting common stock outside of our publicly announced share repurchase program at a total cost of \$6.7 million. Of this amount, we purchased 3,785 shares for \$0.4 million, or \$111.55 per share, for stock-based awards in conjunction with our equity compensation plan, for which the shares were delivered to plan participants in January 2017. We purchased 5,266 shares for \$0.6 million, or \$118.56 per share, to fund the rabbi trust for the outside director deferred stock compensation plan. The shares were transferred to the rabbi trust in March and May 2017. The remaining 46,884 shares were purchased at a total cost of \$5.7 million, or \$122.40 per share, for stock-based awards in conjunction with our long-term incentive plan, for which the shares were delivered to plan participants in June 2017.

Capital Outlook

We regularly prepare forecasts evaluating the current and future cash requirements for both normal and extreme risk events. Should an extreme risk event result in a cash requirement exceeding normal cash flows, we have the ability to meet our future funding requirements through various alternatives available to us.

Outside of our normal operating and investing cash activities, future funding requirements could be met through: 1) cash and cash equivalents, which total approximately \$198.4 million at June 30, 2018, 2) a \$100 million bank revolving line of credit, and 3) liquidation of unpledged assets held in our investment portfolio, including preferred stock and investment grade bonds, which totaled approximately \$334.3 million at June 30, 2018. Volatility in the financial markets could impair our ability to sell certain fixed income securities or cause such securities to sell at deep discounts. Additionally, we have the ability to curtail or modify discretionary cash outlays such as those related to shareholder dividends and share repurchase activities.

As of June 30, 2018, we have access to a \$100 million bank revolving line of credit with a \$25 million letter of credit sublimit that expires on November 3, 2020. As of June 30, 2018, a total of \$99.1 million remains available under the facility due to \$0.9 million outstanding letters of credit, which reduce the availability for letters of credit to \$24.1 million. We had no borrowings outstanding on our line of credit as of June 30, 2018. Bonds with a fair value of \$108.1 million were pledged as collateral on the line at June 30, 2018. These securities have no trading restrictions and are reported as available-for-sale securities in the Statements of Financial Position. The banks require compliance with certain covenants, which include leverage ratios and debt restrictions. We were in compliance with our bank

covenants at June 30, 2018.

Balance Sheet Arrangements and Contractual Obligations

Off-balance sheet arrangements include those with unconsolidated entities that may have a material current or future effect on our financial condition or results of operations, including material variable interests in unconsolidated entities that conduct certain activities. We have no material off-balance sheet obligations. As of June 30, 2018, there were no material changes to our future contractual obligations as previously reported in our Annual Report on Form 10-K for the year ended December 31, 2017.

Surplus Note

We hold a surplus note for \$25 million from Erie Family Life Insurance Company that is payable on demand on or after December 31, 2018; however, no principal or interest payments may be made without prior approval by the Pennsylvania

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Insurance Commissioner. Interest payments are scheduled to be paid semi-annually. For each of the six months ended June 30, 2018 and 2017, we recognized interest income on the note of \$0.8 million.

CRITICAL ACCOUNTING ESTIMATES

We make estimates and assumptions that have a significant effect on the amounts and disclosures reported in the financial statements. The most significant estimates relate to investment valuation and retirement benefit plans for employees. While management believes its estimates are appropriate, the ultimate amounts may differ from estimates provided. Our most critical accounting estimates are described in Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations" for the year ended December 31, 2017 of our Annual Report on Form 10-K as filed with the Securities and Exchange Commission on February 22, 2018. See Part I, Item 1. "Financial Statements - Note 5, Fair Value, of Notes to Financial Statements" contained within this report for additional information on our valuation of investments.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk is primarily related to fluctuations in prices and interest rates. Quantitative and qualitative disclosures about market risk resulting from changes in prices, interest rates, and other risk exposures for the year ended December 31, 2017 are included in Item 7A. "Quantitative and Qualitative Disclosures About Market Risk", of our Annual Report on Form 10-K as filed with the Securities and Exchange Commission on February 22, 2018.

There have been no material changes that impact our portfolio or reshape our periodic investment reviews of asset allocations during the six months ended June 30, 2018. For a recent discussion of conditions surrounding our investment portfolio, see the "Operating Overview", "Results of Operations", and "Financial Condition" discussions contained in Part I, Item 2. "Management's Discussion and Analysis of Financial Condition and Results of Operations" contained within this report.

ITEM 4. CONTROLS AND PROCEDURES

We carried out an evaluation, with the participation of management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (pursuant to Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective.

Our management evaluated, with the participation of the Chief Executive Officer and Chief Financial Officer, any change in our internal control over financial reporting and determined there has been no change in our internal control over financial reporting during the six months ended June 30, 2018 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. Upon adoption of the new revenue recognition guidance on January 1, 2018, we implemented changes to our processes related to revenue recognition and the related control activities. There were no significant changes to our internal control over financial reporting due to the adoption of this new standard.

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

State Court Lawsuit Against Erie Indemnity Company

Erie Indemnity Company (“Indemnity”) was named as a defendant in a complaint filed on August 1, 2012 by alleged subscribers of the Erie Insurance Exchange (the “Exchange”) in the Court of Common Pleas Civil Division of Fayette County, Pennsylvania captioned Erie Insurance Exchange, an unincorporated association, by Joseph S. Sullivan and Anita Sullivan, Patricia R. Beltz, and Jenna L. DeBord, trustees ad litem v. Erie Indemnity Co. (the “Sullivan” lawsuit).

As subsequently amended, the complaint alleges that, beginning on September 1, 1997, Indemnity retained “Service Charges” (installment fees) and “Added Service Charges” (late fees and policy reinstatement charges) on policies written by Exchange and its insurance subsidiaries, which allegedly should have been paid to Exchange, in the amount of approximately \$308 million. In addition to their claim for monetary relief on behalf of Exchange, Plaintiffs seek an accounting of all so-called intercompany transactions between Indemnity and Exchange from 1996 to date. Plaintiffs allege that Indemnity breached its contractual, fiduciary, and equitable duties by retaining Service Charges and Added Service Charges that should have been retained by Exchange. Plaintiffs bring these same claims under three separate derivative-type theories. First, Plaintiffs purport to bring suit as members of Exchange on behalf of Exchange. Second, Plaintiffs purport to bring suit as trustees ad litem on behalf of Exchange. Third, Plaintiffs purport to bring suit on behalf of Exchange pursuant to Rule 1506 of the Pennsylvania Rules of Civil Procedure, which allows shareholders to bring suit derivatively on behalf of a corporation or similar entity.

Indemnity filed a motion in the state court in November 2012 seeking dismissal of the lawsuit. On December 19, 2013, the court granted Indemnity’s motion in part, holding that the Pennsylvania Insurance Holding Company Act “provides the [Pennsylvania Insurance] Department with special competence to address the subject matter of plaintiff’s claims” and referring “all issues” in the Sullivan lawsuit to the Pennsylvania Insurance Department (the “Department”) for “its views and any determination.” The court stayed all further proceedings and reserved decision on all other grounds for dismissal raised by Indemnity. Plaintiffs sought reconsideration of the court’s order, and on January 13, 2014, the court entered a revised order affirming its prior order and clarifying that the Department “shall decide any and all issues within its jurisdiction.” On January 30, 2014, Plaintiffs asked the court to certify its order to permit an immediate appeal to the Superior Court of Pennsylvania and to stay any proceedings in the Department pending completion of any appeal. On February 18, 2014, the court issued an order denying Plaintiffs’ motion. On March 20, 2014, Plaintiffs filed a petition for review with the Superior Court, which was denied by the Superior Court on May 5, 2014.

The Sullivan matter was assigned to an Administrative Judge within the Department for determination. The parties agreed that an evidentiary hearing was not required, entered into a stipulated record, and submitted briefing to the Department. Oral argument was held before the Administrative Judge on January 6, 2015. On April 29, 2015, the Department issued a declaratory opinion and order: (1) finding that the transactions between Exchange and Indemnity in which Indemnity retained or received revenue from installment and other service charges from Exchange subscribers complied with applicable insurance laws and regulations and that Indemnity properly retained charges paid by Exchange policyholders for certain installment premium payment plans, dishonored payments, policy cancellations, and policy reinstatements; and (2) returning jurisdiction over the matter to the Fayette County Court of Common Pleas.

On May 26, 2015, Plaintiffs appealed the Department’s decision to the Pennsylvania Commonwealth Court. Oral argument was held before the Commonwealth Court en banc on December 9, 2015. On January 27, 2016, the Commonwealth Court issued an opinion vacating the Department’s ruling and directing the Department to return the case to the Court of Common Pleas, essentially holding that the primary jurisdiction referral of the trial court was improper at this time because the allegations of the complaint do not implicate the special competency of the

Department.

On February 26, 2016, Indemnity filed a petition for allowance of appeal to the Pennsylvania Supreme Court seeking further review of the Commonwealth Court opinion. On March 14, 2016, Plaintiffs filed an answer opposing Indemnity's petition for allowance of appeal; and, on March 28, 2016, Indemnity sought permission to file a reply brief in further support of its petition for allowance of appeal. On August 10, 2016, the Pennsylvania Supreme Court denied Indemnity's petition for allowance of appeal; and the Sullivan lawsuit returned to the Court of Common Pleas of Fayette County.

On September 12, 2016, Plaintiffs filed a motion to stay the Sullivan lawsuit pending the outcome of the Federal Court Lawsuit they filed against Indemnity and former and current Directors of Indemnity on July 8, 2016. (See below.) Indemnity filed an opposition to Plaintiff's motion to stay on September 19, 2016; and filed amended preliminary objections seeking dismissal of the Sullivan lawsuit on September 20, 2016. The motion to stay and the amended preliminary objections remain pending. On

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June 27, 2018, Plaintiffs filed a motion for a status conference in the Sullivan lawsuit, which is scheduled to occur on July 30, 2018.

Indemnity believes that it continues to have meritorious legal and factual defenses to the Sullivan lawsuit and intends to vigorously defend against all allegations and requests for relief.

Federal Court Lawsuit Against Erie Indemnity Company and Directors

On February 6, 2013, a lawsuit was filed in the United States District Court for the Western District of Pennsylvania, captioned Erie Insurance Exchange, an unincorporated association, by members Patricia R. Beltz, Joseph S. Sullivan and Anita Sullivan, and Patricia R. Beltz, on behalf of herself and others similarly situated v. Richard L. Stover; J. Ralph Borneman, Jr.; Terrence W. Cavanaugh; Jonathan Hirt Hagen; Susan Hirt Hagen; Thomas B. Hagen; C. Scott Hartz; Claude C. Lilly, III; Lucian L. Morrison; Thomas W. Palmer; Martin P. Sheffield; Elizabeth H. Vorsheck; and Robert C. Wilburn (the “Beltz” lawsuit), by alleged policyholders of Exchange who are also the plaintiffs in the Sullivan lawsuit. The individuals named as defendants in the Beltz lawsuit were the then-current Directors of Indemnity.

As subsequently amended, the Beltz lawsuit asserts many of the same allegations and claims for monetary relief as in the Sullivan lawsuit. Plaintiffs purport to sue on behalf of all policyholders of Exchange, or, alternatively, on behalf of Exchange itself. Indemnity filed a motion to intervene as a Party Defendant in the Beltz lawsuit in July 2013, and the Directors filed a motion to dismiss the lawsuit in August 2013. On February 10, 2014, the court entered an order granting Indemnity’s motion to intervene and permitting Indemnity to join the Directors’ motion to dismiss; granting in part the Directors’ motion to dismiss; referring the matter to the Department to decide any and all issues within its jurisdiction; denying all other relief sought in the Directors’ motion as moot; and dismissing the case without prejudice. To avoid duplicative proceedings and expedite the Department’s review, the Parties stipulated that only the Sullivan action would proceed before the Department and any final and non-appealable determinations made by the Department in the Sullivan action will be applied to the Beltz action.

On March 7, 2014, Plaintiffs filed a notice of appeal to the United States Court of Appeals for the Third Circuit. Indemnity filed a motion to dismiss the appeal on March 26, 2014. On November 17, 2014, the Third Circuit deferred ruling on Indemnity’s motion to dismiss the appeal and instructed the parties to address that motion, as well as the merits of Plaintiffs’ appeal, in the parties’ briefing. Briefing was completed on April 2, 2015. In light of the Department’s April 29, 2015 decision in Sullivan, the Parties then jointly requested that the Beltz appeal be voluntarily dismissed as moot on June 5, 2015. The Third Circuit did not rule on the Parties’ request for dismissal and instead held oral argument as scheduled on June 8, 2015. On July 16, 2015, the Third Circuit issued an opinion and judgment dismissing the appeal. The Third Circuit found that it lacked appellate jurisdiction over the appeal, because the District Court’s February 10, 2014 order referring the matter to the Department was not a final, appealable order.

On July 8, 2016, the Beltz plaintiffs filed a new action labeled as a “Verified Derivative And Class Action Complaint” in the United States District Court for the Western District of Pennsylvania. The action is captioned Patricia R. Beltz, Joseph S. Sullivan, and Anita Sullivan, individually and on behalf of all others similarly situated, and derivatively on behalf of Nominal Defendant Erie Insurance Exchange v. Erie Indemnity Company; Kaj Ahlmann; John T. Baily; Samuel P. Black, III; J. Ralph Borneman, Jr.; Terrence W. Cavanaugh; Wilson C. Cooney; LuAnn Datesh; Patricia A. Goldman; Jonathan Hirt Hagen; Thomas B. Hagen; C. Scott Hartz; Samuel P. Katz; Gwendolyn King; Claude C. Lilly, III; Martin J. Lippert; George R. Lucore; Jeffrey A. Ludrof; Edmund J. Mehl; Henry N. Nassau; Thomas W. Palmer; Martin P. Sheffield; Seth E. Schofield; Richard L. Stover; Jan R. Van Gorder; Elizabeth A. Hirt Vorsheck; Harry H. Weil; and Robert C. Wilburn (the “Beltz II” lawsuit). The individual defendants are all present or former Directors of Indemnity (the “Directors”).

The allegations of the Beltz II lawsuit arise from the same fundamental, underlying claims as the Sullivan and prior Beltz litigation, i.e., that Indemnity improperly retained Service Charges and Added Service Charges. The Beltz II

lawsuit alleges that the retention of the Service Charges and Added Service Charges was improper because, for among other reasons, that retention constituted a breach of the Subscriber's Agreement and an Implied Covenant of Good Faith and Fair Dealing by Indemnity, breaches of fiduciary duty by Indemnity and the other defendants, conversion by Indemnity, and unjust enrichment by defendants Jonathan Hirt Hagen, Thomas B. Hagen, and Elizabeth A. Hirt Vorsheck, at the expense of Exchange. The Beltz II lawsuit requests, among other things, that a judgment be entered against the Defendants certifying the action as a class action pursuant to Rule 23 of the Federal Rules of Civil Procedure; declaring Plaintiffs as representatives of the Class and Plaintiffs' counsel as counsel for the Class; declaring the conduct alleged as unlawful, including, but not limited to, Defendants' retention of the Service Charges and Added Service Charges; enjoining Defendants from continuing to retain the Service Charges and Added Service Charges; and awarding compensatory and punitive damages and interest.

On September 23, 2016, Indemnity filed a motion to dismiss the Beltz II lawsuit. On September 30, 2016, the Directors filed their own motions to dismiss the Beltz II lawsuit. On July 17, 2017, the Court granted Indemnity's and the Directors' motions

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to dismiss the Beltz II lawsuit, dismissing the case in its entirety. The Court ruled that “the Subscriber’s Agreement does not govern the separate and additional charges at issue in the Complaint” and, therefore, dismissed the breach of contract claim against Indemnity for failure to state a claim. The Court also ruled that the remaining claims, including the claims for breach of fiduciary duty against Indemnity and the Directors, are barred by the applicable statutes of limitation or fail to state legally cognizable claims. On August 14, 2017, Plaintiffs filed a notice of appeal to the United States Court of Appeals for the Third Circuit.

On May 10, 2018, the United States Court of Appeals for the Third Circuit affirmed the District Court’s dismissal of the Beltz II lawsuit. On May 24, 2018, Plaintiffs filed a petition seeking rehearing of their appeal before the Third Circuit. The Third Circuit denied that petition on June 14, 2018.

Federal Court Lawsuit Against Erie Indemnity Company and Directors

On December 28, 2017 a lawsuit was filed in the United States District Court for the Western District of Pennsylvania captioned Lynda Ritz, individually and on behalf of all others similarly situated and derivatively on behalf of Nominal Defendant Erie Insurance Exchange v. Erie Indemnity Company, J. Ralph Borneman, Jr., Terrence W. Cavanaugh, Eugene C. Connell, LuAnn Datesh, Jonathan Hirt Hagen, Thomas B. Hagen, C. Scott Hartz, Brian A. Hudson, Sr., Claude C. Lilly, III, George R. Lucore, Thomas W. Palmer, Martin P. Sheffield, Richard L. Stover, Elizabeth A. Hirt Vorsheck, and Robert C. Wilburn, and Erie Insurance Exchange (Nominal Defendant) (the “Ritz” lawsuit). The individual named as Plaintiff is alleged to be a policyholder (subscriber) of the Erie Insurance Exchange (the “Exchange”). With the exception of Terrence W. Cavanaugh and Robert C. Wilburn, the individuals named as Defendants comprise the current Board of Directors of Indemnity. Messrs. Cavanaugh and Wilburn are former Directors of Indemnity (the “Directors”).

The Complaint alleges that since at least 2007, Erie Indemnity Company has taken “unwarranted and excessive” management fees as compensation for its services under the Subscriber’s Agreement. Count I of the Complaint purports to allege a claim for breach of alleged fiduciary duties against Indemnity and the Directors on behalf of Plaintiff and a putative class of subscribers. Count II purports to allege a claim for breach of alleged fiduciary duties against Indemnity and the Directors on behalf of Exchange. Count III purports to allege a claim for breach of contract and an alleged implied covenant of good faith and fair dealing against Indemnity on behalf of Plaintiff and a putative class. Count IV purports to allege a claim of unjust enrichment against several Directors.

The Complaint seeks compensatory and punitive damages and requests the Court to enjoin Indemnity from continuing to retain excessive management fees; and order such other relief as may be appropriate.

On March 5, 2018, Indemnity filed a motion to dismiss the Ritz lawsuit. The Directors also filed their own motions to dismiss the Ritz lawsuit on March 5, 2018. Plaintiff filed her responses to both motions on April 26, 2018; and Indemnity and the Directors filed their replies in support of their motions on May 25, 2018. The motions to dismiss the Ritz lawsuit remain pending.

Indemnity believes it has meritorious legal and factual defenses and intends to vigorously defend against all allegations and requests for relief in the Ritz lawsuit. The Directors have advised Indemnity that they intend to vigorously defend against the claims in the Ritz lawsuit and have sought indemnification and advancement of expenses from the Company in connection with the Ritz lawsuit.

For additional information on contingencies, see Part I, Item 1. "Financial Statements - Note 13, Commitments and Contingencies, of Notes to Financial Statements".

ITEM 1A. RISK FACTORS

There have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017 as filed with the Securities and Exchange Commission on February 22, 2018.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Issuer Purchases of Equity Securities

In 2011, our Board of Directors approved a continuation of the current stock repurchase program, authorizing repurchases for a total of \$150 million with no time limitation. This repurchase authority included, and was not in addition to, any unspent amounts remaining under the prior authorization. There were no repurchases of our Class A common stock under this program during the quarter ending June 30, 2018. We had approximately \$17.8 million of repurchase authority remaining under this program at June 30, 2018.

During the quarter ending June 30, 2018, we purchased 4,956 shares of our outstanding Class A nonvoting common stock outside of our publicly announced share repurchase program at a total cost of \$0.6 million. Of this amount, we purchased 2,376 shares for \$0.3 million, or \$116.46 per share, to fund the rabbi trust for the outside director deferred stock compensation plan and the incentive compensation deferral plan. The shares were transferred to the rabbi trust in May 2018. We purchased 2,580 shares for \$0.3 million, or \$114.33 per share, for stock-based awards in conjunction with our equity compensation plan, for which the shares were delivered to plan participants in May 2018.

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ITEM 6. EXHIBITS

| Exhibit Number | Description of Exhibit |
|-------------------|---|
| 10.1* | <u>Fourth Amendment to Erie Insurance Group Employee Savings Plan (As Amended and Restated Effective January 1, 2015), dated May 2, 2018.</u> |
| 31.1* | <u>Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| 31.2* | <u>Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> |
| 32* | <u>Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> |
| 101.INS* | XBRL Instance Document. |
| 101.SCH* | XBRL Taxonomy Extension Schema Document. |
| 101.CAL* | XBRL Taxonomy Extension Calculation Linkbase Document. |
| 101.DEF* | XBRL Taxonomy Extension Definition Linkbase Document. |
| 101.LAB* | XBRL Taxonomy Extension Label Linkbase Document. |
| 101.PRE* | XBRL Taxonomy Extension Presentation Linkbase Document. |

* Filed herewith.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Erie Indemnity Company
(Registrant)

Date: July 26, 2018 By: /s/ Timothy G. NeCastro
Timothy G. NeCastro, President & CEO

By: /s/ Gregory J. Gutting
Gregory J. Gutting, Executive Vice President & CFO