

STATE OF WASHINGTON
DEPARTMENT OF LABOR AND INDUSTRIES
INDUSTRIAL INSURANCE FUND

FINANCIAL INFORMATION

For the following funds:
608 - Accident Fund
609 - Medical Aid Fund
610 - Accident Reserve Fund

As of June 30, 2004

Prepared by: Insurance Services Division
Source: Washington State's
Accounting and Financial Reporting System

December 16, 2004

**State of Washington
Department of Labor and Industries
Industrial Insurance Fund**

**Management's Discussion and Analysis
of Results of Operations and Financial Condition**

Introduction

The Department of Labor and Industries (the Department) administers the Industrial Insurance Fund (the Fund) and the Workers' Compensation Insurance program in the state of Washington. Workers' Compensation benefits are paid for wages lost during disability, permanent partial and total disability, vocational rehabilitation and medical costs incurred in conjunction with the injury. For employers and employees covered by the Fund and not self-insured, premiums paid and earnings of the Fund's investment portfolio fund the benefits.

Cash Flow

Premiums collected during the twelve months ending June 30, 2004 were \$1,191 million, increasing \$293 million (32.6%) compared to the previous twelve months. The January 2003 and 2004 rate changes provided the greatest part of the increase but slightly growing exposures provided some contribution.

Benefits paid during fiscal year 2004 were \$1.17 billion, growing at 5.4% annually. The annual ratio of expenses paid to benefits paid decreased slightly to 15.0% as expenses paid declined 6.5% over the previous year.

Cash flow from investment income was reclassified last year as fixed income was separated from equity dividends. Fixed income cash was \$99 million for the quarter and \$446 million for the latest twelve months. Equity dividend cash was \$25.8 million for the latest 12 months.

Financial Condition

The value of equity holdings increased by \$59 million in the quarter, ending the fiscal year up \$343 million. Realized fixed income gains were \$3 million and \$93 million respectively for the quarter and fiscal year. The contingency reserve increased by \$73 million in the quarter and by \$332 million for the fiscal year to end at \$788 million. The main contributing factors were the equity and fixed income gains and decreasing claims administration expense reserves.

The contingency reserve is distributed by fund as follows:

Funds	Contingency Reserve			
	Target % of Liabilities	Current	Target	Excess (Deficit)
608	10%	\$214 M	\$348 M	-
610	1%	\$0 M	\$22 M	-
Accident*	6.6%	\$214 M	\$370 M	(\$156 M)
Medical Aid	15%	\$574 M	\$447 M	\$127 M
TOTAL	9%	\$788 M	\$817 M	(\$29 M)

**State of Washington
Department of Labor and Industries
Industrial Insurance Fund**

**Management's Discussion,
continued...**

Annual net standard earned premiums increased 24.6% mostly due to the 2003 and 2004 rate increases with exposures increasing modestly. Net annual retrospective rating adjustments earned were \$103 million for the fiscal year.

Reserves

Total benefit reserves increased by \$74 million in the quarter and by \$418 million in the fiscal year. The Accident Fund reserve increased by \$11 million in the quarter and increased by \$141 million in the fiscal year. Medical Aid Fund benefit liabilities increased by \$92 million in the fiscal year. The Pension Fund benefit liabilities increased by \$51 million in the quarter and \$185 million, 9.6%, in the fiscal year.

The claim administration reserves decreased by \$12 million this quarter and \$57 million in the fiscal year.

Benefit and Claims Administration Expense Reserves as of 6/30/2004						
(in thousands of dollars)						
	Non-Pension Undiscounted	Non-Pension Discounted at 4% interest rate	Provision for Uncertainty	Carried	Difference Undiscounted minus Carried	Percent Difference
Benefit Reserves:						
Accident Fund	3,649,382	3,049,961	121,999	3,171,960	477,422	13.1%
Medical Aid Fund	5,104,240	2,597,954	103,918	2,701,872	2,402,368	47.1%
Pension Fund	2,094,403	2,094,403	-	2,094,403	0	0.0%
Total	10,848,025	7,742,318	225,917	7,968,235	2,879,790	26.5%
Claims Administration Expense Reserves:						
Accident Fund	147,073	147,073	5,883	152,956		
Medical Aid Fund	425,317	216,295	8,652	224,947		
Total	572,390	363,368	14,535	377,903	194,487	34.0%
Benefit and Claims Administration Expense Reserves						
Total	11,420,415	8,105,686	240,452	8,346,138	3,074,277	26.9%

The estimate of reserves that a private insurer would use before the application of risk-based capital standards is \$ 10.8 billion for future benefits and \$ 572 million for future claims administration expenses (the column Non-Pension undiscounted),

**State of Washington
Department of Labor and Industries
Industrial Insurance Fund**

**Management's Discussion,
continued...**

where the pension liabilities are discounted at 6.5% (a private insurer would be probably be required to discount pensions at 3.5%), and before the non-pension liabilities are discounted. The non-pension liabilities are discounted to present value at a 4% interest rate reducing the total benefit and claims administration expense liabilities \$3.3 billion (29%). Because the non-pension liabilities are discounted the department increases the discounted value of non-pension liabilities by \$240 million (4%) as an explicit provision for uncertainty. The final carried benefit liabilities are \$8.0 billion and the claims administration expense reserves are \$378 million for a combined total of \$8.3 billion. The difference between the best undiscounted reserve estimate and the liability amounts carried is 27% for benefit liabilities and 34% for claims administration. If the Fund were a private insurer then substantially higher reserves would be required to comply with risk-based capital standards.

Reinsurance

The Fund no longer carries reinsurance protection against catastrophic loss. Rates were deemed to be excessive compared to the coverage provided.

Liquidity and Capital Resources

The Fund's operation requires liquidity sufficient to meet both short-term and long-term requirements. Short-term liquidity requirements come from three basic elements. First, workers' compensation claims are subject to some variation, usually inflationary. Second, benefit payment and investment operations are sensitive to variations in premium adequacy. Finally, dividends and retrospective returns require an increased degree of liquidity.

The Fund has generally met its operating requirements by maintaining appropriate levels of liquidity in its investment portfolio and through utilization of positive cash flow. This has allowed the Fund to minimize trading activity, maintain a stable investment portfolio, and provide a sound basis for adequate reserves for estimated future benefits.

The Washington State Investment Board and the Washington State Treasurer manage the Fund's investment portfolio. The portfolio is managed to balance cash flow, timing and reinvestment risks, and then maximize current income while preserving capital. The Fund has the financial capability to hold its fixed-income portfolio to maturity, and to match projected cash inflows from premiums and investment income from this portfolio with projected cash outflows for payment of benefits. All currently held fixed-income securities were rated Investment Grade when purchased. All foreign fixed-income securities are dollar-denominated. The

**State of Washington
Department of Labor and Industries
Industrial Insurance Fund**

**Management's Discussion,
continued...**

values of invested assets and associated investment earnings are to be considered as preliminary values except for final statements at fiscal year ends.

All equity holdings are in the form of index funds. The Barclay-Wilshire 5000 equity fund (BGI) was designed to match the Wilshire 5000. The Wilshire 5000 index decreased .9% in the quarter but is up 19.3% in the last twelve months. The EAFE index, tracking the performance of the International Index Fund, was down .7% in the quarter but up 29.5% since last fiscal year end.

Equity securities were distributed by fund as follows:

	<u>6/30/2004</u>
Barclay-Wilshire 5000 Index Fund	85%
International Index Fund	<u>15%</u>
	<u>100%</u>

The Fund realized gains of \$4 million on sales of fixed income investments in the quarter and \$93 million in the year. Equity securities are recorded at market value; investments in fixed-income securities are usually recorded at amortized cost. Distressed securities are carried at the lesser of amortized cost or market value. There were \$90 million of bonds valued at market due to being below investment grade. The current unrealized loss to asset values is \$11 million.

The market value of fixed-income investments increases as interest rates decline. Fixed maturities (bonds) are usually held until close to maturity so that differences between market value and carrying value will not significantly influence management's investment decisions or future investment income or yields.

At June 30, 2004, the investment portfolio consisted of the following (in \$millions):

Asset Class	<u>Carrying Value</u>		<u>Market Value</u>		<u>Diff</u>
Corporate fixed income securities	4,324	49%	4,486	49%	(162)
Mortgages and mortgage backed securities	1,408	16%	1,435	16%	(27)
Common and preferred stocks (at market)	1,656	19%	1,656	18%	-
U.S. Treasury securities	1,030	12%	1,148	13%	(118)
Debt securities issued by foreign governments	35	0%	35	0%	-
Asset backed securities	93	1%	97	1%	(4)
Money market	<u>245</u>	<u>3%</u>	<u>245</u>	<u>3%</u>	-
Total Securities	8,791	100%	9,102	100%	(311)

**State of Washington
Department of Labor and Industries
Industrial Insurance Fund**

**Management's Discussion,
continued...**

Commitments and Contingencies

Effective July 1, 1992, the Washington State Legislature required the Fund to participate in an assigned risk pool providing workers compensation coverage under the United States Longshore and Harbor Workers' Act. The Fund is obligated to participate 50% in the operating results of the assigned risk pool. This participation is scheduled to continue since state legislation passed in 1997 extended the Fund's participation indefinitely.

STATE OF WASHINGTON INDUSTRIAL INSURANCE FUND
SUMMARY of FINANCIAL CONDITION
(in thousands of dollars)
UNAUDITED

Assets	<u>6/30/2004</u>	<u>3/31/2004</u>	<u>6/30/2003</u>
Cash and Investments:			
Fixed Income, at Amortized Cost	\$7,134,852	\$7,136,064	\$6,811,345
Equities, at Market Value (Cost \$1,620,023 \$1,666,297, \$1,697,204)	\$1,656,180	\$1,597,277	\$1,313,283
Net Unsettled Trades	\$33,241	\$13,899	\$68,170
Cash	\$4,111	(\$42)	(\$26,371)
Interest Receivable	\$87,926	\$96,765	\$90,843
Total Cash and Investments	\$8,916,310	\$8,843,964	\$8,257,270
Other Assets:			
Premiums Receivable, Net	\$344,205	\$311,483	\$305,803
Land, Buildings and Equipment, Net	\$54,292	\$59,541	\$57,751
Self-Insured Pension Receivable, Net	\$17,176	\$21,144	
Other Assets	\$2,599	\$329	\$20,882
Total Other Assets	\$418,273	\$392,498	\$384,436
Total Assets	\$9,334,583	\$9,236,461	\$8,641,706
 Liabilities and Contingency Reserve			
Liabilities			
Benefits:			
Accident Fund	\$3,171,960	\$3,160,903	\$3,030,914
Medical Aid Fund	\$2,701,872	\$2,690,207	\$2,609,441
Pension Fund	\$2,094,403	\$2,043,057	\$1,909,324
Total Estimated Future Benefits	\$7,968,235	\$7,894,167	\$7,549,679
Other Liabilities:			
Claims Administration	\$377,903	\$389,542	\$435,363
Retrospective Rating Adjustments	\$111,037	\$148,714	\$110,223
General Obligation Bonds Payable	\$42,784	\$42,789	\$45,507
Other Accrued Liabilities	\$43,299	\$43,152	\$42,314
Deferred Revenue	\$3,135	\$2,447	\$2,022
Total Other Liabilities	\$578,159	\$626,643	\$635,429
Total Liabilities	\$8,546,394	\$8,520,810	\$8,185,108
Contingency Reserve	\$788,189	\$715,651	\$456,598
Total Liabilities and Contingency Reserve	\$9,334,583	\$9,236,461	\$8,641,706

**STATE OF WASHINGTON INDUSTRIAL INSURANCE FUND
SUMMARY of OPERATIONS and CONTINGENCY RESERVE**

(in thousands of dollars)

For 3 months and 12 months ending June 30, 2004,
and 12 months ending June 30, 2003

UNAUDITED

	3 months ended <u>6/30/2004</u>	Percent of Net <u>Premium</u>	YEAR ended <u>6/30/2004</u>	Percent of Net <u>Premium</u>	YEAR ended <u>6/30/2003</u>	Percent of Net <u>Premium</u>
Revenues						
Premiums Earned:						
Net Standard Premiums	\$330,218	110%	\$1,229,483	109%	\$986,384	111%
Retrospective Rating Adjustments	(\$29,118)	-10%	(\$102,810)	-9%	(\$101,058)	-11%
Net Premiums Earned	<u>\$301,100</u>	<u>100%</u>	<u>\$1,126,673</u>	<u>100%</u>	<u>\$885,326</u>	<u>100%</u>
Net Investment Income	\$106,519	35%	\$432,389	38%	\$452,552	51%
Net Realized Gains (Losses) Fixed Income	\$3,756	1%	\$92,755	8%	\$40,643	5%
Net Gains (Losses) Equities	\$58,903	20%	\$342,897	30%	\$680	0%
Self Insured Pension Contributions	\$18,352	6%	\$67,647	6%	\$55,084	6%
Other Income (Expense)	\$3,298	1%	\$17,650	2%	\$18,018	2%
Total Revenues Earned	<u>\$491,928</u>	<u>163%</u>	<u>\$2,080,011</u>	<u>185%</u>	<u>\$1,452,303</u>	<u>164%</u>
Expenses						
Benefits Incurred:						
Accident Fund	\$143,209	48%	\$643,800	57%	\$500,795	57%
Medical Aid Fund	\$122,117	41%	\$547,105	49%	\$535,792	61%
Pension Fund	\$106,613	35%	\$393,755	35%	\$401,722	45%
Total Benefits Incurred	<u>\$371,939</u>	<u>124%</u>	<u>\$1,584,660</u>	<u>141%</u>	<u>\$1,438,309</u>	<u>162%</u>
Administrative Expenses:						
Claims Administration	\$11,296	4%	\$31,697	3%	\$62,417	7%
Premium Administration	\$7,203	2%	\$27,359	2%	\$30,172	3%
General Insurance Expense	\$3,249	1%	\$13,100	1%	\$15,171	2%
Other Administrative Expenses	\$12,809	4%	\$50,414	4%	\$36,776	4%
Total Administrative Expenses	<u>\$34,557</u>	<u>11%</u>	<u>\$122,570</u>	<u>11%</u>	<u>\$144,536</u>	<u>16%</u>
Total Expenses Incurred	<u>\$406,496</u>	<u>135%</u>	<u>\$1,707,230</u>	<u>152%</u>	<u>\$1,582,845</u>	<u>179%</u>
Net Income	\$85,432	<u>28%</u>	\$372,781	<u>33%</u>	(\$130,542)	<u>-15%</u>
Change in Non-Admitted Assets	<u>(\$12,894)</u>		<u>(\$41,190)</u>		\$5,356	
Change in Contingency Reserves	\$72,538		\$331,591		(\$125,186)	
Contingency Reserve, beginning of period	<u>\$715,651</u>		<u>\$456,598</u>		<u>\$581,783</u>	
Contingency Reserve, end of period	<u>\$788,189</u>		<u>\$788,189</u>		<u>\$456,598</u>	

The source of this financial information is Washington State's Accounting and Financial Reporting System.

STATE OF WASHINGTON INDUSTRIAL INSURANCE FUND
CASH FLOW SUMMARY
(in thousands of dollars)
For the 3 months and 12 months ended June 30, 2004
and
12 months ended June 30, 2003
UNAUDITED

	3 months ended 6/30/2004	Percent of Net Premium	12 months ended 6/30/2004	Percent of Net Premium	12 months ended 6/30/2003	Percent of Net Premium
Net Standard Premiums Collected	\$297,495	129%	\$1,191,080	109%	\$897,861	112%
Retrospective Rating Adjustments	(\$66,795)	-29%	(\$101,996)	-9%	(\$93,628)	-12%
Net Premiums Collected	<u>\$230,700</u>	100%	<u>\$1,089,084</u>	100%	<u>\$804,233</u>	100%
Other Income (Expense)	\$3,298	1%	(\$460)	0%	\$17,313	2%
Self-Insured Pension Contributions	\$22,320	10%	\$68,489	6%	\$62,031	8%
Operational Revenues Collected	<u>\$256,318</u>	111%	<u>\$1,157,112</u>	106%	<u>\$883,577</u>	110%
Benefits Paid	\$297,871	129%	\$1,166,104	107%	\$1,106,119	138%
Claims Administration Expense	\$22,934	10%	\$89,157	8%	\$95,940	12%
Premium Administration Expense	\$6,744	3%	\$25,599	2%	\$26,856	3%
General Insurance Expense	\$3,197	1%	\$12,449	1%	\$13,503	2%
Other Administrative Expense	\$12,444	5%	\$47,906	4%	\$50,895	6%
Operational Expenses Paid	<u>\$343,191</u>	149%	<u>\$1,341,214</u>	123%	<u>\$1,293,313</u>	161%
Operating Cash Flow	(\$86,873)	-38%	(\$184,102)	-17%	(\$409,736)	-51%
Net Investment Cash Fixed Income	\$98,871	43%	\$445,859	41%	\$471,802	59%
Net Investment Cash Equities	\$7,259	3%	\$25,825	2%	\$21,881	3%
Investment (Purchases)/Sales	(\$14,714)	-6%	(\$256,666)	-24%	(\$94,336)	-12%
Fixed Asset Activity, Net	(\$389)	0%	(\$434)	0%	(\$332)	0%
Net Cash Flow	<u>\$4,153</u>	2%	<u>\$30,482</u>	3%	<u>(\$10,721)</u>	-1%
Beginning Cash	<u>(\$42)</u>		<u>(\$26,371)</u>		<u>(\$15,650)</u>	
Ending Cash*	<u>\$4,111</u>		<u>\$4,111</u>		<u>(\$26,371)</u>	

The source of this financial information is Washington State's Accounting and Financial Reporting System.

State of Washington Industrial Insurance Fund

Notes to Financial Information

Note A - Summary of Significant Accounting Policies

The State of Washington prepares a Comprehensive Annual Financial Report (CAFR), audited annually by the State Auditor's Office, which includes all funds and account groups of the State. The CAFR is prepared in accordance with generally accepted accounting principles (GAAP). The financial activities of the Labor and Industries workers' compensation programs are included in the CAFR.

The accompanying financial information uses "statutory" accounting practices and principles (SAP) as promulgated by the National Association of Insurance Commissioners, as would be required of any property and casualty insurance enterprise in the United States when reporting its financial condition to insurance regulators. This accounting basis is used to allow regulation of insurance solvency and the stability of premium rates.

Under SAP, bonds are stated at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to investment income. This helps to smooth out fixed income. Under GAAP, some or all of the fixed income securities would be stated at market value which can cause fluctuations in fixed income. Gains or losses on disposition are based on net proceeds and the adjusted carrying amount of the securities sold, using the specific identification method. Equity securities are stated at market value. Equity gains (losses) are reflected separately in the income statement.

In addition, under SAP, certain assets (principally receivables which are greater than ninety days past due and office furniture and equipment) are charged against the contingency reserve. Under GAAP, such assets would be recorded on the balance sheet as assets, less valuation allowances or accumulated depreciation.

The Supplemental Pension and Second Injury Funds (See Note C) were not included in these statements because the primary purpose of this financial information is to present the financial condition and results of operations of those funds required to maintain actuarial solvency as a basis for premium rates. In the CAFR the insurance funds presented in this report is called the Basic Plan.

Certain classes of assets and liabilities that are shown on the CAFR are excluded in these SAP based reports. The inclusion of these classes of assets and liabilities are deemed not to add to the evaluation of the actuarial solvency of the funds. Assets and liabilities from the "old" DOE contract and collateral held/security lending agreements and obligations under security agreements are the two principal classes of assets and liabilities excluded.

State of Washington Industrial Insurance Fund

Notes to Financial Information

Note B - Description of the Industrial Insurance Fund

The State of Washington, through Title 51 RCW, requires employers to secure payment of benefits for job-related injuries and diseases either by paying insurance premiums to the Workers' Compensation Fund or by self-insuring. Direct private insurance is not authorized, although self-insurers are permitted to reinsure up to 80 percent of their obligations.

The statutes provide five benefit funds to make compensation payments to injured employees for various losses. The Accident, Medical Aid, and Pension Reserve Benefit Funds are required to be self-sustaining by insurance premiums. These financial statements report on the financial condition and results of operations of these funds.

The Accident Fund pays compensation directly to injured employees for lost wages during temporary disability, for permanent partial disability awards, and awards pensions to survivors of fatally injured workers and to workers adjudged to be permanently and totally disabled. Claim liabilities are discounted to their present value, as reported in these financial statements, based upon a 4.0% annual interest rate assumption. Revenues for this fund are provided by employer-paid premiums, calculated on the basis of hours worked. Employers may elect to be retrospectively rated. All retrospective premium adjustments are financed entirely through the Accident Fund. The adjustment calculation considers both Accident Fund and Medical Aid Fund experience and premiums together; however, no retrospective adjustments are made through the Medical Aid Fund.

The Medical Aid Fund pays for the cost of medical and vocational rehabilitation service to injured workers. Employers are allowed to withhold half of the medical aid premium from employees' wages. Medical reserves are discounted to their present value, as reported in these financial statements, based upon a 4.0% annual interest rate assumption. Revenues for this fund are provided by equal contributions from employers and employees.

The Pension Reserve Fund pays benefits to all permanently disabled pensioners including disabled employees of self-insured employers. These reserves are discounted based upon a 6.5% annual interest rate assumption. Funding for these pensions is provided by transfers from the Accident Fund and from self-insurers.

The Accident, Medical Aid and Pension Reserve Funds are required to be maintained on an actuarially solvent basis, except that a cash flow basis is

State of Washington Industrial Insurance Fund

Notes to Financial Information

authorized for the components of the Pension Reserve fund when self-insured employers guarantee related benefits with a surety bond.

The department's actuaries compute benefit and claim administration expense liabilities. Actuaries from Milliman USA, independently review these liabilities after the end of the fiscal year. The liabilities are estimated future claim and claim administration expense payments for injuries occurring on or before the balance sheet date on a discounted basis. Future premium income is not offset against claim liabilities, as the claims liabilities arise from coverage periods for which premiums have, in general, already been fully earned. The obligation to pay claim and claim administration expense liabilities is not contingent upon any future premium for future coverage periods.

Note C - Other Related Funds

The Second Injury Fund is used to pay pension costs on claims where permanent total disability is at least partially caused by a prior injury. It is funded by amounts received from the Accident and Medical Aid Funds for state fund claims, and by self-insured assessments for self-insured claims. An allowance for future second injury benefit payments is contained within the Accident Fund and Medical Aid Fund claim reserves for State Fund claims. Therefore, this fund does not carry any reserves. This fund's operations are not directly accounted for in these financial statements, but second injury claims, which it services, are accounted for through the Accident and Medical Aid Funds.

The Supplemental Pension Fund provides for supplemental cost-of-living adjustments (COLA) to injured employees receiving disability payments. However, the enabling statute requires this fund to operate on a current payment basis and is subject to legislative cancellation. No assets are allowed to accumulate for the future servicing of current claims.

Cost-of-living increases are based on the increase in the state average wage during the preceding calendar year and are granted in July. This fund is financed through assessments to self-insurers and State Fund employers; half of the assessment may be deducted from employees' wages. Income, expense, assets, or future claim liabilities related to Supplemental Pension or Second Injury Funds are not included in the attached financial statements.

The Second Injury Fund and the Supplemental Pension Fund are included in the CAFR. Because these funds are not required to maintain actuarial solvency, as the Accident, Medical Aid, and Pension Funds do, they are not included in this financial information.

State of Washington Industrial Insurance Fund

Notes to Financial Information

Note D - Premiums Receivable, Net

All employers in the State of Washington subject to Title 51 of RCW are required to be covered by the Industrial Insurance Fund and pay policy premiums for workers' compensation insurance, except for certain qualifying employers electing to self-insure. Premiums are normally based on individual employers' reported payroll hours and insurance rates based on each employer's risk classification(s) and past experience. In addition to its regular premium plans, the Fund offers a retrospective premium rating plan under which premiums are adjusted annually for up to four years following the plan year based on employers' loss experience. Adjustments to the original premiums are paid to or collected from the associations and employers approximately ten months after the end of each plan year.

Employer premiums are due 30 days following the calendar quarter covered. An allowance for uncollectible premiums is established when the account becomes delinquent.

Note E - Reinsurance

The department maintains an agreement with a reinsurance broker to purchase reinsurance at reasonable rates. The current rates are believed to be aggressively in excess of reasonable. The department therefore carries no catastrophic reinsurance cover, but remains in contact with the broker and will purchase reinsurance when it becomes available at appropriate rates.

Note F - Estimated Future Benefits

Reserves for unpaid benefits and claims administration expenses in the Accident Fund and Medical Aid Fund are provided based primarily on ratios of paid to date losses for older accident periods. For more recent accident periods, a selection of several common actuarial techniques is used. These estimates are continually under review and, as changes to the liabilities become necessary, such adjustments are reflected in income currently. The estimates are calculated and presented net of all recoveries. Recoveries include overpayments and successful subrogation against third parties. Recoveries may be in the form of cash or deduction against continuing benefits.

The liability for benefits for the Pension Reserve Fund is determined from individual claims transferred to this fund using actuarial pension annuity tables. Such liabilities are necessarily based on estimates and, while management believes that the amount is adequate, the ultimate liability may be in excess of or less than the amounts provided.

**STATEMENT OF ACTUARIAL OPINION - DEPARTMENT OF LABOR & INDUSTRIES
AS OF JUNE 30, 2004**

Identification

I, Guy A. Avagliano, am associated with Milliman, Inc. I am a member of the American Academy of Actuaries and meet its qualification standards for statements of actuarial opinion. I am also a Fellow of the Casualty Actuarial Society. The loss and loss adjustment expense reserves are the responsibility of the Department's management; my responsibility is to express an opinion of those reserves based on my review.

Scope

I have performed an actuarial review of the reserves for loss and loss adjustment expense as of June 30, 2004 in the Accident Fund (\$3,324,916,000), Medical Aid Fund (\$2,926,819,000), and Pension Reserve Fund (\$2,094,403,000) for the Department. These reserves are contained in the Industrial Insurance Balance Sheet as of June 30, 2004.

My examination of the loss and loss adjustment expense reserves was based upon the review of the data and related information, methodology, assumptions, and calculations utilized by the Department. In this regard, I relied on the Department as to the accuracy and completeness of the data. In performing this evaluation I evaluated the data used directly in my analysis for reasonableness and consistency. My evaluation did not reveal any data points materially affecting my analysis that fell outside of the range of reasonable possibilities. In performing this evaluation, I have assumed that the Department (a) used its best efforts to supply accurate and complete data and (b) did not knowingly provide inaccurate data. In other respects, my examination included the use of such actuarial assumptions and methods and such tests of calculations as I considered necessary.

My review was limited to the items listed above and did not include an analysis of any income statement items or other balance sheet items. My opinion on the reserves is based upon the assumption that all reserves are backed by valid assets, which have suitably scheduled maturities and/or adequate liquidity to meet cash flow requirements.

I evaluated the loss and loss adjustment expense reserves on a discounted basis with regard to the time value of money. The average interest rate used to discount was 4.6%, which I consider reasonable. I evaluated the loss and loss adjustment expense reserves, net in regards to salvage and subrogation, and gross of reinsurance.

Opinion

In my opinion, these reserves are consistent with reserves computed in accordance with Standards of Practice issued by the Actuarial Standards Board (including the Casualty Actuarial Society's Statement of Principles Regarding Property and Casualty Loss and Loss Adjustment Expense Reserves) and make a reasonable provision for all the unpaid loss and loss adjustment expense obligations of the Department under the terms of its policies and agreements.

Comments

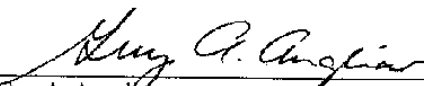
The Department writes a coverage whose risk factors expose the Department's reserves to significant variability. I have identified the major risk factors that could have a material impact as rising medical costs and any future court decisions that could have a retrospective impact on liabilities. The potential impact of these risk factors is described in more detail in the following paragraph and in the report supporting this opinion. The absence of other risk factors from this listing does not imply that additional risk factors will not be identified in the future as having been a significant influence on the Department's reserves.

The risk factor of rising medical costs is evident by the escalation of recent national trend levels and continuation at this level would have a material impact on the reserves. Future court decisions are also a risk factor that could have a material impact, with a recent example being the impact the Cackle decision had on reserves.

I believe the risk factors above, coupled with the variability that is inherent in any reserve estimate, could result in material adverse deviation from the carried reserve. In making this determination, I have considered a material adverse deviation to be one in which the actual reserves exceed the amounts above by an amount greater than 10% of the reserves. Other measures of materiality might be used for reserves that are being evaluated in a different context.

In evaluating whether the reserves make a reasonable provision for unpaid losses and loss expenses, it is necessary to project future loss and loss adjustment expense payments. These estimates incorporate actuarial assumptions as to future long-term contingencies based upon the available data. It is certain that actual future losses and loss adjustment expenses will not develop exactly as projected and may, in fact, vary significantly from the projections. Further the projections make no provision for extraordinary future emergence of new classes of losses or types of losses not sufficiently represented in the Department's historical database or which are not yet quantifiable.

This statement of opinion is solely for the use of, and only to be relied upon by, the Department and the State of Washington.



Guy A. Avagliano
Fellow, Casualty Actuarial Society
Member, American Academy of Actuaries
November 12, 2004