California Earthquake Authority

Report on Audits of Financial Statements
For the years ended December 31, 2005 and 2004

California Earthquake Authority
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Report of Independent Auditors

The Governing Board
California Earthquake Authority:

In our opinion, the accompanying balance sheets and the related statements of revenues, expenses, and changes in net assets and of cash flows present fairly, in all material respects, the financial position of the California Earthquake Authority (the Authority) at December 31, 2005 and 2004, and the changes in its financial position and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

The Management's Discussion and Analysis, presented on pages 2 through 9, is not a required part of the basic financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures on the information, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The accompanying Schedule of Participating Insurer Capital Contributions as of December 31, 2005 and 2004, Schedules of Participating Insurer Premiums Written for the years ended December 31, 2005 and 2004, Schedules of Participating Insurer Unearned Premiums as of December 31, 2005 and 2004, Schedules of Participating Insurer Commissions for the years ended December 31, 2005 and 2004 and Schedules of Participating Insurer Operating Costs for the years ended December 31, 2005 and 2004 are presented for purposes of additional analysis and are not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

PricewaterhouseCoopers LLP

June 21, 2006

HISTORY AND FINANCING

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

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

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

The CEA uses its capital (net assets) to leverage approximately $7.28 billion in claims-paying capacity at December 31, 2005. The CEA's claims-paying capacity is determined from the CEA's net assets, reinsurance coverage, available letters of credit, and post event prospective participating insurance company assessments. The CEA derives its capital from participating insurance company capital contributions and from increases in net assets generated from the sale of earthquake insurance policies. The CEA is exempt from federal income tax and from state insurance-premium tax. California Insurance Code section 10089.44 provides, in pertinent part, that "… premiums collected by the authority shall be exempt from collection of the state's insurance premium tax, and the amount of tax foregone by the state shall be considered for all purposes a contribution by the state and its citizens to the capital and operating revenues of the authority."

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

The CEA has 751,767 policyholders at December 31, 2005, most of whom insure single-family dwellings through the CEA. The CEA offers a basic residential earthquake policy to homeowners, which includes coverage for the insured dwelling and limited coverage for contents and loss-of-use if the home or mobile home is uninhabitable due to an earthquake. The CEA also offers policies to condominium unit owners and renters. For an additional premium, CEA policyholders can significantly increase insured limits on contents and for loss of use, and homeowners can lower their CEA policy deductible from 15 percent to 10 percent.

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

USING THIS REPORT

While the CEA is an instrumentality of the state, the State of California's General Fund is not liable for CEA claims, losses, or other liabilities. However, the CEA meets the definition of a governmental organization, as defined by accounting principles generally accepted in the United States of America. The CEA's financial statements for the years ended December 31, 2005 and 2004 have been prepared using accounting standards applicable to governmental entities. This financial report consists of three financial statements with accompanying notes. The Balance Sheets, prepared on the accrual basis of accounting, include all assets, liabilities and net assets of the CEA. The Statements of Revenues, Expenses, and Changes in Net Assets, also prepared on the accrual basis, take into account all revenues and expenses for the CEA for a specified period of time regardless of when cash is received or paid. The Statements of Cash Flows reflect the actual cash receipts and disbursements for a specified period of time.

CONDENSED BALANCE SHEETS

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

	2005	2004	2003
Assets			
Cash and investments	$ 2,369,027,129	$ 2,006,625,972	$ 1,732,881,761
Premiums receivable, net of allowance for doubtful accounts of $1,334,849, $1,254,241, and $1,476,791 in 2005, 2004 and 2003, respectively	32,358,981	33,134,717	31,233,896
Unearned ceded premiums	20,710,598	16,924,668	14,049,335
Deferred policy acquisition costs	33,648,134	29,827,145	27,708,925
Other assets	18,533,328	12,462,068	9,510,856
Total assets	$ 2,474,278,170	$ 2,098,974,570	$ 1,815,384,773
Liabilities and Net Assets			
Unearned premiums	$ 262,876,047	$ 233,024,570	$ 216,475,974
Supplemental reinsurance premiums payable	9,300,623	7,182,156	5,796,289
Other liabilities	14,718,056	5,042,337	9,216,274
Total liabilities	286,894,726	245,249,063	231,488,537
Net assets:			
Restricted, expendable	8,485,890	2,297,727	2,718,974
Unrestricted	2,178,897,554	1,851,427,780	1,581,177,262
Total net assets	2,187,383,444	1,853,725,507	1,583,896,236
Total liabilities and net assets	$ 2,474,278,170	$ 2,098,974,570	$ 1,815,384,773

Assets

Total assets grew $375.3 million (18%) and $283.6 million (16%) primarily due to an increase in net assets of $333.7 million and $269.8 million for the years 2005 and 2004, respectively. Cash and investment securities grew $362.4 million (18%) and $273.7 million (16%) for 2005 and 2004, respectively. Investment securities are managed by external managers under the guidance of the CEA. U.S. Treasuries, short-term investments and cash-equivalent securities comprise 100% of the CEA's investment portfolio.

Premium receivable balances decreased $0.8 million (-2%) and increased $1.9 million (6%) in 2005 and 2004, respectively. The decrease in 2005 was largely attributable to receiving participating insurance carrier premium payments by year end. The increase in 2004 was due to the $27.2 million increase in written premiums. The allowance for uncollectible premium remained essentially the same at $1.3 million for both 2005 and 2004. The CEA does not anticipate any unusual collection problems with respect to the premium balances.

Unearned ceded premiums relating to the Supplemental Quota Share reinsurance agreement have been steadily increasing primarily as a result of an increase in policyholders who purchase supplemental coverages.

Deferred policy acquisition costs, consisting of unearned participating insurer commissions and operating costs, are deferred and amortized ratably over the terms of the underlying policies. Deferred policy acquisition costs increased 13% in 2005 and 8% in 2004, commensurate with the increase in unearned premiums.

Other assets increased $6.1 million and $3.0 million for the years 2005 and 2004, respectively. The 2005 increase is the result of a $4.6 million assessment receivable from Foremost Insurance Company. The remaining $1.5 million increase in 2005 and the 2004 increase result from the increase in interest receivable caused by the CEA acquiring long-term U.S. Treasuries with semi-annual coupon payments instead of purchasing cash-equivalent securities with maturities of less than 10 days.

Liabilities

Unearned premiums represent the pro rata portion of the premiums written related to the remaining terms of policies in force. Unearned premiums increased $29.9 million and $16.5 million in 2005 and 2004, respectively. These increases are due to increases in written premiums and the increase in policyholders who purchase supplemental coverages.

Supplemental reinsurance premiums payable increased $2.1 million in 2005 and $1.4 million in 2004 due to the increase in policyholders who purchase supplemental coverages.

Other liabilities include claims and claims expense reserves, which are not significant since California has not suffered a major earthquake during the CEA's existence. Other liabilities increased $9.7 million in 2005 due to $4.5 million of premium adjustment expense on the reinsurance contracts which did not occur for the 2004 reinsurance contracts. The remaining increase of $5.2 million is due to brokers fees related to reinsurance agreements which were not paid until 2006 after the underlying broker agreements were completed. There were no unpaid broker fees at the end of 2004. Other liabilities declined $4.2 million in 2004 primarily as a result of settling accrued claims from the San Simeon earthquake which occurred in December 2003.

Net Assets

The CEA's net assets grew $333.7 million (18%) and $269.8 million (17%) in 2005 and 2004, respectively. In 2005, the primary reasons for the increase were underwriting profit of $263.4 million, investment income of $54.4 million, and other income of $15.9 million. In 2004, the same reasons for the increase apply with an underwriting profit of $237.0 million, investment income of $22.1 million, and other income of $10.7 million.

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

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

	2005		2004		2003	
Underwriting income:						
Premiums written	$ 502,962,824	100%	$ 464,909,264	100%	$ 437,725,414	100%
Less premiums ceded - reinsurance	(131,329,113)		(134,445,864)		(138,390,962)	
Net premiums written	371,633,711	74%	330,463,400	71%	299,334,452	68%
Change in net unearned premiums	(26,065,547)		(13,673,263)		(2,508,561)	
Net premiums earned	345,568,164	69%	316,790,137	68%	296,825,891	68%
Other underwriting income:						
Supplemental commission income, net	6,375,197		5,453,721		5,337,319	
Expenses:						
Claims and claims (income) expense	(6,564)		(2,645,937)		5,602,673	
Other underwriting expenses	87,734,618		87,442,992		84,333,844	
Mitigation Fund expenses	818,328		444,139		161,420	
Line of credit fees	-		-		4,478,580	
Total expenses	88,546,382		85,241,194		94,576,517	
Underwriting profit	263,396,979	52%	237,002,664	51%	207,586,693	47%
Net investment income	54,410,384		22,129,705		24,618,267	
Other income	15,850,574		10,696,902		10,665,447	
Increase in net assets	333,657,937	66%	269,829,271	58%	242,870,407	55%
Net assets, beginning of year	1,853,725,507		1,583,896,236		1,341,025,829	
Net assets, end of year	$ 2,187,383,444		$ 1,853,725,507		$ 1,583,896,236	

The increase in net assets was $333.7 million in 2005, which resulted in a net profit margin of 66%, and $269.8 million in 2004, which resulted in a net profit margin of 58%. The CEA's net premiums written increased $41.1 million in 2005 and $31.1 million in 2004. The 2005 and 2004 increases in net premiums written were primarily due to a $38.1 million and a $27.2 million increase in premiums written, respectively. Written premium increased in both years as a result of improved retention of existing policyholders and increased supplemental coverages sold. Additionally, the average written premium per policy increased as the result of policyholders increasing their level of insurance and adjustments to premiums due to rising costs for rebuilding homes. Effective July 1, 2006, the CEA's rates will be reduced by a statewide weighted average of 22.1%.

The change in net unearned premiums decreased $12.4 million in 2005 and $11.2 million in 2004 due to increasing unearned premiums resulting from an increase in written premiums.

The 2005 minimal claims and claims expenses results from no major earthquakes having occurred during 2005. The 2004 $8.2 million decrease in claims and claims expenses was largely due to actual and anticipated losses being less than what was originally projected in 2003.

Reinsurance broker commissions, included in other underwriting expenses, decreased by $4.5 million in 2005 due to declining reinsurance premiums and other underwriting expenses increased $4.8 million in 2005 as a result of the increase in premiums written. Other underwriting expenses increased $3.1 million in 2004 as a result of the increase in premiums written.

The termination of the CEA's line of credit facility at December 31, 2003 resulted in a reduction of $4.5 million in fees during 2004.

In 2005, net investment income was 146% higher than in 2004, a difference of $32.3 million, due to rising interest rates on CEA's investment portfolio. Although the CEA was earning more interest by investing in long-term U.S. Treasuries as opposed to cash equivalent securities, the additional earnings were offset by a $18.2 million unrealized loss during 2005 associated with a decrease in market value of U.S. Treasuries due to steadily rising interest rates throughout 2005. The CEA intends to hold all investments to maturity unless there is an earthquake or series of earthquakes causing significant damage in California.

In 2004, net investment income was 10% lower than in 2003, a difference of $2.5 million. Although the CEA was earning more interest by investing in long-term U.S. Treasuries as opposed to cash equivalent securities, the additional earnings were offset by a $9.3 million unrealized loss during 2004 associated with a decrease in market value of U.S. Treasuries due to steadily rising interest rates throughout 2004.

Other income increased $5.2 million in 2005 primarily resulting from a $4.6 million capital contribution from Foremost Insurance Company as a new participating insurer and a $0.6 million increase in State of California premium tax contributions associated with the increase in supplemental premiums written. Other income remained relatively flat in 2004 as compared to 2003.

CONDENSED STATEMENT OF CASH FLOWS

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

The cash flows of the CEA are summarized as follows:

	2005	2004	2003
Net cash provided by operating activities	$ 309,154,013	$ 254,463,128	$ 218,495,144
Net cash provided by noncapital financing activities	396,355	373,440	707,725
Net cash provided by (used in) capital and related financing activities	436,295	(97,647)	(62,046)
Net cash provided by (used in) investing activities	69,172,909	(275,900,658)	(413,750,541)
Net increase (decrease) in cash and cash equivalents	379,159,572	(21,161,737)	(194,609,718)
Cash and cash equivalents, beginning of year	924,144,590	945,306,327	1,139,916,045
Cash and cash equivalents, end of year	$ 1,303,304,162	$ 924,144,590	$ 945,306,327

Cash from operating activities increased $54.7 million (21%) in 2005 and $36.0 million (16%) in 2004. The 2005 increase in cash provided by operating activities was due to the increase in premiums and other income received of $41.8 million, the decrease in reinsurance premiums paid of $3.8 million and the $9.2 million decrease in operating expenses paid. The 2004 increase was due to increased premiums received of $33.0 million, decreased reinsurance premiums paid of $4.5 million, and the $1.5 million increase in operating expenses paid.

The change in cash provided by capital and related financing activities increased by $0.5 million in 2005 while remaining relatively the same for 2004. The 2005 increase was due to Foremost Insurance Company joining the CEA as a participating insurer in July 2005 and paying $0.5 million of their total capital contribution of $4.6 million.

Cash flows provided by investing activities increased $345.1 million in 2005. Under its investment policy, the CEA is allowed to purchase U.S. Treasuries with maturities of up to five years to help counteract the diminishing yields for high-quality domestic investments, while maintaining a total-portfolio modified duration of 1.75 years or less. Therefore, as the CEA acquires long-term U.S. Treasuries, the CEA also shortens the duration of its cash-equivalent securities to comply with the Board's maximum portfolio modified duration requirement. The 2005 increase was due to an increase in investment income received of $27.2 million, an increase in the proceeds from maturities of $48.6 million and a decrease of $269.3 million in purchases of U.S. Treasuries. Cash flows provided by investing activities increased $137.8 million in 2004 because of the CEA's purchase of additional short-term and long-term U.S. Treasuries rather than cash equivalent securities.

LIQUIDITY

The CEA maintains a highly liquid investment portfolio in order to be able to quickly pay claims in the event of a large earthquake. As of December 31, 2005, 55.0% of the portfolio was to mature in 90 days or less. Securities maturing between 91 days and one year accounted for 2.6% of the portfolio, while securities maturing between one to five years accounted for the remaining 42.4% of the portfolio. Based on earthquake modelers' results of analyzing the CEA's portfolio, management believes the CEA has sufficient liquidity to meet its obligations as they become due resulting from an earthquake or series of earthquakes. The probability of an earthquake or series of earthquakes occurring that would deplete CEA's liquidity and the associated claims-paying capacity is estimated to be .137% under CEA's earthquake model, prepared by the CEA's modeler, EQECAT, in any one year. The CEA pays policyholder claims from its claim-paying capacity. The following depicts the CEA's claim-paying capacity in effect as of December 31, 2005, in millions of dollars:

CEA capital available for claims	$ 2,145
First layer assessments on Participating Insurers	2,183
Risk transfer financial products (reinsurance only at December 31, 2005)	1,500
Second layer assessments on Participating Insurers	1,456
Total	$ 7,284

The calculation of CEA capital available for claims is defined in the California Insurance Code. Under California's Insurance Code, the CEA has the ability to assess the participating insurers on a post-event basis if claims reach certain levels, as defined. The first layer assessments on the participating insurers expire in December 2008. Additionally, the CEA is able to collect amounts under reinsurance contracts when claims reach certain levels, as defined.

California Earthquake Authority
Balance Sheets
December 31, 2005 and 2004

	2005	2004
Assets		
Cash and Investments:		
Cash and cash equivalents	$ 1,303,304,162	$ 924,144,590
Investments	1,065,722,967	1,082,481,382
Total cash and investments	2,369,027,129	2,006,625,972
Premiums receivable, net of allowance for doubtful accounts of $1,334,849 and $1,254,241	32,358,981	33,134,717
Assessments receivable	4,066,995	-
Interest receivable	14,276,945	12,281,056
Unearned ceded premiums	20,710,598	16,924,668
Deferred policy acquisition costs	33,648,134	29,827,145
Other assets	189,388	181,012
Total assets	$ 2,474,278,170	$ 2,098,974,570
Liabilities and Net Assets		
Unearned premiums	$ 262,876,047	$ 233,024,570
Unearned supplemental commission income	3,556,943	3,059,173
Claim and claim expense reserves	36,411	464,877
Supplemental reinsurance premiums payable	9,300,623	7,182,156
Accounts payable and accrued expenses	11,124,702	1,518,287
Total liabilities	286,894,726	245,249,063
Net assets:		
Restricted, expendable	8,485,890	2,297,727
Unrestricted	2,178,897,554	1,851,427,780
Total net assets	2,187,383,444	1,853,725,507
Total liabilities and net assets	$ 2,474,278,170	$ 2,098,974,570

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

California Earthquake Authority
Statements of Revenues, Expenses and Changes in Net Assets
For the Years Ended December 31, 2005 and 2004

	2005	2004
Underwriting income:		
Premiums written	$ 502,962,824	$ 464,909,264
Less premiums ceded - reinsurance	(131,329,113)	(134,445,864)
Net premiums written	371,633,711	330,463,400
Change in unearned premiums	(29,851,477)	(16,548,596)
Change in unearned premiums ceded - reinsurance	3,785,930	2,875,333
Net unearned premiums	(26,065,547)	(13,673,263)
Net premiums earned	345,568,164	316,790,137
Other operating income:		
Supplemental commission income, net	6,375,197	5,453,721
Total revenues	351,943,361	322,243,858
Expenses:		
Claim and claims (income) expense	(6,564)	(2,645,937)
Participating insurer commissions	47,365,803	44,889,736
Participating insurer operating costs	13,237,517	12,545,391
Reinsurance broker commissions	6,376,000	10,850,000
Pro forma premium taxes	10,839,915	10,318,921
Mitigation Fund expenses	818,328	444,139
Other underwriting expenses	9,915,383	8,838,944
Total expenses	88,546,382	85,241,194
Income from operations	263,396,979	237,002,664
Net investment income	54,410,384	22,129,705
Other income	396,355	377,981
Participating insurer capital contribution	4,614,304	-
State of California premium tax contribution	10,839,915	10,318,921
Increase in net assets	333,657,937	269,829,271
Net assets, beginning of year	1,853,725,507	1,583,896,236
Net assets, end of year	$ 2,187,383,444	$ 1,853,725,507

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

California Earthquake Authority
Statements of Cash Flows
For the Years Ended December 31, 2005 and 2004

	2005	2004
Cash flows from operating activities:		
Cash received from premiums and other	$ 510,611,527	$ 468,775,986
Cash payments for premiums ceded - reinsurance	(129,210,646)	(133,059,997)
Cash payments for operating expenses	(69,392,864)	(78,619,011)
Cash payments to employees for services	(2,854,004)	(2,633,850)
Net cash provided by operating activities	309,154,013	254,463,128
Cash flows from noncapital financing activities:		
Other income	396,355	373,440
Net cash provided by noncapital financing activities	396,355	373,440
Cash flows from capital and related financing activities:		
Contributions received from participating insurers	547,309	-
Acquisition of equipment	(111,014)	(97,647)
Net cash provided by (used in) capital and related financing activities	436,295	(97,647)
Cash flows from investing activities:		
Proceeds from maturities of investments	177,250,000	128,700,000
Purchases of investments	(185,953,915)	(455,280,887)
Investment income	77,876,824	50,680,229
Net cash provided by (used in) investing activities	69,172,909	(275,900,658)
Net increase (decrease) in cash and cash equivalents	379,159,572	(21,161,737)
Cash and cash equivalents, beginning of year	924,144,590	945,306,327
Cash and cash equivalents, end of year	$ 1,303,304,162	$ 924,144,590

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

	2005	2004
Reconciliation of operating income to net cash provided by operating activities:		
Income from operations	$ 263,396,979	$ 237,002,664
Adjustments to reconcile income from operations to net cash provided by operating activities:		
Depreciation of equipment	131,120	174,750
Pro forma premium tax expense	10,839,915	10,318,921
Loss on disposal of fixed assets	-	70,697
Allowance for bad debts	80,608	(38,138)
Changes in operating assets and liabilities:		
Premiums receivable	695,128	(1,862,683)
Unearned ceded premiums	(3,785,930)	(2,875,333)
Deferred policy acquisition costs	(3,820,989)	(2,118,220)
Other assets	(28,481)	29,944
Unearned premiums	29,851,477	16,548,596
Unearned supplemental commission income	497,770	313,822
Claim and claim expense reserves	(428,466)	(5,025,352)
Supplemental reinsurance premiums payable	2,118,467	1,385,867
Accounts payable and accrued expenses	9,606,415	537,593
Net cash provided by operating activities	$ 309,154,013	$ 254,463,128

Non-cash Investing, Capital and Financing Activities

The CEA carries investments that experience changes in fair value from year to year. Net unrealized depreciation in the fair value of investments, which is included as a component of net investment income in the Statements of Revenues, Expenses, and Changes in Net Assets, was $18.2 million and $9.3 million for 2005 and 2004, respectively.

1. Reporting Entity and Summary of Significant Accounting Policies

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

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

CEA policies are sold to policyholders by participating insurance carriers of the CEA. Insurance companies admitted to write residential property insurance in California and who elected to become participating members of the CEA signed Insurer Participation Agreements with the Insurance Commissioner and the CEA. Under these agreements, participating insurers act as independent contractor agents on behalf of the CEA by performing policy and claims services which include policy issuance, premium collection, and claims adjustment. Under the agreements, the CEA reimburses participating insurers for non-claims related costs incurred by these companies in servicing CEA policies. The operating cost reimbursement is equal to 2.8% of written premium and the producer commission is equal to 10.0% of written premium of all CEA policies. Additionally, participating insurers receive reimbursement for expenses associated with servicing CEA claims equal to 9.0% of paid claims. As of December 31, 2005, 22 participating insurance carriers sell the CEA policy, 4 of which service 84% of CEA policies. However, as of December 31, 2005, only 17 participating insurers were writing policies.

The CEA has eligibility requirements that compel the CEA to issue and renew policies if the insured structure has no pre-existing, non-cosmetic earthquake damage and the policyholder has a companion policy of residential property insurance from a participating insurer.

In the event that a natural disaster program is enacted by Congress, the advisory panel is required to prepare a plan to dissolve the CEA or conform sections of the California Insurance Code regarding the CEA to the federal program and recommend an action plan to the CEA Governing Board and the California State Legislature.

Basis of accounting
While the CEA is an instrumentality of the state, the State of California’s General Fund is not liable for CEA claims, losses, or other liabilities. However, the CEA meets the definition of a governmental organization, as defined by accounting principles generally accepted in the United States of America.

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

In accordance with governmental accounting standards, the CEA applies all applicable statements issued by the Governmental Accounting Standards Board (GASB). The CEA applies all of the following pronouncements issued on or before November 30, 1989: Financial Accounting Standards Board Statements and Interpretations, Accounting Principles Board Opinions and Accounting Research Bulletins, unless those pronouncements conflict with or contradict GASB pronouncements. In addition, the CEA has elected to apply statements and related interpretations issued by the Financial Accounting Standards Board after November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements.

Revenue recognition

Premiums are recognized as earned on a pro rata basis over the contract period. All premium rates charged by the CEA must be approved by the State of California Insurance Commissioner before use. Effective July 1, 2006, the CEA's rates will be reduced by a statewide weighted average of 22.1%.

Unearned premiums represent amounts written which relate to coverage in future periods.

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

Cash and cash equivalents

For purposes of the statement of cash flows, the CEA considers investments in certificates of deposit, U.S. treasuries, U.S. government money market accounts, commercial paper, corporate bonds, bankers' acceptances, and repurchase agreements with original maturities of three months or less, to be cash equivalents.

Investments

Investments consist primarily of certificates of deposit, U.S. treasuries, U.S. government money market accounts, commercial paper, repurchase agreements, corporate bonds, and bankers' acceptances, as authorized by the 1996 legislation creating the CEA. All investments are reported at fair value in the balance sheets. Fair value is the amount at which a financial instrument could be exchanged in a current transaction between willing parties, and is determined from published data provided by the exchanges, computerized pricing sources, the National Association of Securities Dealers' National Market System, securities custodians, and other authoritative sources.

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

Claims and claim expense reserves
Reserves for insurance claims and claim adjustment expenses include the accumulation of case estimates for claims reported, claims incurred but not reported, and estimates of expenses for investigating and adjusting all incurred claims. The reserve is established at a level that management estimates to be sufficient to satisfy those claims. Estimates are revised as more information becomes available. Since the CEA's inception, there has not been a major earthquake. If a major California earthquake were to occur, there would be a significant increase in the reserve for claims and claim adjustment expenses. The negative claims expenses for the years ended December 31, 2005 and 2004 are a result of reducing the claims reserve to reflect losses less than were projected at the previous year-end.

If the CEA's Governing Board determines that the CEA's net assets, additional participating insurer capital contributions and reinsurance proceeds are exhausted and that no source of additional funds is available to the CEA to pay policyholder claims, the Governing Board is required to develop a plan for approval by the State of California Insurance Commissioner to pay policyholder claims on a pro rata basis. In such circumstance, the CEA would be required by the State of California Insurance Code to permanently or temporarily cease renewing or accepting new earthquake insurance policies.

Participating insurer capital contributions
Each insurer that elected to participate in the CEA during its first year of operations was required to contribute as its share of the CEA's initial operating capital, an amount equal to $1,000,000 multiplied by the percentage representing that insurer's residential earthquake insurance market share as of January 1, 1994. Insurers that elect to participate in the CEA after December 1, 1996, are required to make an initial capital contribution calculated using their residential earthquake insurance market share as of January 1, 1994, or the latest date for which such market share information is available to the CEA, whichever contribution amount is greater. As of December 31, 2005, participating insurer capital contributions totaled $704.6 million and were 99% funded.

The California Insurance Code (Code) states that, subject to certain maximum limits as set forth in the Code, the CEA has the power to make additional assessments of participating insurance companies in the event of a major California earthquake, subject to the approval of the State of California Insurance Commissioner. The CEA's ability to make a portion of the additional assessments expires in December 2008.

As of December 31, 2005, participating insurers have a cumulative residential property insurance market share of approximately 69% of the total residential property insurance market in California. If participating insurers withdraw their participation in the CEA such that the cumulative residential property insurance market share is less than 65%, the Insurance

Commissioner is required by law to make recommendations to the California Legislature for the continuation or termination of the CEA.

Net assets
The CEA classifies its net assets into two components, restricted - expendable and unrestricted net assets. Restricted net assets include the net assets of the Mitigation Fund described in Note 5. The remaining net assets of the CEA are classified as unrestricted.

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

State of California premium tax contributions
California Insurance Code section 10089.44 provides that “notwithstanding any other provision of law, premiums collected by the authority shall be exempt from collection of the state’s insurance premium tax, and the amount of tax foregone by the state shall be considered for all purposes a contribution by the state and its citizens to the capital and operating revenues of the authority.” As a result, the amounts that the state would otherwise impose on the CEA as premium tax are collected by the CEA as premium and retained by the CEA as a contribution by the state; as premium is earned, the portion attributable to the premium-tax exemption is included in the CEA’s net assets. State premium-tax-exemption contributions were $10,839,915 and $10,318,921 for the years ended December 31, 2005 and 2004, respectively. Since inception of the CEA to December 31, 2005, state premium-tax contributions total $81,840,030.

Supplemental commission income
The CEA cedes 100% of its risk under supplemental coverages written to reinsurers. The CEA earns a ceding commission on supplemental insurance coverages written. Of that commission, the CEA remits 10% of premium written to the agents generating the policies and 2.8% to the participating insurance companies for operating expenditures. Unearned supplemental commission income represents the pro rata portion of commissions related to the remaining terms of supplemental coverages in force.

Reclassifications
Certain amounts in the 2004 financial statements have been reclassified in conformity with the 2005 presentation. Such reclassifications do not have a material impact on the CEA's financial position, changes in net assets or cash flows.

2. Cash and Investments and Fair Value of Financial Instruments

As of December 31, 2005, the CEA had the following cash and investments:

	December 31, 2005					
	Investment Maturities (in Years)					Total
	< 1	<2	<3	<4	<5	
U. S. Treasuries	$ 81,324,542	$ 144,650,585	$ 280,066,674	$ 135,006,855	$ 444,638,833	1,085,687,489
U.S. Government money market funds	27,010,681	-	-	-	-	27,010,681
Commercial paper	304,606,986	-	-	-	-	304,606,986
Corporate bonds	55,000,000	-	-	-	-	55,000,000
Banker's acceptances	50,065,401	-	-	-	-	50,065,401
Negotiable certificates of deposit	280,200,014	-	-	-	-	280,200,014
Repurchase agreements	566,000,000	-	-	-	-	566,000,000
Total	1,364,207,624	144,650,585	280,066,674	135,006,855	444,638,833	2,368,570,571
Reconciliation to statement of net assets:						
Cash equivalent items included above						$ 1,302,847,604
Investments						1,065,722,967
						2,368,570,571
Cash not included above						456,558
Total cash and investments						$ 2,369,027,129

	December 31, 2004					
	Investment Maturities (in Years)					Total
	< 1	<2	<3	<4	<5	
U. S. Treasuries	$ 165,038,721	$ 498,482,043	$ 163,047,010	$ 161,346,765	$ 78,900,980	1,066,815,519
U. S. agencies	44,294,728	15,662,706	-	-	-	59,957,434
U.S. Government money market funds	13,698,901	-	-	-	-	13,698,901
Commercial paper	220,878,814	-	-	-	-	220,878,814
Corporate bonds	40,011,893	-	-	-	-	40,011,893
Banker's acceptances	10,602,874	-	-	-	-	10,602,874
Negotiable certificates of deposit	209,300,390	-	-	-	-	209,300,390
Repurchase agreements	382,500,000	-	-	-	-	382,500,000
Total	1,086,326,321	514,144,749	163,047,010	161,346,765	78,900,980	2,003,765,825
Reconciliation to statement of net assets:						
Cash equivalent items included above						$ 921,284,443
Investments						1,082,481,382
						2,003,765,825
Cash items not included above						2,860,147
Total cash and investments						$ 2,006,625,972

Interest Rate Risk

As a means of limiting its exposure to fair value losses arising from rising interest rates, the CEA's investment policy limits U.S. Treasuries purchased for short-term purposes to securities with maximum maturities of 181 days. For long-term purposes, Treasuries are allowed to have maturities of up to 5 years as long as the total CEA's portfolio does not exceed a weighted average maturity of 1.75 years.

Credit Risk

The CEA investment policy limits investments in banker's acceptances and commercial paper to issuers with the highest rating category by all rating agencies that rate the issuer. The policy limits investments in corporate bonds to the top three ratings issued by nationally recognized rating services. As of December 31, 2005, the CEA's investments in banker's acceptances and commercial paper were rated A-1 by Standard & Poor's and P-1 by Moody's Investors Service. The CEA's investments in corporate bonds were rated AAA by Standard & Poor's and Aaa by Moody's Investors Service. In order to reduce counterparty exposure, the CEA maintains collateral of 105% on repurchase agreements.

Concentration of Credit Risk

There is no concentration of investments in any one non U. S. governmental issuer that represents 5% or more of total investments.

Investment Income

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

Investment income for the years ended December 31, 2005 and 2004 was as follows:

	2005	2004
Certificates of deposit	$ 8,033,596	$ 2,233,389
U.S. agency securities and government money market accounts	1,049,820	747,270
Repurchase agreements	15,815,860	5,651,379
Corporate bonds	2,675,603	512,045
U.S. Treasuries	28,750,815	23,817,048
Commercial paper	8,495,759	2,719,914
Banker's acceptances	238,745	259,270
Interest income	65,060,198	35,940,315
Change in fair value of investments	(8,893,764)	(12,189,146)
Less investment expenses	(1,756,050)	(1,618,305)
Net investment income	$ 54,410,384	$ 22,132,864

The change in fair value of investments for the years ended December 31, 2005 and 2004 is calculated as follows:

	2005	2004
Fair value of investments at the end of year	$ 1,065,722,967	$ 1,082,481,382
Add: Proceeds of investments matured	177,250,000	128,700,000
Add: Amortization of discounts	16,568,566	19,485,793
Less: Cost of investments purchased	(185,953,915)	(455,280,887)
Less: fair value of investments at the beginning of year	(1,082,481,382)	(787,575,434)
Change in fair value of investments	$ (8,893,764)	$ (12,189,146)

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

3. Reinsurance

The CEA cedes risk to reinsurers under catastrophe excess of loss reinsurance contracts and a supplemental coverages reinsurance contract, for purposes of limiting its maximum exposure. All contracts provide coverage for losses as well as allocated loss adjustment expenses. Although the ceding of risk does not discharge the CEA from its primary responsibility to its policyholders, the insurance company that assumes the coverage assumes responsibility to reimburse the CEA for the related liability. Management believes that its reinsurers are and will continue to be able to satisfy their obligations under the reinsurance agreements. To date, losses have been ceded only under the supplemental coverages reinsurance contracts. In the event that legislation is enacted by the State of California that has the effect of increasing a reinsurer's exposure to loss under the reinsurance contract, a reinsurer has the right to cancel the reinsurance contract.

The 2005 and 2004 aggregate excess reinsurance contracts allowed for an adjustment of premium, based on the average aggregate insurance in force and the exposure adjustment limit, as defined in the contracts. As of December 31, 2005, in accordance with these terms, the CEA accrued a premium adjustment expense of $4.5 million against the contract. As of December 31, 2004, in accordance with these terms, the CEA had no premium adjustment due to or from reinsurers.

In 2005 and 2004, the CEA continued to cede insurance to reinsurers under catastrophe excess-of-loss reinsurance contracts. Effective January 1, 2005, the CEA has entered into contracts to continue to cede insurance to reinsurers under catastrophe excess-of-loss reinsurance contracts, of which one is collateralized, extending through December 31, 2006. While one of the 2006 contracts has not been finalized as of May 18, 2006, the CEA has a binding letter of agreement with the reinsurer. For 2004, 2005, and 2006, the reinsurance contracts provide maximum coverages of $1.5 billion, $1.5 billion, and $1.8 billion, respectively, at varying attachment points.

The CEA entered into a supplemental coverages quota share reinsurance contract effective July 1, 1999 through June 30, 2004, which was extended through June 30, 2006. Under the terms of this contract, the CEA cedes 100% of its liability under supplemental insurance policies to the reinsurer, in return for ceding 100% of premiums written on this business. The extended contract has a limit of liability for the reinsurers of $350 million. The CEA commission was 20% under the expired contract and ranges from 16% to 18.5% under the extended contract. Effective January 1, 2005, the extended quota share contract was modified to increase the limit of liability to $450 million, to change the CEA commission to 17.5%, and to extend the contract for an additional six months through December 31, 2006. Additionally, accumulated ceding commissions from the supplemental coverage program were used to purchase $146 million in reinsurance coverage for 2006 in excess of the quota share coverage.

4. Statutory Compliance

The State of California Insurance Code limits CEA's "operating expenses" to 3% of its "premium income." In calculating this limitation, the CEA has determined that its premium income is its reported premiums written and that its operating expenses do not include certain start-up expenses and certain credits and payments, including payments to reinsurers, payments to investment managers and advisors, payments to participating insurers, or payments of agent commissions. Operating expenses, as determined by the CEA, totaled $5.2 million and $4.1 million for the years ended December 31, 2005 and 2004, respectively, and did not exceed 3% of premiums written.

5. Mitigation Fund

California Insurance Code Section 10089.37 created the Earthquake Loss Mitigation Fund (Mitigation Fund) as a "sub-account of the CEA". By statute, the Mitigation Fund must be used solely for the establishment and operation of the mitigation program. The Insurance Code requires the CEA annually transfer an amount equal to the lesser of 5% of investment income or $5 million to the Mitigation Fund if deemed actuarially sound by a consulting actuary. The transfer and setting aside of those monies into the Mitigation Fund sub-account have been formally approved by the CEA governing board. It is the opinion of the general counsel of the CEA and of the CEA's outside counsel that the monies that are resident in the Mitigation Fund sub-account within the CEA are by statute not available to pay policyholder or other claims against the CEA.

As of December 31, 2005 and 2004, the balance sheets include expendable restricted net assets related to the Mitigation Fund totaling $8,485,890 and $2,297,727, respectively.

SUPPLEMENTARY INFORMATION

California Earthquake Authority
Schedule of Participating Insurer Capital Contributions
December 31, 2005 and 2004

	2005	2004
State Farm Insurance Company	$ 249,188,275	$ 249,188,275
Allstate Insurance Company	145,612,517	145,612,517
Farmers Insurance Company	143,280,000	143,280,000
United Services Automobile Association	58,992,512	58,992,512
California State Automobile Association	39,013,494	39,013,494
California Fair Plan	15,029,487	15,029,487
Automobile Insurance Exchange of Southern California	14,443,651	14,443,651
CNA/Continental	13,924,611	13,924,611
Prudential Insurance Company	11,531,455	11,531,455
Liberty Mutual Insurance Company	6,699,434	6,699,434
Foremost Insurance Company	4,614,304	-
Mercury Insurance Company	1,406,238	1,406,238
Armed Forces	783,685	783,685
GuideOne (formerly Preferred Risk)	123,133	123,133
Merastar	-	-
Golden Eagle	-	-
Homesite Insurance	-	-
Workmen's Auto Insurance	-	-
Pacific National Insurance	-	-
Encompass Insurance	-	-
Glen Falls Insurance Company	-	-
ACA Insurance Company	-	-
Total	$ 704,642,796	$ 700,028,492

California Earthquake Authority
Schedules of Participating Insurer Premiums Written
For the years ended December 31, 2005 and 2004

	2005	2004
State Farm Insurance Company	$ 189,781,589	$ 173,492,846
Allstate Insurance Company	106,449,224	99,089,402
Farmers Insurance Company	60,729,414	57,981,726
United Services Automobile Association	65,649,254	62,339,028
California State Automobile Association	16,085,881	14,313,437
California Fair Plan	6,410,338	6,664,626
Automobile Insurance Exchange of Southern California	30,213,282	26,874,866
CNA/Continental	-	-
Prudential Insurance Company	(2,602)	509,929
Liberty Mutual Insurance Company	11,878,572	10,691,697
Foremost Insurance Company	1,507,173	-
Mercury Insurance Company	8,311,848	7,108,449
Armed Forces	793,157	742,579
GuideOne (formerly Preferred Risk)	-	-
Merastar	82,919	83,093
Golden Eagle	24,382	21,077
Homesite Insurance	428,961	283,926
Workmen's Auto Insurance	43,081	28,392
Pacific National Insurance	-	-
Encompass Insurance	4,380,169	558,749
Glen Falls Insurance Company	(40,357)	4,125,442
ACA Insurance Company	236,539	-
Total	$ 502,962,824	$ 464,909,264

California Earthquake Authority
Schedules of Participating Insurer Unearned Premiums
December 31, 2005 and 2004

	2005	2004
State Farm Insurance Company	$ 97,775,937	$ 85,797,617
Allstate Insurance Company	56,088,654	50,333,267
Farmers Insurance Company	32,402,197	29,776,283
United Services Automobile Association	34,008,644	31,083,724
California State Automobile Association	8,328,902	7,013,936
California Fair Plan	3,564,794	3,475,196
Automobile Insurance Exchange of Southern California	15,873,081	13,379,605
CNA/Continental	-	-
Prudential Insurance Company	-	61,264
Liberty Mutual Insurance Company	6,287,171	5,569,345
Foremost Insurance Company	1,075,717	-
Mercury Insurance Company	4,192,179	3,343,987
Armed Forces	423,305	374,222
GuideOne (formerly Preferred Risk)	-	-
Merastar	51,575	44,875
Golden Eagle	16,282	6,498
Homesite Insurance	215,631	131,158
Workmen's Auto Insurance	18,743	10,466
Pacific National Insurance	-	-
Encompass Insurance	2,408,580	2,129,138
Glen Falls Insurance Company	27	493,989
ACA Insurance Company	144,628	-
Total	$ 262,876,047	$ 233,024,570

California Earthquake Authority
Schedules of Participating Insurer Commissions
For the years ended December 31, 2005 and 2004

	2005	2004
State Farm Insurance Company	$ 17,802,556	$ 16,789,151
Allstate Insurance Company	10,080,442	9,596,891
Farmers Insurance Company	5,818,132	5,657,206
United Services Automobile Association	6,277,873	6,012,235
California State Automobile Association	1,478,313	1,384,188
California Fair Plan	632,604	664,546
Automobile Insurance Exchange of Southern California	2,775,231	2,482,932
CNA/Continental	46,109	-
Prudential Insurance Company	5,864	261,576
Liberty Mutual Insurance Company	1,117,506	822,605
Foremost Insurance Company	43,415	-
Mercury Insurance Company	747,377	642,649
Armed Forces	74,491	71,333
GuideOne (formerly Preferred Risk)	-	-
Merastar	7,637	7,883
Golden Eagle	2,421	823
Homesite Insurance	34,513	24,998
Workmen's Auto Insurance	3,491	2,947
Pacific National Insurance	-	-
Encompass Insurance	197,418	101,087
Glen Falls Insurance Company	211,200	366,686
ACA Insurance Company	9,210	-
Total	$ 47,365,803	$ 44,889,736

California Earthquake Authority
Schedules of Participating Insurer Operating Costs
For the years ended December 31, 2005 and 2004

	2005	2004
State Farm Insurance Company	$ 4,971,347	$ 4,688,269
Allstate Insurance Company	2,818,677	2,683,417
Farmers Insurance Company	1,625,413	1,580,542
United Services Automobile Association	1,757,009	1,682,683
California State Automobile Association	413,444	387,087
California Fair Plan	176,974	185,925
Automobile Insurance Exchange of Southern California	775,854	694,199
CNA/Continental	-	-
Prudential Insurance Company	1,643	73,199
Liberty Mutual Insurance Company	312,172	229,481
Foremost Insurance Company	12,124	-
Mercury Insurance Company	208,787	179,484
Armed Forces	20,830	19,958
GuideOne (formerly Preferred Risk)	-	-
Merastar	2,122	2,194
Golden Eagle	677	228
Homesite Insurance	9,633	6,991
Workmen's Auto Insurance	965	820
Pacific National Insurance	-	-
Encompass Insurance	68,133	2,744
Glen Falls Insurance Company	59,135	128,170
ACA Insurance Company	2,578	-
Total	$ 13,237,517	$ 12,545,391