Pinnacol Assurance Restructuring Proposal

Presented to Governor John Hickenlooper

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PINNACOL ASSURANCE

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PINNACOL ASSURANCE RESTRUCTURING PROPOSAL

I. Restructuring Overview

The restructuring contemplated by this proposal is intended to result in Pinnacol separating from the State of Colorado while, at the same time, protecting the interests of policyholders and injured workers, ensuring Pinnacol's long term viability and maintaining Pinnacol's position as Colorado's market leader in workers' compensation insurance. Some of the key components of this restructuring include:

- Pinnacol transitioning to a mutual insurance holding company, clearly defining policyholder ownership interest.
- Pinnacol continuing to serve as the State's insurer of last resort.
- Pinnacol continuing to focus on providing workers' compensation insurance so its expertise would not be diluted.
- Pinnacol becoming a member of the Colorado Guaranty Insurance Association providing additional assurance that injured workers and their families receive their benefits in the event Pinnacol is unable to pay benefits.
- Subject to the approval of policyholders, Pinnacol considering supporting certain limited changes to the Colorado workers' compensation system that would be applicable to all insurance carriers.
- Pinnacol becoming a tax-paying entity similar to other insurance companies operating in Colorado.
- Pinnacol remaining headquartered in Colorado, resulting in job growth as Pinnacol expands its scope of operations and provides workers' compensation insurance on a regional basis.
- Pinnacol issuing convertible preferred stock to the yet-to-be established heritage funds with a fixed annual cumulative dividend creating economic development and educational opportunities for the people of Colorado.

A number of other states have successfully restructured their workers' compensation entities, and those changes have proven beneficial in stabilizing competitive marketplaces and providing superior service to customers. The proposed restructuring (a) would require the approval of legislation providing for, among other things, the termination of Pinnacol's status as a political subdivision of the State and its transition to a mutual insurance holding company whose membership interests would be held by policyholders and (b) is conditioned upon policyholder and regulatory approvals as well as an A.M. Best Rating of "A-" or better.

II. Company Overview

Since 1915, Pinnacol Assurance, together with its predecessors, has been the assured and trusted source of workers’ compensation insurance for Colorado employers. Established under the provisions of the Workers’ Compensation Act of Colorado (CRS 8-45), Pinnacol generally operates as a domestic mutual company and yet is a political subdivision of the State of Colorado. Pinnacol is governed by a nine member Board of Directors appointed by Colorado’s Governor with the consent of the Senate.

The Company sells only workers’ compensation insurance (mono-line) and has grown to insure more than 55,000 Colorado businesses and 1 million Colorado employees. In 2010, the Company’s earned premium was nearly $350 million and its surplus was more than $600 million. The Company’s strong surplus position has permitted it to pay more than $435 million in general dividends since 2005.

Pinnacol has averaged 57.4% of total insurable earned premiums in Colorado since 2004. Although exclusively focused in Colorado (mono-state), Pinnacol ranked 19th in domestic market share in 2010 based on total premiums and is the fourth largest “state fund” behind State Insurance Fund Workers’ Compensation (New York), State Compensation Insurance Fund (California), and Texas Mutual Insurance Company (Texas). A total of 25 states offer state workers’ compensation funds while North Dakota, Ohio, Washington, and Wyoming operate monopoly state funds.

III. Workers' Compensation Market Overview

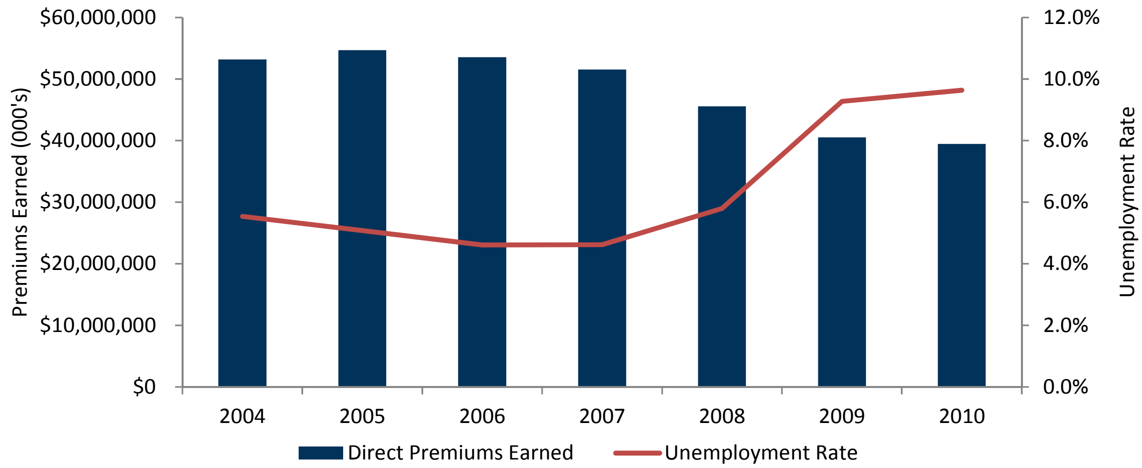
The workers' compensation industry experienced a pre-tax operating loss of 1% in 2010, the first pre-tax industry operating loss since 2002; the loss was driven by low premium revenue and a low interest rate environment. In 2010, for the second straight year, the workers' compensation industry had the highest losses - 118% - of all commercial lines of insurance. This ratio is projected to increase, growing to 119% in 2011 and 120% in 2012.

The decrease in premium revenue in the market over the last few years has been attributed to:

- General economic recession and reduced payrolls
- Steep losses of manufacturing and construction jobs (40% of industry premium and 20% of total workers employed in these two industries)
- Smaller employers hit harder than larger employers who may self-insure or have multi-peril policies

As indicated below, the economic downturn and rising unemployment rate have contributed to domestic industry premiums earned decreasing 28% since 2005.

Table 1: National Premiums Earned vs. Unemployment Rate

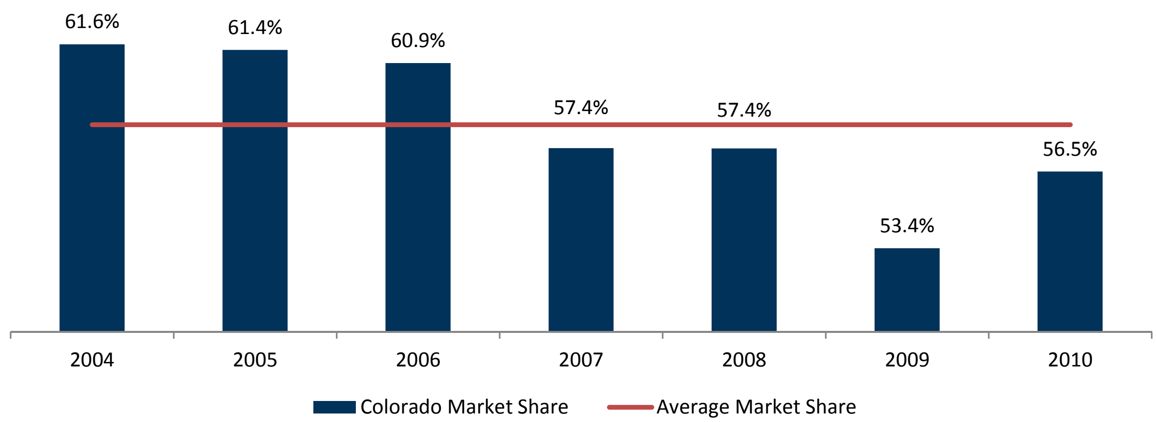


Source: SNL Financial

IV. Impact of Challenging Market Conditions on Pinnacol

The national workers' compensation insurance market has been in a period of falling rates, increased competition, and pressure on profit margins. For these reasons, Pinnacol experienced operating losses in 2010. Furthermore, as shown below in Table 2, Pinnacol's average Colorado market share has remained relatively flat since 2004, at approximately 57.4%.

Table 2: Pinnacol's Colorado Market Share (measured as a % of insurable premiums)



Source: SNL Financial

Since 2007, Pinnacol has lowered policyholders' rates by 40%. During that same period, the Company maintained an appropriate surplus level while, at the same time, issuing general dividends to policyholders.

Due to increasing industry costs, management anticipates that it will be required to increase policyholders' rates in order to maintain financial stability. The Colorado Commissioner of Insurance recently ordered a rate increase in the "loss costs" component of workers' compensation premiums in order to ensure that premiums remain adequate. This increase will happen regardless of whether the proposed restructuring occurs.

V. Restructuring Rationale

The State of Colorado and Pinnacol have been discussing a proposed restructuring whereby Pinnacol would become independent from the State. By restructuring, Pinnacol will be better positioned to (1) continue providing competitively priced and reliable workers' compensation coverage for its policyholders, (2) strengthen protections for injured workers, (3) maintain its role as Colorado’s insurer of last resort, and (4) provide short and long-term economic benefits for all of Colorado. In addition, the restructuring addresses three important objectives:

1. Unlock Policyholder/Public Interest Value

Pinnacol’s current structure as a political subdivision of the State constrains the value of the Company, preventing policyholders and the people of Colorado from benefitting from their respective interests in Pinnacol. Details are provided below about the proposed restructuring, which the Company believes will unlock the value of policyholders’ and the public’s interest in Pinnacol.

2. Support Colorado’s Economy

Pinnacol shall retain its headquarters and principal place of business in the State of Colorado. In addition, Pinnacol shall remain the State’s insurer of last resort. At the same time, restructuring Pinnacol would give the Company the ability to pursue leveraging its expertise and success beyond the State of Colorado and reduce its industry and geographic concentration. Given Pinnacol’s commitment to Colorado, this will permit the Company to create jobs and drive future economic development for the benefit of everyone in the State.

3. Adapt to Changing Market Conditions

Although Pinnacol is a financially sound company, the Company’s structure as a mono-line, mono-state insurance carrier constrains its ability to adapt to rising costs. Across the workers’ compensation industry, costs are increasing due to medical inflation and increased frequency of injuries. Unlike its competitors, Pinnacol is unable to adapt to rising costs, since it cannot expand its product offerings or increase its geographic footprint. In order to better serve policyholders and injured workers, Pinnacol needs to adapt to changing business conditions. Through diversification, a restructured Pinnacol will be better positioned to navigate changing industry and economic environments, keep pace with trends impacting the workers' compensation industry and mitigate some factors that would otherwise result in increased premiums and decreased dividends.

VI. Determining the Value of the State's Support to Pinnacol

Although the State of Colorado does not currently provide direct financial support to Pinnacol, the State historically provided other support, including allowing the Company to operate with an insufficient surplus for a number of years, exemption from premium taxes and theoretical capital support permitting Pinnacol to operate without an A.M. Best Rating. As a part of this proposal, consideration will be paid in exchange for the value of such historical support and enabling the restructuring.

In 2010, Pinnacol approached the State of Colorado with a proposal to become an independent entity. As part of the proposed 2010 restructuring, Morgan Stanley was engaged by the State of Colorado, and Goldman Sachs was retained by Pinnacol. Morgan Stanley prepared an analysis evaluating the 2010 restructuring proposal which included (a) a present value calculation of the prior support provided by the State of Colorado to Pinnacol and (b) an evaluation of the ability of Pinnacol to provide consideration to the State of Colorado if Pinnacol were to become independent. Morgan Stanley computed the present value of the support provided by the State of Colorado to Pinnacol to be in the range of $331 million to $375 million and concluded the consideration Pinnacol had the ability to provide to the State was in the range of $304 to $376 million. Goldman Sachs reviewed the Morgan Stanley analysis and presented its report to Pinnacol. Neither report was intended to provide a valuation of Pinnacol as a going concern. Further, both reports were prepared prior to the recognition of an obligation due to the Public Employees' Retirement Association (discussed in Section IX).

As part of the current restructuring proposal, two public-purpose heritage funds will be established and they will each receive an equity interest issued by Pinnacol as described below. The income derived from the equity interest will support economic development and education in Colorado. Furthermore, if Pinnacol successfully grows its business, the heritage funds will benefit from Pinnacol's increased value. The heritage fund model follows the precedent established by the State in 1998 when the Blue Cross Blue Shield system was sold to Anthem, and a portion of the proceeds were used to fund the Caring for Colorado Foundation.

VII. Benefits Resulting From Restructuring

Policyholders

- Clarification of policyholders' interest in the mutual insurance company
- Elimination of legislative uncertainty
- A voice in the governance of the Company
- Assurance that Pinnacol will continue to serve as the State's insurer of last resort
- Evidence of the Company's financial stability with an A.M. Best Rating of "A-" or better
- Continued eligibility to receive policyholder dividends as declared by the Board

Injured Workers

- Additional injured worker protection through membership in the Colorado Insurance Guaranty Association
- Subject to the support of policyholders, Pinnacol considering supporting certain limited changes to Colorado's workers' compensation system that would be applicable to all insurers

State of Colorado

- Expected job growth
- Assurance that Pinnacol will continue to serve as the State's insurer of last resort
- Pinnacol will keep its headquarters and principal place of business in Colorado

- New source of ongoing premium tax revenue
- Pinnacol will become a member of the Colorado Insurance Guaranty Association

Heritage Funds

- Source of recurring annual dividend income that will fund economic and educational opportunities for the people of Colorado
- Opportunity to participate in growth of the Company through an equity interest

Agents

- Access to new products and services
- Ability to sell products and services in other states
- Increased marketability of Pinnacol due to A.M. Best Rating

Pinnacol

- Access to capital
- Clarification of interests of policyholders and the State
- Facilitates strategic options, organic growth, acquisitions, geographic expansion, and new product lines
- Resolution of underfunded Public Employees' Retirement Association ("PERA") liability

Competitors

- Level playing field in which all companies pay the same taxes and participate in the Colorado Insurance Guaranty Association

VIII. Restructuring of Pinnacol

The proposed restructuring consists of a statutorily mandated reorganization of Pinnacol into an indirect, wholly owned subsidiary of a Colorado mutual insurance holding company owned by its policyholders, a structure used by many other insurance companies. It will be a condition of the restructuring that the transaction is approved by policyholders and regulators and that the Company receive an A.M. Best Rating of "A-" or better.

Near Term: Convert to a Mutual Company and Issue Preferred Stock

Initially, Pinnacol will convert from a political subdivision of the State to a mutual insurance holding company. This structure is similar to the one used by the Nevada State Industrial Insurance System (n/k/a Employers Insurance Company of Nevada, Inc.) which was formerly the Nevada state workers' compensation fund, in connection with its separation from the State of Nevada. Subject to approval of enabling legislation and policyholder and regulatory approval, policyholders will become members of the mutual insurance holding company, which clarifies the policyholders' ownership interest in the mutual insurance company.

As part of the restructuring, the newly-formed public purpose heritage funds will receive convertible preferred stock in a wholly owned subsidiary of the mutual insurance holding company. The heritage funds will immediately begin receiving quarterly dividends on the preferred stock, estimated to be worth $13.6 million annually.

Long Term: Possible Demutualization

Going forward, Pinnacol could, with policyholder and regulatory approval and in compliance with all applicable laws, demutualize, and in that case policyholders of record at that time would receive common shares in Pinnacol or its holding company in exchange for their membership interests in the mutual insurance holding company. These shares would increase and decrease in value based on Pinnacol's financial strength but wouldn't be able to be sold until a trading market for the common stock is established. In order for policyholders to receive all the benefits of typical common stock shareholders, Pinnacol would have to complete a transaction that provides liquidity such as an initial public offering. Upon completion of such a transaction, policyholders would be able to sell or transfer their shares if they desire.

The heritage funds will be able to convert the funds' preferred shares to common shares at any time but won't likely choose to do so until a liquidity event occurs, if at all. Upon conversion of the preferred shares, the heritage funds will no longer receive the preferred stock dividend.

There are a number of factors outside of Pinnacol's control that may impact the Company's ability to demutualize. This includes, but is not limited to, market conditions, Pinnacol's financial strength, and the regulatory landscape at such time.

IX. Restructuring Terms

In contrast to the 2010 restructuring proposal, the current proposal does not include any cash payment to the State, which will allow Pinnacol to maintain its strong surplus position. This proposed restructuring of Pinnacol includes issuing the heritage funds convertible preferred stock, which is a security similar to common stock, except the preferred stock will have preferential treatment in certain aspects over the common stock. The convertible preferred stock will have a par value of $340 million, will pay cumulative cash dividends of 4% annually, payable quarterly, will have a perpetual duration and will be convertible into shares of common stock representing approximately 40% of the fully-diluted common stock outstanding as of the date of the restructuring. The convertible preferred stock otherwise has the rights and preferences set forth in a term sheet to be delivered to the State under separate cover within the next seven days. As part of the restructuring, Pinnacol will need to disaffiliate from PERA, which will result in the Company having to compensate PERA for the amount of the unfunded liability associated with Pinnacol's participation in PERA. Although the cost of such disaffiliation is being determined, the Company believes the amount will be approximately $125 million, which cost will be satisfied by the delivery to PERA of a long-term surplus note. Based on the anticipated capital and earnings impact of the preferred stock, the PERA surplus note, and other operating and financial factors, the Company expects to receive an "A-" rating from A.M. Best. In addition, Pinnacol will begin paying premium taxes to the State, similar to all other insurance companies. The premium taxes are estimated at 1% of annual earned premium. This will amount to approximately $3.5-$4 million in 2012 and, based upon the Company's premium projections, should increase annually. Pinnacol will also begin paying federal taxes, estimated at 15% of annual pre-tax income.

X. Restructuring Costs

Table 3 below summarizes the restructuring costs anticipated to be paid by the Company, but the table does not include professional fees (legal, financial, and other advisors) and expenses of Pinnacol or the State. Pinnacol has agreed to pay the professional fees and expenses of advisors of the State.

Table 3: Restructuring Costs

	Description	**Costs**
PERA Disaffiliation	Pinnacol will need to disaffiliate from PERA. This cost is currently being determined. Based on preliminary discussions and currently available data, management estimates a cost of $125 million to disaffiliate.[1]	One-time charge estimated to be $125 million payable pursuant to a long-term surplus note.
Preferred Stock Dividends	Annual dividend payment to the heritage funds associated with the convertible preferred stock.	4% dividend, or $13.6 million per year.
State Premium Tax	State imposed premium tax payable on earned premium.	Estimated 1% of annual earned premium except on the residual business.
Operating	Overhead expenses expected to increase related to	Estimated at 0.5% of annual earned

[1] Proposed accounting rules would require the unfunded liability associated with Pinnacol's PERA obligation to be recognized as a liability in its financial statements in 2014 if the restructuring does not occur. Although the amount of the cost of the disaffiliation is not necessarily the same as the unfunded liability, Pinnacol believes the difference in the amount of the liabilities will likely not be material.

	Description	Costs
Expenses	professional staff and outside professional fees associated with being a taxable entity.	premium.
Reinsurance	Pinnacol currently purchases reinsurance coverage above $20 million. To reduce policyholders' risk, Pinnacol will purchase reinsurance coverage above $5 million.	Estimated reduction of earned premium by $1.5 million.
Federal Income Tax	Pinnacol would be subject to federal income taxation.	Estimated at 15% of annual pre-tax income.
Guaranty Fund	Pinnacol would become a member of the Colorado Insurance Guaranty Association.	$6 million liability.

XI. Conclusion

Ultimately, this restructuring proposal attempts to address several challenging issues pertaining to Pinnacol's ownership structure and its inherent risks, uncertainties and limitations. Pinnacol's current sub-optimal ownership structure has resulted in ongoing debate among the Company's constituents as to who "owns" Pinnacol. Under the current structure, it is difficult to imagine a scenario that will adequately resolve that question. The proposed restructuring resolves this ownership uncertainty. In addition, as described above, the restructuring will unlock underlying value in the Company, create jobs and drive future economic development for the benefit of everyone in the State, and allow Pinnacol to adapt to changing market conditions. Lastly, and most importantly, by restructuring, Pinnacol will be better positioned to continue providing competitively priced and reliable workers' compensation coverage for its policyholders, strengthen protections for injured workers and maintain its critical role as Colorado's insurer of last resort.

XII. Glossary of Terms

- A.M. Best Rating – A measure of a company’s ability to meet its ongoing obligations to policyholders. It is used extensively by agents when placing business.
- Earned premium – The amount of total premiums collected by an insurance company over a period that have been earned based on the ratio of the time passed on the policies to their effective life. This pro-rated amount of paid-in-advance premiums have been "earned" and now belong to the insurer.
- Reserves – An estimate of how much in benefits the company will pay to injured workers and to the dependents of workers who have been injured or killed on the job. Reserve levels are determined based on reported and unreported claims.
- Surplus – The amount of undistributed net income from prior periods retained to meet unexpected losses. The Company’s surplus is set aside and protected to cover such things as catastrophic events, medical inflation and to guard against economic uncertainty.