

Special Task Force Committee Report
to the Board of Directors
of Pinnacol Assurance

June 1, 2011

Table of Contents

I.	Executive Summary.....	1
II.	Introduction.....	6
III.	Insurance Industry Regulation.....	8
IV.	Corporate Governance.....	10
V.	Board of Directors and CEO Compensation.....	13
VI.	Pinnacol Travel & Entertainment Expenses.....	18
VII.	Professional Services.....	28
	Appendix A	

EXECUTIVE SUMMARY

Pinnacol Assurance (the “Company” or Pinnacol) serves over 55,000 Colorado employers providing workers’ compensation insurance to nearly one million Colorado employees, including employers and workers who would not otherwise qualify for worker’s compensation coverage from private insurance companies competing with Pinnacol within Colorado. Feedback regularly collected by Pinnacol’s management demonstrates a very high level of satisfaction among employers, injured workers and Pinnacol employees. In addition, Pinnacol has been successful in managing costs and providing workplace safety education, thereby enabling it to return dividends to its customers for a number of years.

The Pinnacol Foundation (a separate non-profit entity) also provides scholarships to children of injured workers, a public service that exceeds its workers’ compensation obligations.

Despite its success and community service, Pinnacol has been the subject of intense negative media and legislative scrutiny over the last two years associated with issues of executive compensation and agent incentive trips, creating a public perception that Pinnacol’s Board and management are not effectively managing Pinnacol for the benefit of its primary constituents; i.e. Colorado employers and Colorado workers and their families.

The Special Task Force Committee (the “Special Committee” or the “Committee”) examined issues that have been the subject of public scrutiny with the goal of evaluating Pinnacol’s executive compensation and other business practices in the context of Pinnacol’s environment; i.e. a political subdivision of the State operating as a mutual insurance company which competes with private insurance companies.

The Special Committee found no substantial improprieties in Pinnacol’s executive compensation or other business practices. The Special Committee, however, noted some particular areas where Pinnacol’s practices and policies can be improved. Those findings and recommendations are summarized below and described in detail in this report.

Pinnacol Examinations

Pinnacol’s recent financial reporting, including audits performed by the Division of Insurance, KPMG, Deloitte & Touche LLP, and Ernst & Young did not identify any issues regarding the Company’s overall financial stability. The Special Committee confirmed that the Company has responded to issues raised by the Division of Insurance, State Auditor and the Company’s internal audit accountants, with policy changes by the Company. The Special Committee found that management has effectively implemented the policy changes.

Corporate Governance

In light of issues raised concerning Board member responsibilities and their relationship to senior management, the Special Committee sought guidance regarding corporate governance principles applicable to Pinnacol, with particular reference to Pinnacol’s statutory character as a political subdivision of the State of Colorado charged with acting as a mutual insurance company. To

assist it in that process, the Special Committee retained J. William Callison, a partner in Faegre and Benson, LLP and a respected corporate governance expert.

Mr. Callison highlighted the complex nature of Pinnacol's corporate governance model, characterizing Pinnacol's origins as a "muddled pedigree," with the Board and management having to operate simultaneously as a political subdivision of the State and a mutual insurance company. Mr. Callison confirmed that these multiple legislative directives create inherent tension for the Board and senior management in executing their respective roles and responsibilities. In addition, Pinnacol's identity as a political subdivision subjects it to greater public and legislative scrutiny than a private insurance company.

The Special Committee recommends that the Board and management maintain a heightened sensitivity that reflects Pinnacol's unique public nature while operating in the private sector. Such sensitivity would reflect an expectation of transparency with respect to Pinnacol's business activities that would attempt to avoid even the appearance of impropriety with respect to those activities and associated expenses. The Special Committee makes this recommendation with the understanding that this standard may be above the standard imposed by law.

Based upon the foregoing, the Special Committee recommends that the Board review and revise the following policies: 1) Board of Director's Travel and Activities Policy; 2) Travel and Expense Reimbursement Policy; 3) Board of Directors Third Party Gift Policy; 4) Business Ethics and Conflicts of Interest Policies and Procedures of the Board of Directors; and 5) minimizing redaction in response to CORA requests. Revisions included prohibiting Board members, acting in that capacity, from accepting third party gifts, as well as gifts from Pinnacol or its managers or employees. In addition, the Committee recommends prohibiting spouses/guests from accompanying Board members on business travel at Pinnacol's additional expense.

Pinnacol Travel and Entertainment Expenses

The May 2010 agent incentive trip generated significant negative publicity for Pinnacol. The Special Committee evaluated Pinnacol travel and entertainment expenses including: 1) policies and controls related to Pinnacol travel and entertainment; 2) expense reports from 2006 to 2010 for all Board members and the top ten highest paid Pinnacol employees; 3) historical data related to the "Pinnacol Club" agent incentive trip, including costs, location, and attendees from 2003 to 2010; and 4) historical data regarding the cost of and attendees at a Denver Broncos suite leased annually by Pinnacol since 1998.

The Special Committee found the following:

- Based on a review by GHP Horwath, a firm retained by the Special Committee to provide forensic analysis and accounting services, Pinnacol has significantly improved its internal controls and approval process since the May 2010 Performance Audit.

- From August 2006 to March 2011, Horwath identified 14 Board and 71 individual employee expenses that were “potentially excessive.” The review consisted of approximately 10,700 expenses contained within expense reports.
- After examining the history of Pinnacol Club agent incentive trips from 2003 to 2010, the Special Committee found increases in both the costs and the number of Board and Pinnacol employees in attendance.

As a result, the Special Committee recommends that Pinnacol limit attendance on incentive trips to senior management and senior marketing representatives. Attendance should be decided based upon whether there is a substantial business purpose for such person’s attendance and concomitant costs of attendance should be limited to the scope of such business purpose. The number and identity of Pinnacol employees attending incentive events should bear a reasonable relationship to the number and identity of agents and their guests. The Special Committee further recommends that Board members not attend Pinnacol Club agent incentive trips.

The Special Committee also recommends that the Board further review the policies and procedures for management travel and entertainment expenditures adopted on December 1, 2010.¹ The Special Committee reviewed those policies from a compliance standpoint and found that the revised policies are substantially improved. From a substantive standpoint, however, the revised policies do not provide details of what constitutes appropriate guidelines for what expenditures are appropriate for business purposes. As part of its review, the Board should ensure that the policy provides ample detail and guidance to management such that future expenditures satisfy heightened scrutiny and transparency standards.

Such policy and procedure standards should deal with travel, entertainment, spousal and/or guest participation and gifting policies for all purposes; including internal meetings, meetings with agents, clients, vendors, lobbyists, public servants and all other categories of persons or entities that may be the subject of such expenditures. Different standards may well be appropriate for expenditures incurred in connection with Pinnacol’s function as a mutual insurance company competing with private insurers and Pinnacol’s internal functions and/or functions as a state subdivision.

Included in the review of travel and entertainment expenses, the Committee examined the use of a Denver Broncos suite leased by Pinnacol. From 2000 to 2010, the Special Committee found only sporadic attendance by Board members at Denver Bronco games, with 2007 the only year in which individuals attended multiple games. The Committee found no indication of abuse of Bronco tickets by Board members. Further, Pinnacol’s use of Bronco tickets as an agent incentive is well within industry standards.

¹ The travel and entertainment expense reimbursement policy was adopted in its final form on January 25, 2011 after a minor modification.

Board & CEO Compensation

In light of the scrutiny placed on Board of Director and senior management activities, particularly after the May 2010 agent incentive trip, the Special Committee examined compensation for Pinnacol's CEO and its Board of Directors. Specifically, the Special Committee reviewed Pinnacol CEO and Board of Director compensation as well as independent third-party benchmarking data regarding CEO and Board of Director compensation in the workers' compensation insurance market.

Based on its review, the Special Committee found Pinnacol's CEO compensation generally comparable to peer group companies, defined as state funds that operate in a competitive environment where CEO compensation is set by a Board of Directors. Additionally, the Special Committee found that Pinnacol's Board of Director's compensation is 13 percent of the average for peer group companies.

The Special Committee recommends that the Board of Directors continue to exert critical oversight of the process for determining incentive payout, including establishing performance goals, associated metrics, and setting the appropriate weight for each metric. While the base salary for Pinnacol's CEO is generally within the norm for peer state fund workers' compensation companies, the Board's continued due diligence with respect to incentive compensation is important to demonstrate that incentive compensation correlates with Company performance and individual employee performance.

Professional Services

The Special Committee reviewed professional services contracting from 2006 to 2010, looking in particular at third party lobbying, advertising, and communications contracts. The Special Committee found a 173 percent increase in lobbying and a 269 percent increase in communications expenditures from 2006 to 2010. The significant increases began in 2009 and should be considered in light of four factors that resulted in intense media and government scrutiny: 1) discussion during the 2009 session regarding control of Pinnacol and its surplus funds; 2) the State Auditor's May 2010 performance audit; 3) the Pebble Beach incentive trip in May 2010; and 4) Pinnacol testimony before the Legislative Audit Committee in June 2010.

The Special Committee noted certain lobbying expenses that seemed potentially excessive and lacked sufficient back up to establish that they were appropriate. These expenses warrant further review by the full Board and are relevant to retention of lobbyists and future hiring by the Company. The Special Committee recommends that contracts with lobbyists be augmented to include the following provisions:

- A clause acknowledging that lobbyists are familiar with all laws and regulations governing lobbyist activity and agreeing that violation of any such laws or regulations shall be grounds for immediate termination of their contracts and indemnification of Pinnacol for damages caused by lobbyist violations of laws or regulations
- Requirement that detailed receipts for all expenses incurred by the lobbyist be included in invoices for reimbursement and approved by the General Counsel

- Inclusion of time and task logs and/or periodic written reports/memos to senior management detailing lobbying activities
- Description of specific lobbying activities to be undertaken (e.g. direct lobbying, general consultancy, communication strategy) in order to clearly delineate activity required to be disclosed to the Secretary of State
- Proof of lobbyist registration with the Secretary of State to be attached to the signed lobbying agreement

In addition, in light of issues raised as a result of improperly receipted expenses submitted for reimbursement, the Special Committee further recommends that the full Board of Directors immediately review the current lobbying contracts to ensure compliance with Amendment 41. The Board of Directors should also conduct an appropriate investigation of whether lobbyists have breached their contracts with Pinnacol by violating lobbying laws.

Finally, the Special Committee noted the long-term contractual relationships between Pinnacol and third-party consultants offering actuarial and financial advising services. The Board's investment and audit sub-committees review the performance of these consultants in the normal course of business and no issues have been raised regarding the performance of these professionals. The Special Committee recommends that the respective sub-committees continue to review these services on a regular basis to ensure continued adherence to Pinnacol's business objectives.

INTRODUCTION

PURPOSE AND SCOPE

On March 2, 2011, the Board of Directors of Pinnacol Assurance (the Company) established a Special Task Force Committee charged with performing “a general review of the agent incentive trip in May 2010 and other relevant matters,” including a report to the Governor with the Committee’s findings. The Committee of four Board Members² had the following responsibilities:

- Generally review Board and management’s governance processes and procedures related to the agent incentive trip in May 2010
- Compare event with industry standards which include but are not limited to the type of event, where the event is held, who attends, and other relevant industry comparisons
- Make any recommendations within the scope of this charge
- Address other related issues in order to provide context for and an overall understanding of the agent incentive event
- Prepare a report to be delivered to the Governor sixty days after the Committee’s formation regarding agent incentive trips and any other relevant matters. The report will detail a general review of the agent incentive trip in May 2010

The Special Committee retained legal and accounting professionals and staff to assist in its analysis and its review of relevant documents between 2006 and 2010.³ Documents reviewed include the following:

- Pinnacol’s corporate governance documents, including the Board of Director bylaws, communications between the Board and senior Company officials, and the Board’s travel, expense, and conflict of interest policies
- Financial audits, including those performed by the Office of the State Auditor, the Division of Insurance, and Ernst & Young
- Expense reports for Board and senior management from 2006 through 2010, including travel and entertainment costs incurred by the Company during that time frame
- Professional services contracting from 2006 through 2010, including third-party contracts for lobbying, advertising, and communication services

The Special Committee reviewed several areas, including: 1) Pinnacol’s regulation as a mutual insurance company and its recent financial reporting; 2) corporate governance, specifically the role and responsibilities of the Board of Directors; 3) Board of Director and CEO compensation; 4) travel and entertainment expenses, specifically the Pinnacol Club agent incentive trip and the use of a Denver Broncos suite; and 5) professional services contracting, including lobbying expenses.

² Special Committee Board members included John Plotkin (Chair), Nonie Willis, RJ Jolly, and John Cevette.

³ Consultants hired to assist the Special Committee were William Callison, Faegre & Benson (legal), Mark Pedigo, GPH Horwath (forensic accounting) and Roberto Venegas.

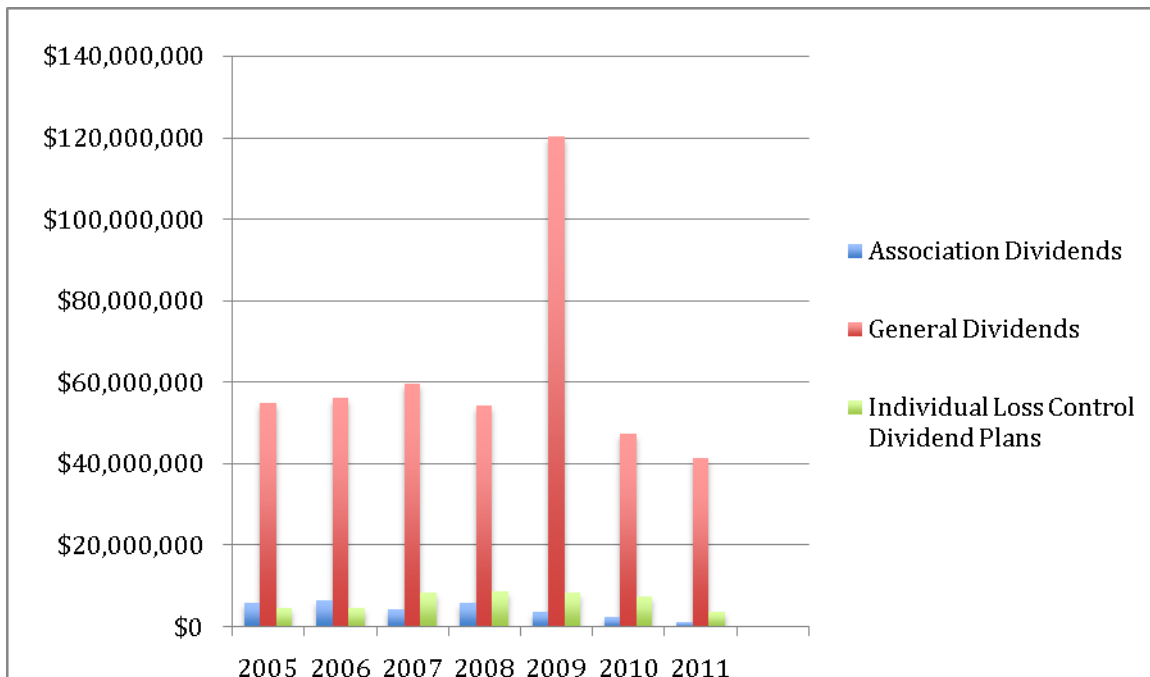
OVERVIEW OF PINNACOL ASSURANCE

The General Assembly created the State Compensation Insurance Fund on August 1, 1915 under the provisions of the Workmen’s Compensation Act of Colorado. The State Compensation Insurance Authority, which was created in 1987 and assumed the responsibilities of the Fund, later formally changed its name to the Colorado Compensation Insurance Authority in July 1990. Subsequently in July 2002, the General Assembly created Pinnacol Assurance, which replaced the Colorado Compensation Insurance Authority. The General Assembly charged the Company with offering workers’ compensation liability insurance to Colorado employers.

Pinnacol operates not as an agency of state government but as a “state fund,” a term referring to insurance companies that specialize in writing workers’ compensation insurance within a single state and are generally affiliated with state government. Nationally, states vary in the number of workers’ compensation options offered to employers, with several restricting the market to state funds exclusively, while others allow employers the option of private insurance, state fund, or authorized self insurance. Colorado operates under the latter system, with the state designating Pinnacol as a political subdivision of the state operating as a mutual insurance company. As a subdivision of the state, Pinnacol adheres to quasi-public requirements such as a Governor-appointed Board of Directors, but as a state fund still must compete with private insurers in the workers’ compensation market and is directed to operate as a mutual insurance company.

As a state fund, Pinnacol has no shareholders and consequently does not pay shareholder dividends. Instead, as a mutual insurance company Pinnacol can, and has paid dividends to the companies it insures. Over the last seven years, Pinnacol has made significant dividend payments, as reflected in the chart below. The effect of dividends is to reduce the net cost of workers’ compensation insurance to insured companies and groups that have favorable loss experience.

Pinnacol Dividend Payments 2005-2011



INSURANCE INDUSTRY REGULATION

The Special Committee reviewed Pinnacol’s most recent audits to better understand the financial health of the Company. The review of financial reporting found no issues with the Company’s financial stability and in fact found Pinnacol in excellent financial health.

PINNACOL EXAMINATIONS

By statute Pinnacol operates as a domestic mutual insurance company and it is subject to extensive oversight by the Colorado Division of Insurance (“Division”), the Colorado Division of Workers’ Compensation, and the Office of the State Auditor (“OSA”). The former resides within the Department of Regulatory Agencies and conducts periodic examinations of all Colorado insurers, reviewing each insurer’s risk based capital (surplus) to ensure the capital meets the requirements of Colorado Insurance Regulation 3-1-11. In addition, the Division of Insurance reviews the rate-setting procedures and data used by workers’ compensation insurers to calculate premiums. With regard to Pinnacol, the Division conducted two primary examinations reviewed by the Special Committee:

- Annual audits of Pinnacol financial statements by an independent auditor retained by OSA and filed with the Division of Insurance in accordance with Colorado Insurance Regulation 845-121
- Pursuant to Section 10-1-205 of the Colorado Revised Statutes, a three-year examination of Pinnacol’s financial condition by the Division of Insurance⁴

Within the Colorado Division of Workers’ Compensation, Pinnacol must follow the claims handling guidelines and procedures that are established in the Colorado Workers’ Compensation Act and the Workers’ Compensation Rules of Procedure. The Division of Workers’ Compensation conducts audits of the claims filed by each workers’ compensation insurer approximately every two years, examining the timely reporting of claims, timely and accurate compensation payments, and the timely medical benefit payment or denial of payment. Because no significant concerns have been raised regarding the claims process, the Special Committee did not include this audit in its review.

Beyond the Department of Insurance and Division of Workers’ Compensation, the State Auditor annually retains an independent auditor to examine Pinnacol’s financial condition. The Special Committee reviewed the most recent audit from Deloitte & Touche, LLP for the year ended December 31, 2009. Additionally, since 2008 and continuing presently, Pinnacol retained Ernst & Young in an internal audit capacity to complete reviews of operational processes.

⁴ The most recent examination covered the period from January 1, 2007 through December 31, 2009.

PINNACOL FINANCIAL AUDIT FINDINGS

To better understand Pinnacol’s financial reporting, the Special Committee reviewed the most recent audits performed by the Division of Insurance, KPMG, Deloitte & Touche LLP, and Ernst & Young. The Committee retained GHP Horwath to assist in its review of Pinnacol’s most recent financial audits.

Division of Insurance

The Special Committee examined the annual statements from 2006 to 2010 submitted by Pinnacol to the Division of Insurance, commonly referred to as the Yellow Book. The Committee also reviewed the three-year examination of Pinnacol completed by the Division for the period from January 1, 2007 through December 31, 2009. The examination cited no irregularities with Pinnacol’s annual statements and found company growth over the review period, as indicated in the table below:

Year	Admitted Assets	Liabilities	Surplus
2007	\$2,141,126,744	\$1,419,054,532	\$722,473,454
2008	\$2,090,100,699	\$1,392,099,707	\$698,000,992
2009	\$2,016,666,435	\$1,284,139,248	\$732,527,187

The Division report does not raise any concerns related to Pinnacol’s financial stability or make any adjustments to the capital and surplus.

KPMG and Deloitte & Touche, LLP 2008-2010 Financial Audits

The financial audits performed by KPMG and Deloitte & Touche for OSA made various recommendations related to the internal controls at Pinnacol (e.g., improvement of information technology general controls, establishment of a new system to ensure timely payment processing). While recommending internal improvements, both KPMG and Deloitte’s financial audits do not raise any concerns related to the financial stability of the Company for the periods audited. Additionally, Pinnacol’s operating results contained in the financial audits were materially identical to the operating results in Pinnacol’s annual statements.

Ernst & Young Internal Audit Reports 2009-2010

During 2009 and 2010, Ernst & Young provided internal audit services for Pinnacol covering various implementation and internal control objectives. The Audit Sub-Committee of the Board of Directors established the objectives and annual audit plan. Ernst & Young made various recommendations to which the sub-committee was able to respond, but did not raise any concerns regarding Pinnacol’s financial stability.

CORPORATE GOVERNANCE

In light of issues raised concerning Board member responsibilities and their relationship to senior management, the Special Committee sought to better understand corporate governance applicable to Pinnacol. The Committee retained the services of J. William Callison, a partner at Faegre & Benson, LLP and a respected corporate governance expert. The Committee asked Mr. Callison to address three areas:

- A general review of corporate governance principles
- An analysis of Pinnacol’s corporate governance model
- An analysis of the adequacy of currently adopted board policies governing fiduciary duties and related matters

Mr. Callison’s report is submitted to the full Board but is not made a part of this report in order to preserve attorney-client confidentiality.

CORPORATE GOVERNANCE PRINCIPLES

Mr. Callison described two general board responsibilities, duty of care and duty of loyalty. Duty of care requires that Board members engage in a “reasonable process of inquiry, deliberation and oversight, in which directors reasonably inform themselves, prior to making decisions, of material information available to them.”⁵ Additionally, Board members must maintain a level of independence in order to effectively assess managerial performance and ratify decisions initiated by management. The duty of loyalty requires that Board members avoid favoring personal interests over those of the firm or its owners. Management has like duties of care and loyalty that are subject to Board oversight.

With regard to duty of loyalty, Mr. Callison writes that the duty “includes an obligation to put the firm’s interests before the interests of self and others.” As such, board members must not compete with the firm, “usurp opportunities appropriately belonging to the firm, (or) use firm assets for personal benefits...” Similar to duty of loyalty, Mr. Callison includes in his analysis a “best interest” corporate governance concept, describing it as “an expression of primary allegiance...(whereby) directors should place the firm’s interests before those of self and outsiders.”⁶

PINNACOL’S CORPORATE GOVERNANCE MODEL

In 2002, the State Legislature “created Pinnacol Assurance, which shall be a political subdivision of the state and shall operate as a domestic mutual insurance company except as otherwise provided by law.”⁷ The legislature vested the powers of Pinnacol with a board of directors, consisting of nine members appointed by the Governor for five-year terms. Of those nine members, four are required to be employers insured by Pinnacol with one of those employers to

⁵Callison Report, p. 2.

⁶Callison Report, p. 3.

⁷ C.R.S. § 8-45-01(1).

be a farmer or rancher. Three of the board members must be employees of companies whose worker's compensation liability is insured by Pinnacol. The remaining two members must include an individual experienced in the management and operation of insurance companies and an individual experienced in finance or investments. The statute provides for a \$140 per diem compensation for board members, plus their actual and necessary expenses.

The Pinnacol statute also provides for the creation of a “Pinnacol Assurance Fund” for “the benefit of injured and the dependents of killed employees.” The fund consists of premiums paid into the fund for workers’ compensation insurance and responsibility for administering it rests with the Board and CEO. As part of administering the fund, the Board by statute establishes and monitors the lowest premium rates consistent with fund solvency and maintains reasonable reserves.

In his analysis, Mr. Callison writes of Pinnacol’s corporate governance structure:

“Characterization of Pinnacol for purposes of establishing board duties and obligations is difficult. First, the enabling statute states that Pinnacol is a political subdivision of the State. Second, the enabling statute provides that Pinnacol shall be operated as a private mutual insurance company. Third, the statutory language to the effect that the Pinnacol fund is for the benefit of injured employees and their dependents contains trust overlays.”⁸

Mr. Callison characterizes Pinnacol’s origins as a “muddled pedigree,” with the Board and management having to operate simultaneously as a political subdivision of the State, a mutual insurance company, and the custodian of a fund for the benefit of the injured and the dependents of killed employees. Mr. Callison acknowledges that this statutory framework creates a thread of conflict for the Board and senior management in all aspects of the business operation as roles and responsibilities are executed.

ADEQUACY OF BOARD POLICIES

The Special Committee, with Mr. Callison’s guidance, has assessed several Board policies for their adequacy in addressing sound corporate governance principles: 1) Board of Director’s Travel and Activities Policy; 2) Travel and Expense Reimbursement Policy; 3) Board of Directors Third Party Gift Policy; 4) Business Ethics and Conflicts of Interest Policies and Procedures of the Board of Directors; and 5) redaction policies in response to CORA requests.

The Special Committee recommends revisions to the Business Ethics and Conflicts of Interest Policy. Specifically regarding the policy governing third party gifts for Board members, the Special Committee recommends prohibiting Directors, acting in that capacity, from accepting third party gifts entirely, as well as gifts from Pinnacol or its managers or employees.

With regard to the Board of Director’s Travel and Activities Policy, the Special Committee suggests further clarifying that Board travel for participation in Pinnacol activities be limited to travel with a clear, necessary and proper business purpose, and that the length and cost of such

⁸Callison Report, p. 4.

travel be limited to that consistent with Pinnacol’s business purpose.”⁹ Further, the Special Committee recommends prior approval for Board travel should be received from the Governance & Ethics Committee, with the Board chair empowered to approve travel in the absence of the Governance & Ethics Committee. In addition, the Special Committee recommends prohibiting spouses/guests from accompanying Board members on travel at Pinnacol’s additional expense.

With regard to the Travel and Expense Reimbursement Policy, the Special Committee recommends the following language changes:

- Non-reimbursable travel expenses should state that personal expenses (not just items) are not reimbursable.
- Travel reimbursement should be reimbursed at coach class only, irrespective of prior approval.
- Receipts should be required in all cases (including taxi receipts, meals under \$50, baggage fees under \$50, and other expenses under \$50).

Finally, with respect to Pinnacol redaction policies, the Special Committee recommends that the Board and Management adopt a policy of redacting as little information as possible in response to CORA requests. The Board and Management should operate in an environment of presumed transparency and information should be provided in response to appropriate requests that excludes only such information as appropriate under CORA law such as privileged or private information regarding injured workers and third parties.

⁹Callison Report, p. 5

BOARD OF DIRECTORS AND CEO COMPENSATION

In light of the scrutiny placed on Board of Directors and senior management activities, particularly after the May 2010 incentive trip, the Special Committee sought to better understand compensation for Pinnacol's CEO and its Board of Directors. Specifically, the Special Committee reviewed the following:

- CEO compensation, including base salary and incentive pay
- Independent third-party benchmarking data regarding CEO compensation
- Board of Directors compensation
- Independent third-party benchmarking data regarding Board of Director compensation in the workers' compensation insurance market

Based on its review, the Special Committee addressed the following questions: How does Pinnacol's CEO compensation package compare with those of peer group companies, defined as state funds that operate in a competitive environment with compensation set by a Board of Directors? How does compensation for Pinnacol's Board of Directors compare with peer group companies?

CEO COMPENSATION

In 2010, Pinnacol CEO Ken Ross earned a base salary of \$323,000 and an incentive payout (bonus) of \$123,007, making his total compensation \$446,007. In 2009, Mr. Ross earned \$311,000 in base salary and \$157,500 in incentive pay for a total of \$468,500. For 2008, the base salary was \$297,500 and an incentive payout of \$131,545 for a total of \$429,045.

To place these compensation figures in context, the Special Committee reviewed data compiled by the HayGroup, a global management consulting firm with comprehensive benchmarking data for state fund workers' compensation companies. The HayGroup conducts an annual survey of state fund CEO compensation. Pinnacol asked the HayGroup, using this data, to specifically assess its CEO compensation in the context of other state fund peer group companies. The "state fund peer group" consisted of non-state agency funds that operate in a competitive environment with CEO compensation set by a board of directors and not by state government. These state funds operate in Arizona, California, Hawaii, Idaho, Kentucky, Louisiana, Maine, Maryland, Minnesota, Missouri, Montana, New Mexico, Oregon, Rhode Island, Texas, and Utah, as well as in Colorado.

In addition, the HayGroup compiles data across the insurance industry in general, allowing for analysis by industry, geography, job function, and organization size. Of note, the overwhelming majority of insurance companies set their compensation policies based on a national market, regardless of geographic location. Pinnacol also asked the HayGroup to assess its CEO compensation in the context of this "insurance industry peer group." Organizations in the insurance industry peer group are those with similar organization size, job function and CEO requirements to Pinnacol, and with total revenues of less than \$1 billion per year.

The following table represents the HayGroup’s findings comparing Pinnacol’s CEO compensation for 2010 with both the state fund peer group compensation for 2010, and the insurance industry peer group compensation for 2010.

2010 Compensation (\$000s)

Comparison of CEO Compensation CY 2010	Base Salary (\$000s)	Annual Cash Incentive (\$000s)	Total Cash Compensation (\$000s)
HayGroup Peer Group	\$329.80	\$106.10	\$410.80
Pinnacol Assurance	\$323.80	\$123.10	\$446.10
Pinnacol CEO as % of Peer Group	98.2%	116.0%	108.6%
HayGroup data on insurance sector for CEO position of similarly sized companies	\$392.20	\$117.40	\$507.60
Pinnacol CEO as % of Peer Group	83.0%	104.9%	87.9%

As shown in the chart, the comparison places Pinnacol’s 2010 CEO base salary at 98.2 percent of the state fund peer group, and Pinnacol’s CEO annual cash incentive at 116.0 percent of the state fund peer group. Overall, the total cash compensation earned by the CEO of Pinnacol was 108.6 percent of the average total cash compensation for incentive-eligible CEOs in the state fund peer group who received incentive payouts in 2010. Of note, the Pinnacol CEO base salary in 2009 was 98.8 percent of the average base salary of the state fund peer group, and 121.2 percent of the average incentive payout of the state fund peer group. While Pinnacol’s CEO *base salary* was generally within the norm for state fund CEO compensation in both 2009 and 2010, the primary driver for pay differences were the annual incentive payouts to Pinnacol’s CEO, which for 2009 and 2010 averaged 18.6 percent higher than cash incentives paid by other state funds. Variations in the level of CEO incentive payout are, by design, attributable to the Company’s performance.

The comparison also places Pinnacol’s CEO base salary at 83.0% of the insurance industry peer group, and Pinnacol’s CEO annual cash incentive at 104.9% of the insurance industry peer group. Overall, the total cash compensation for Pinnacol’s CEO was 87.9% of the average total cash compensation for a CEO of a similarly sized insurance company in the private sector.

Change of Control Agreements

During the course of its review of executive compensation, the Special Committee also reviewed certain Change of Control Agreements entered into between Pinnacol and certain members of management in 2009. The Special Committee evaluated the terms of the Change of Control Agreements and concludes that they are unlikely to be implemented. First, the Agreements contain “double trigger” provisions. In order for the Change in Control Agreements to be relevant, first one of several “change in control” events must occur. The Special Committee believes that such events are unlikely to occur. Second, the Change in Control Agreements do

not provide members of management with enhanced compensation unless they are terminated without cause during a change in control event.

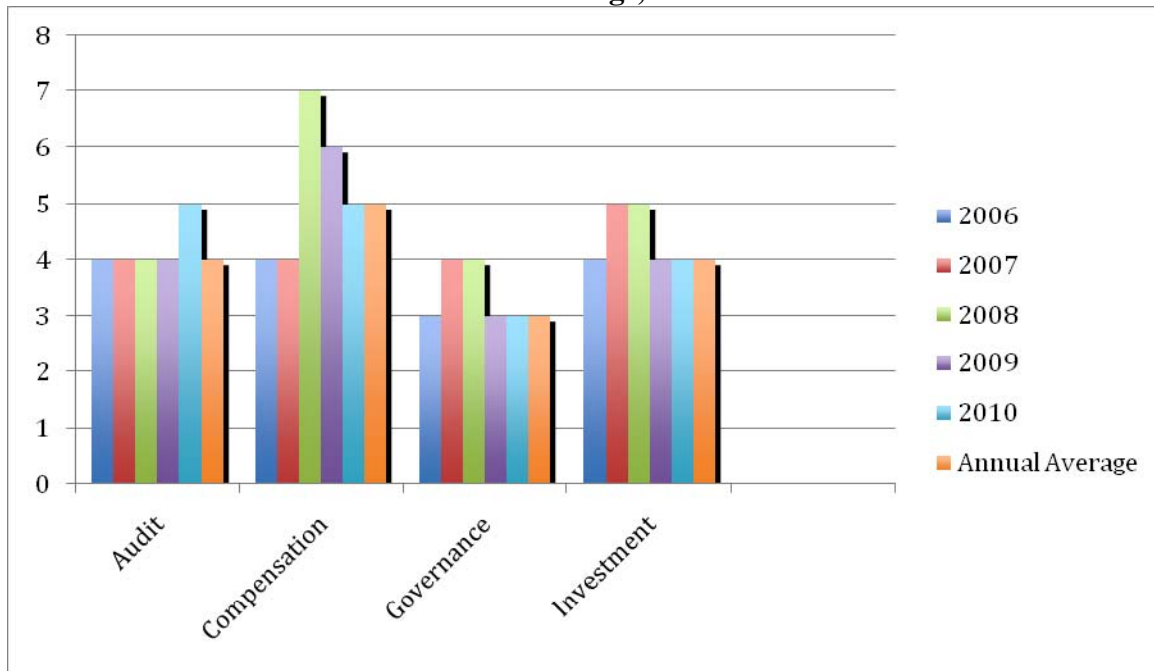
The Special Committee does not offer any opinion regarding whether or not it would have authorized such Change in Control Agreements when they were executed. The Special Committee is aware, based upon information provided by consultants that Change in Control Agreements are not uncommon among private carriers within the workers’ compensation industry generally. The Special Committee assumes that the Board acted in the best interests of Pinnacol, relying upon the advice of counsel, when it authorized such agreements.

However, as part of its due diligence, the Special Committee recommends that the Board, through its compensation sub-committee, review the appropriateness of the Change in Control Agreements and refer the existing agreements to outside counsel for further legal review.

BOARD OF DIRECTORS

A nine-member Board of Directors, appointed by the Governor of Colorado, governs Pinnacol Assurance. From 2006 through 2010, the full Board held formal meetings, in its entirety, an average of fifteen times per year. 2010 served as the outlier, when the full Board met formally on nineteen occasions. In addition, the Board has four separate sub-committees: 1) audit; 2) compensation; 3) governance and ethics; and 4) investment. Each Board member participates in one or two sub-committees, each of which meets on average four times annually. The following chart depicts the sub-committee meetings from 2006 through 2010.

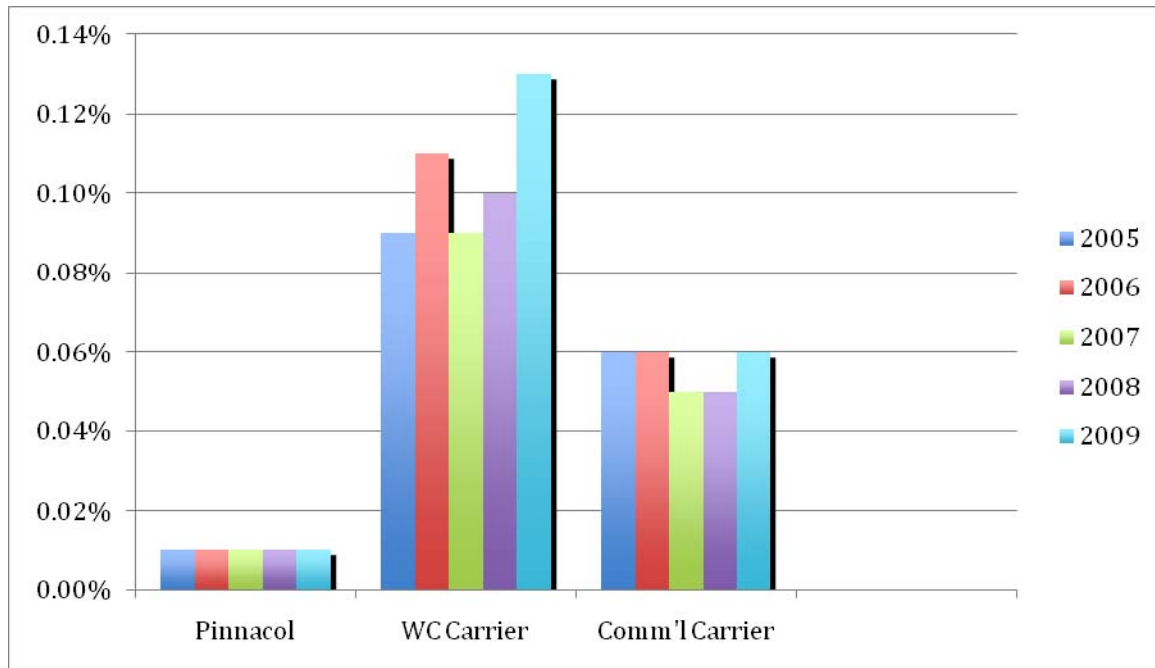
Number of Pinnacol Sub-Committee Meetings, 2006-2010



As outlined in the previous section on corporate governance, authority over Pinnacol rests with the Board, from setting premium rates to determining CEO compensation. Exercising due diligence requires a significant time commitment, with attendance at an average of nineteen Board and sub-committee meetings annually. For their time, Board members are paid \$140 per meeting day, as well as expenses such as per diem and travel reimbursement. Board members are reimbursed for a maximum of 30 meetings annually.

Given the significant time commitment made by the Board, the Special Committee sought to compare Pinnacol’s annual expenditures for the Board, including compensation and expenses, with other workers’ compensation insurers. To obtain this information, the Special Committee retained the Ward Group, a provider of benchmarking and best practices data for insurance companies across the nation. The graph below compares Board of Directors fees as a percentage of written premiums from 2005 to 2009 for Pinnacol, “Workers’ Compensation Carriers,” and “Commercial Line” companies.¹⁰

Board of Director’s Fees As Percentage of Written Premiums, 2005-2009



Board member compensation has remained stable over the years, so the upward movement in recent years in the Workers’ Compensation graph is related to premium decline in the industry and not an increase in Board fees. Of note, Pinnacol’s Board fees are significantly less than its peers in both the workers’ compensation group and commercial line carrier group. The following table contains the Board fees in actual dollars for Pinnacol, workers’ compensation group, and commercial line carriers from 2005 through 2009. Of note, Pinnacol’s average expenditures for Board fees for that five-year time period are approximately 13 percent of the expenditures made by the workers’ compensation carriers during the same time period.

¹⁰ The Ward Group sample for “Workers’ Compensation Carriers” is comprised of twelve companies nationally, nine of which are affiliated with state governments.

Board of Directors Fees in Dollars, 2005-2010 (aggregate)

Industry Type	2005	2006	2007	2008	2009
Pinnacol	\$39,000	\$45,000	\$49,000	\$52,000	\$52,000
WC Carrier	\$342,000	\$368,000	\$349,000	\$354,000	\$378,000
Commercial Carrier	\$310,000	\$318,000	\$301,000	\$296,000	\$323,000

Recommendation

As part of its responsibility for setting CEO compensation, the Board of Directors must continue to exert critical oversight of the process for determining incentive payout, including establishing performance goals, associated metrics, and setting the appropriate weight for each metric. While the base salary for Pinnacol’s CEO is generally within the norm for peer state fund workers’ compensation companies, the Board’s ongoing due diligence in the area of incentive payout is required to ensure that the CEO demonstrates performance meriting incentive pay. The Compensation Sub-Committee recommended to the full Board of Directors a set of performance metrics related to incentive pay and received approval of that recommendation on April 14, 2011.¹¹ Effectively implementing these performance metrics will be critical as the Board performs its continued due diligence with respect to CEO compensation.

The Committee makes no recommendation with respect to Board compensation, an amount prescribed by statute. The Committee notes, however, that the substantially below market compensation for Pinnacol Board members raises questions of Pinnacol’s ability to attract and retain board members of the quality and background appropriate for a company of Pinnacol’s size and complexity.

¹¹ PERA’s approval of the compensation plan adopted by the Board of Directors on April 14, 2011 is pending.

PINNACOL TRAVEL AND ENTERTAINMENT EXPENSES

The Special Committee sought to address concerns over Pinnacol travel and entertainment expenses, heightened in light of the May 2010 agent incentive trip. Toward that end, the Committee examined: 1) policies and controls related to Pinnacol travel and entertainment; 2) expense reports from 2006 to 2010 for all Board members and the top ten highest paid Pinnacol employees; 3) historical data regarding the cost of and attendees at a Denver Broncos suite leased annually by Pinnacol since 1998; and 4) historical data related to the “Pinnacol Club” agent incentive trip, including costs, location, and attendees from 2003 to 2010.

Based on a review of the data above, the Special Committee addressed the following questions:

- Has Pinnacol been in compliance with the revised travel and entertainment policies enacted in response to the State Auditor’s May 2010 Performance Audit?
- Are Board and senior management expenses appropriate (i.e. documentation, cost, purpose) for the period August 2006 to March 2011?
- What is the history of “Pinnacol Club” agent incentive trip, including analysis of costs, location, attendees and the use of such trips in the insurance industry broadly?
- How did Pinnacol employees, Board members and agents utilize the Denver Broncos suite from 2000 to 2010?

PINNACOL RESPONSE TO THE COLORADO STATE AUDITOR MAY 2010 PERFORMANCE AUDIT

In May 2010 the Office of the State Auditor conducted a performance audit of Pinnacol Assurance, reviewing the Company’s controls over travel and entertainment expenses as well as third-party payments made on behalf of Pinnacol personnel and Board members. The State Auditor found weaknesses in Pinnacol’s policies and controls and recommended the following:

- “Pinnacol Assurance should strengthen its controls over lodging and non-business meal expenses by establishing clear ‘not to exceed’ spending guidelines on these expenses in its expense policies and requiring employees and Board members to follow the guidelines.”
- “...Adhere to established policies over travel and entertainment expenses by a) establishing a meaningful review process to enforce all policy requirements and disciplining managers that do not uphold policies, and b) implementing a policy that requires an independent review of Board member and CEO travel and entertainment expenses.”¹²
- “...Strengthen its controls over lodging and non-business meal expenses by establishing clear ‘not to exceed’ spending guidelines on these expenses in its expense policies and requiring employees and Board members to follow the guidelines.”

¹² The State Auditor specifically recommended that the Board or a designated Board member review the CEO’s expenses and require the Board chair to review Board member expenses.

In response to the State Auditor findings, Pinnacol implemented revised travel and expense reimbursement policies for both Board members and Company employees. The policies, titled “Board Travel Policy” and “Employee Travel Policy” went into effect December 1, 2010.

Board Travel Policy

Given the recommendations of the State Auditor, Pinnacol revised its Board Travel Policy to require review of Board member expense reports by the CEO and on a quarterly basis the Chair of the Audit Sub-Committee will review and approve the processed expense reports and any adjustments noted will be corrected by the Board member. The Chairman of the Board will review and approve the expense reports submitted by the Chair of the Audit Sub-Committee. All expense reviews will look at business purpose, accuracy of totals, supporting documentation and receipts, policy compliance, and appropriate relationship to budget.

The Board Travel Policy additionally addresses requirements and restrictions for receipts, air travel, lodging rates, non-reimbursable travel expenses, telephone and internet usage while traveling, ground transportation, business meals and entertainment, use of personal auto for business purposes, other reimbursable expenses, and other non-reimbursable expenses. In particular, the Board Travel policy lays out the following additional requirements:

- Hotel lodging nightly rates are restricted to \$141 and if a Board member incurs a higher rate than \$141, “the Board member must explain the reason in the expense report.”¹³
- Receipts for items over \$50 are required for most expenses.
- Pinnacol will only reimburse coach class air travel “unless another class is approved by the Chair of the Audit Committee or the Chairman of the Board.”¹⁴
- For all business meal and entertainment reimbursement, the Board member must submit the name of all attendees if five or fewer, the name of vendor (i.e. restaurant, city and state), amount and date of expense, and business purpose.

Employee Travel Policy

The employee travel policy mirrors the restrictions and requirements in the Board and Travel Policy outlined above, with the exception that the employee expense report requires manager approval. Additionally, the Chair of the Audit Sub-Committee must review and approve the CEO’s expense report.

Compliance With Revised Travel and Expense Policies

The Special Committee retained the services of GHP Horwath – a firm providing forensic analysis and accounting services – to review Pinnacol’s expense reports from January to March 2011 to determine compliance with the revised travel and expense policies. GHP Horwath

¹³ Board Travel Policy, p. 4.

¹⁴ Board Travel Policy, p. 4.

analyzed approximately 700 expenses over the three month time period and noted 13 exceptions in violation of the new policies. They summarized the exceptions below:

- In four instances, Pinnacol employees stayed at hotels with nightly room rates exceeding \$141 but did not provide the explanation in the expense report as to why the room rates exceeded \$141¹⁵
- In five instances, employees incurred expenses that exceeded \$50 but failed to provide a receipt
- In three instances, the required breakdown of mileage was not provided
- In one instance, an employee miscalculated the amount of her mileage reimbursement and as a result was reimbursed \$9.18 more than she should have been

Based on its review, GHP opined that “Pinnacol has significantly improved its internal controls and approval process since the May 2010 Performance Audit. While there were still exceptions (13 out of approximately 700 or less than two percent), the exception rates noted in the May 2010 Performance Audit were substantially higher.”

APPROPRIATENESS OF BOARD OF DIRECTOR AND SENIOR MANAGEMENT TRAVEL EXPENSES

The Committee also asked GHP Horwath for a general review of Pinnacol’s expense reports from August 2006 to March 2011, looking for potentially excessive expenses. The review included approximately 10,700 expenses in expense reports for Board members and senior management. The results of Horwath’s analysis are below:

- “...noted 14 expenses for employees for meals and entertainment (excluding Pinnacol Club trips) that involved board members and agents or other guests that may or may not be agents.”
- “...noted 71 expenses for employees that involved meals and/or entertainment with board members. The total cost of these expenses was \$5,228. The majority of these expenses appeared to be for business meals. Of these expenses, 6 were for meals where the cost per person exceeded \$50 with a cost of \$106 per person in one instance and an average cost of \$76 person.”
- “There were six expenses for employees totaling \$1,300 for gift cards or other gifts for board members and one expense totaling \$1,609 for Kindle wireless reading devices that were referred to in the expense report as ‘gifts for executive team.’”¹⁶
- “There were nine expenses for Pinnacol events such as holiday celebrations or management/board retreats totaling \$20,110.”

¹⁵It should be noted that three of the four expenses pertained to initial deposits for hotel costs at a conference. In these situations the conferences had not yet occurred and the explanation of the reason why the hotel cost per night exceeded \$141 may be forthcoming in a subsequent expense report. For one of the expenses, however, the expense was for lodging that occurred in February 2011 and there was no explanation provided for the higher hotel rate.

¹⁶The Kindle expenses were recognized as additional income and taxes were paid thereon.

GHP Horwath noted no other expenses that may be “unreasonable” other than those noted above. However, while Horwath may define an expense as “reasonable” in the context of Pinnacol conducting business as a mutual insurance company, the Special Committee understands that specific expenses may raise concerns with the general public.

INCENTIVE TRIPS

Incentive trips are a common business strategy in the insurance industry, with companies rewarding exceptional sales performance by agents with trips to a variety of international and domestic destinations. In light of the public scrutiny associated with the May 2010 Pebble Beach incentive trip, the Special Committee sought to better understand the practice by reviewing the following areas.

- Historical overview of Pinnacol’s largest incentive event, the “Pinnacol Club,” and the Club trips between 2003 and 2010
- Analysis of Pinnacol Club costs, including primary factors causing cost increases
- Comparative analysis regarding incentive trips in the insurance industry using independent benchmarking data
- Analysis of the number and composition of Pinnacol Club attendees from 2003 to 2010

Pinnacol Club History

After its creation as a mutual insurance company in 2002, Pinnacol faced competition with private insurers in the workers’ compensation market. To compete successfully, Pinnacol understood that agent retention was key to business growth. The Company had already strategically shifted in the early 1990s from an internal sales force to the use of independent agents. Subsequent to that shift, Pinnacol set out to establish itself as a viable option for agents when placing their business. As a result, those independent agents have historically accounted for 85 to 90 percent of the Company’s premium business. In addition, 76 percent of Pinnacol’s customers made their purchasing decision based upon a recommendation from their agent.

With agents central to Pinnacol’s business strategy, the Company “needed to create strong relationships with independent insurance agents who would serve as its ‘sales force’ and agent incentive trips were a proven tactic in the industry for achieving that goal.”¹⁷ Toward that end, Pinnacol created the “Pinnacol Club,” the Company’s largest incentive event recognizing its top ten agency partners. Those agency partners must meet the following benchmarks:

- \$10 million in minimum premium volume
- New business of at least \$1 million
- Loss ratio of less than 55 percent

The Club rewards the top 10 agents who meet these requirements with an annual all-expense-paid trip for the agent and his/her spouse to domestic and international destinations.

¹⁷Historical information regarding agent incentive event provided by Pinnacol.

The following table provides the location, total cost and attendees for Pinnacol Club trips between 2003 and 2010.

Pinnacol Club Location, Cost, and Attendees, 2003-2010

Year	Location	Cost	Pinnacol Attendees	Agent Attendees	Total Attendees
2003	Boulders Resort and Golden Door Spa, Scottsdale, AZ	\$131,068	19	18	37
2004	The Little Nell, Aspen, CO	\$109,312	19	17	36
2005	Wyndham Peaks Resort & Golden Door Spa, Telluride, CO	\$110,000	28	19	47
2006	Four Seasons Resort, Punta Mita, Mexico	\$204,798	28	16	44
2007	Fours Seasons Resort, Scottsdale, AZ	\$221,572	29	18	47
2008	The Sanctuary at Kiawah Island, SC	\$230,016	27	18	45
2009	Esperanza, Cabo San Lucas, Mexico	\$327,615	31	18	49
2010	The Lodge at Pebble Beach, Pebble Beach, California	\$310,626	31	20	51

Pinnacol Club Cost Analysis

From 2003 to 2009, the total cost of the Pinnacol Club trip increased 150 percent to \$327,615. In 2006 and 2009, total costs from the previous year increased significantly by \$95,000 and \$98,000, respectively. As a percentage of premium revenue, the total costs increased 237 percent from 0.027 percent in 2003 to 0.090 percent in 2010. Of note, the cost of the Pinnacol Club trip declined 5 percent from 2009 to 2010 to \$310,626.

Just as total costs increased over time, Pinnacol Club costs per attendee increased significantly between 2003 and 2009. In 2003, Pinnacol paid \$3,542 per attendee and in 2009 that figures almost doubled to \$6,971, with a decrease of 11 percent to \$6,213 in 2010. According to GHP Horwath, a firm retained by the Special Committee to provide forensic analysis and accounting services, the increase in costs cannot be attributed entirely to inflation. GHP writes:

“While a portion of the increase (in cost per attendee) can be attributable to inflation, the cost of airfare and lodging increased only 21 percent and 18 percent respectively from 2003 to 2010.¹⁸ Therefore, just over 25 percent of the increase in the cost per attendee can be attributable to inflation.”¹⁹

¹⁸Consumer price index for airfare and Host Study (average revenue per rented room) for lodging.

¹⁹ Midpoint of 2003 to 2010 increase in airfare and lodging (19.5 percent) divided by 75 percent in the Pinnacol Club cost per attendee during the same period equals 26 percent.

The increase in total costs per attendees could be attributed to enhancements in the venue and amenities offered agents since 2003.

Industry Information

To better understand the use of incentive trips in the insurance industry, the Special Committee retained the Ward Group, a provider of benchmarking and best practices data for insurance companies nationally. Specifically, the Committee asked Ward to address the following questions:

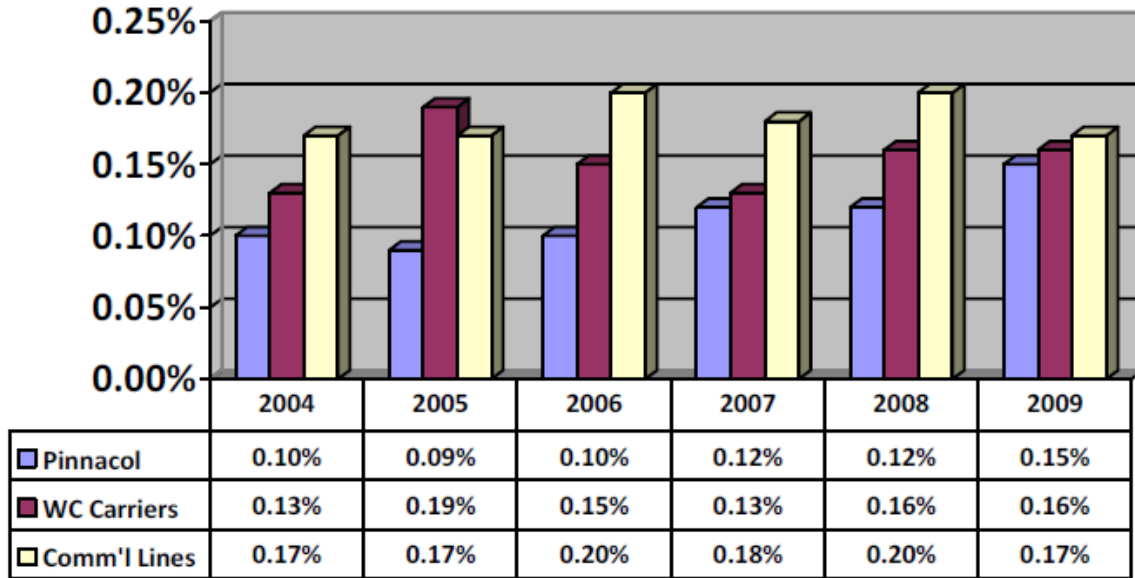
- 1) How prevalent are incentive trips in the insurance industry and what are typical destinations?
- 2) How much do these trips cost on average?
- 3) What company personnel typically attend these trips with the agents?

To address the prevalence of trips within the industry, the Ward Group utilized its Property and Casualty Insurance benchmarking data, best practices database, and results from their Agency Management and Compensation Study. Ward analyzed data from 2004 to 2009 and created two categories: workers' compensation companies and commercial line companies. The former consisted of twelve companies, nine of which, like Pinnacol, are affiliated with state government. The commercial line companies are comprised of 35 companies that write over 80 percent commercial line business – 30 percent of which is workers' compensation. The average premium volume for the workers' compensation companies is \$353 million and for the commercial lines companies is \$539 million. Of note, Pinnacol collected approximately \$399 million in premiums in 2009.

Incentive trips are a common practice within the industry, with the Ward Group finding that 55 percent of workers' compensation carriers held a trip in 2004. That figure decreased slightly to 51 percent in 2009. For commercial line companies, the percentage of companies that held agency incentive trips declined from 59 percent in 2004 to 52 percent in 2009. For both workers' compensation and commercial line companies, 84 percent of trips were to domestic locations in 2004, with that number decreasing slightly to 74 percent by 2009. Of note, the Special Committee interviewed two Colorado-based agents who both described incentive trips as standard practice within the insurance business, with companies such as Colorado Casualty and Travelers frequently offering incentive trips to both foreign and domestic locations.

The Ward Group also analyzed the average cost of trips as a percentage of premiums. The chart below is excerpted from its analysis.

Agent trip expense as a % of written premium



As the chart indicates, Pinnacol’s total agent trip costs, as a percentage of premiums, were consistently lower than industry averages.

Pinnacol Club Attendees

Pinnacol limits attendance to incentive trip events to agency owners and principals, as well as their spouses/guests. From 2003 to 2010, the total number of agent attendees, including guests, has not changed significantly (18 attending on average). However, the number of Pinnacol staff in attendance has increased 61 percent from 2003 (19 attendees including guests), to 2010 (31 attendees with guests). One of the primary drivers in increased staff attendance appears to be an increase in attendance by marketing representatives, with ten attending in 2003 and 17 in 2010. An additional driver was Board attendance, with one Board member attending the Pinnacol Club event in 2003 and that number increasing to six (including three Board members and three guests) in 2010. Finally, in 2003 the ratio of Pinnacol employees to agents was approximately 1:1. In 2010, the ratio had increased to 1.5:1, with 31 Pinnacol employees and 20 agents in attendance.

The Special Committee asked the Ward Group for industry standards related to the categories of individuals who attended incentive trips, as well as the ratio of carrier personnel to agents. The Ward Group’s analysis indicated that typically the President/CEO, Chief Operating Officer, Vice President of Sales & Marketing, and perhaps a few senior marketing/agency management personnel attend incentive events. Board members usually do not attend the trips.²⁰ The Ward

²⁰Ward Group April 15, 2011 Report.

Group also indicated a ratio of five to eight agent attendees for every one company employee. In addition, in interviews with two Colorado-based agents, they both confirmed that board members typically do not attend incentive trips and there are usually more agents than representatives from the carrier.

Recommendations

Regarding Pinnacol Club agent incentive trips, the Special Committee recommends the following:

- Limit the number of Pinnacol employees in attendance to essential staff and appropriate management representatives, that may include the CEO, Vice President of Marketing, Chief Operating Officer, and if appropriate senior marketing representatives charged with maintaining agency relationships. Attendance should be decided based upon whether there is a substantial business purpose for such person's attendance and concomitant costs of attendance should be limited to the scope of such business purpose.
- The number and identity of Pinnacol employees attending incentive events should bear a reasonable relationship to the number and identity of agents and their guests.
- Eliminate Board member attendance at all Pinnacol Club incentive trips.
- Finally, the Special Committee recommends that Board and management exercise heightened scrutiny to assure that business expenditures are reasonable and do not create an appearance of impropriety or lavish spending.

Regarding travel and entertainment expenses generally, the Special Committee, aided by the analysis of GHP Horwath and industry data supplied by the HayGroup, concludes that Pinnacol management expenses have been generally reasonable in the context of a company competing with private insurance companies in the workers' compensation industry. However, the Special Committee finds that certain travel and entertainment expenses incurred by management, in addition to the Pinnacol Club expenditures, were questionable when subjected to the heightened sensitivity and transparency standard suggested by the Special Committee with respect to future expenditures. In particular, some management expenditures could be criticized as being excessive and/or providing undue personal benefit. Because of the overall reasonableness of management expenses, the Special Committee does not deem it necessary to focus on specific past expenditures.

Further, the Special Committee does not feel it necessary or appropriate for the Board to review future management expenditures other than from an overall policy perspective and from an overall compliance standpoint. In short, the Board should not "micro-manage" management. The Special Committee, however, does recommend that the Board review the policies and procedures for management travel and entertainment expenditures adopted on December 1, 2010. The Special Committee reviewed those policies from a compliance standpoint and found that the revised policies are substantially improved. From a substantive standpoint, however, the revised policies do not provide details of what constitutes appropriate guidelines for what expenditures are appropriate for business purposes. As part of its review, the Board should ensure that the policy provides ample detail and guidance to management such that future expenditures satisfy heightened scrutiny and transparency standards. Such policy and procedure

standards should deal with travel, entertainment, spousal and guest participation and gifting policies for all purposes; including internal meetings, meetings with agents, clients, vendors, lobbyists, public servants and all other categories of persons or entities that may be the subject of such expenditures. Different standards may well be appropriate for expenditures incurred in connection with Pinnacol's function as a mutual insurance company competing with private insurers and Pinnacol's internal functions and/or functions as a state subdivision.

ENTERTAINMENT EXPENSE – DENVER BRONCOS SUITE

Responding to concerns brought to the attention of the full Board regarding the potentially inappropriate use of a Denver Bronco suite, the Special Committee reviewed data regarding the costs of and attendees at the suite between 2000 and 2010.

Every year since 1998, Pinnacol Assurance has leased a suite with the Denver Broncos and renewed that commitment in 2000, 2005, and 2010. Pinnacol spent \$84,000 for the suite in 1998 and in 2011 will spend \$94,607. The suite offers twenty tickets per home game – two preseason and eight regular season – and according to Pinnacol's Vice-President for Marketing "is used primarily for the entertainment of agents and their policyholders." Currently, eight Pinnacol marketing representatives rotate responsibility for each home game on an equal basis and invite their agents as appropriate. Used as a relationship building strategy, the suite serves as a means to entertain and thank selected policyholders.

Pinnacol provided the Special Committee with the names of all Board members, along with staff members and other individuals, who attended each home game for the 2000 to 2010 time period. Each game contained the date and opponent as well as the Pinnacol staff and guests in attendance. Of note, the data is self-reported and rarely did the information contain the name of the individual recipient for each of the twenty tickets. Instead, the data usually contained the name of the Pinnacol staff member but not his/her guest, or the name of the agency but not the number of or specific individuals from that agency who attended the game. In addition, the tickets are transferable, making the tracking of individual attendance impossible. The Special Committee recommends that this practice be changed such that Pinnacol can identify each ticket recipient and attendee.

A review of the data revealed that Pinnacol staff, primarily marketing and senior management, attended the majority of games with no Board members having attended a Broncos game prior to 2006. On October 15, 2006, records indicated that Pinnacol CEO Ken Ross attended with the Board, but specific names of Board members were not provided. Similarly on October 29, 2007, the records indicated that Ken Ross attended with the Board, but again Board member names were not provided. The listing simply stated: "Ken/Board." Aside from the October 29, 2007 game, in 2007 four Pinnacol Board members did attend three separate games. Finally, two Board members attended the Broncos game on October 11, 2009.²¹

²¹ In 2007, Debra Lovejoy received four tickets for a game on August 25, RJ Jolly and David Green received six tickets for a game on November 19, and Gary Johnson received two tickets for a game on December 9. In 2009, Debra Lovejoy and Gary Johnson both attended a game on October 11.

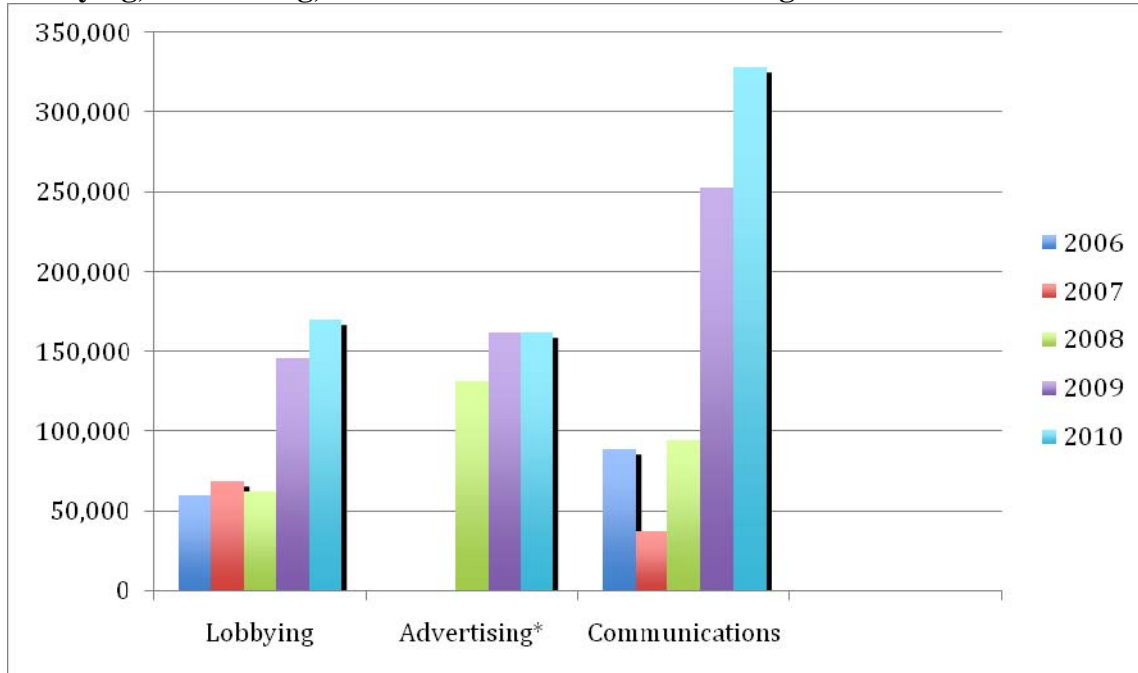
The Special Committee consulted with the Ward Group, a company that provides benchmarking data for the insurance industry, about the prevalence of insurance carriers providing sporting event tickets as an agent/agency incentive. While not providing statistical data, the Ward Group indicated that it was a regular practice within the industry for carriers to offer tickets to a variety of entertainment, including sporting events. In addition, in two separate interviews with Colorado-based insurance agents, both revealed that insurance carriers offered tickets regularly as a relationship builder and an incentive to place business with the carrier.

The Special Committee found only sporadic attendance by Board members at Denver Bronco games, with 2007 the only year in which individuals attended multiple games. The Committee found no indication of abuse of Bronco tickets by Board members. Further, Pinnacol's use of Bronco tickets as an agent incentive is well within industry standards. However, the Special Committee recommends that the lease of the Bronco's suite and like entertainment vehicles be regularly evaluated by management to assure that their lease is a justifiable business expense consistent with industry standards and that they are used for business purposes.

PROFESSIONAL SERVICES

In examining Pinnacol’s “professional services” expenditures, the Special Committee asked for third-party contracts for lobbying, advertising, and communications services entered into between 2006 and 2010. The table outlines those costs over time.

Lobbying, Advertising, and Communications Contracting 2006-2010



*In 2006 and 2007, Pinnacol had no advertising expenditures

LOBBYING

Lobbyists Retained by Pinnacol from 2006 to 2010

From 2006 through 2010, Pinnacol employed three separate lobbyists: Cathy Wanstrath; Axiom Strategies, Inc. (“Axiom”); and Steve Farber of the law firm Brownstein Hyatt Farber Schreck LLP.

For the years 2006, 2007 and 2008, Pinnacol’s lobbying expenditures held relatively steady at \$60,000, \$68,850 and \$62,242.50 per year, respectively. All of these payments were made to Ms. Wanstrath. In 2009, lobbying expenditures increased by 134% from the previous year to \$145,861. This amount included \$53,467 paid to Ms. Wanstrath, and \$83,729 paid to Axiom. In 2010, Pinnacol’s lobbying expenditures totaled \$170,162, an increase of 12% from the previous year and an increase of 173% from 2008. 2010 lobbying fees consisted of \$35,846 paid to Ms. Wanstrath, \$104,066 paid to Axiom, and \$30,250 paid to Mr. Farber.

Cathy Wanstrath

From 2006 to 2008, Pinnacol employed a single independent lobbyist, Cathy Wanstrath, who primarily focused on workers' compensation related legislation. In 2006, Ms. Wanstrath contracted with Pinnacol for a flat rate of \$5,000 per month, with Pinnacol paying a total of \$60,000. In 2007 and 2008, Ms. Wanstrath shifted from a flat rate to a \$150 per hour agreement and billed \$68,850 and \$62,242.50, respectively. For 2009 and 2010, Ms. Wanstrath increased her hourly fee to \$165 per hour and billed \$53,467 and \$35,846 per year, respectively.²² Cumulatively since 2006, Pinnacol Assurance has paid Ms. Wanstrath a total of \$279,408, or on average \$55,881 per year, for lobbying services.

Axiom Strategies, Inc.

In April 2009, as legislative issues arose related to the control of Pinnacol Assurance and the disposition of surplus funds, the Company contracted with Axiom Strategies to provide lobbying services on its behalf. According to the Lobbying Services Agreement entered into by Axiom,

The LOBBYIST (Axiom Strategies) agrees to provide the CLIENT (Pinnacol) legislative strategy and lobbying services which shall include the following: the full-time, on-the-scene effort of the LOBBYIST, who will propose political strategy, review pending legislation, assist the CLIENT in developing a position on legislation, track the legislation through committees and floor action, articulate the CLIENT'S position to members of the Colorado General Assembly...and also assist the CLIENT in preparing testimony before legislative committees, drafting legislation, amendments to legislation, and documentation which will support both, and will find sponsors for CLIENT-proposed legislation.²³

The agreement was effective April 2, 2009 through June 2009. Per the agreement, payment was made in one lump sum of \$30,000, which equated to \$10,000 per month. Axiom subsequently entered into an identical lobbying agreement from July 2009 through June 2011, but for a flat retainer of \$8,500 per month, with additional reimbursement for postage, photocopying, and expenses incurred.²⁴ The Lobbying Service Agreements did not define "expenses incurred." In addition, at the request of Axiom, Pinnacol sponsored legislative welcoming receptions in December 2009 and November 2010, at the cost of \$500 for each reception. For the second half of 2009, Pinnacol paid Axiom a total of \$51,999.01 and for the entire year \$83,728.65. In 2010, Axiom billed Pinnacol \$104,232.89. As in 2009, that fee included a flat retainer of \$8,500 per month and additional reimbursement for photocopying, postage, and expenses incurred.

Steve Farber - Brownstein Hyatt Farber Schreck LLP

Again in response to issues related to surplus funds and control of Pinnacol Assurance, the Company in February 2010 retained Steve Farber, a partner with the firm Brownstein Hyatt

²²Wanstrath Lobbying Services Agreement dated November 16, 2009.

²³ Lobbying Services Agreement dated April 6, 2009.

²⁴ Lobbying Services Agreement dated July 31, 2009.

Farber Schreck LLP, for communications strategy “with identified members of the State Legislature and certain identified business interests concerning current and anticipated legislative proposals during the current Colorado Legislative Session impacting Pinnacol.”²⁵ Although the Letter of Agreement with Mr. Farber proposed a fee of \$60,000, ultimately Pinnacol paid only \$30,250 to Mr. Farber, disbursing one payment of \$10,250 on April 14, 2010 and a second payment of \$20,000 on July 8, 2010.

Lobbyist Disclosures

Colorado Statutory Provisions

According to Colorado state law, all registered lobbyists shall disclose on a monthly basis with the Secretary of State the nature of their lobbying efforts, including the “gross income....and the names and addresses of any person from whom gross income for lobbying is received totaling one hundred dollars or more.”²⁶ Gross income is defined as “the total income, including compensation for services, fees, and similar payments, before any deductions are made, received by a professional lobbyist for lobbying or by a firm organized for professional lobbying purposes that employs a professional lobbyist.”²⁷ The Special Committee reviewed the disclosure statements available through the Secretary of State in order to determine the appropriateness and transparency of lobbying efforts undertaken on behalf of Pinnacol.

Cathy Wanstrath

The Special Committee reviewed Ms. Wanstrath’s lobbyist disclosures between 2006 and 2010 as reported on the Colorado Secretary of State website. In those disclosures, the invoices for lobbying services rendered matched the actual monthly amounts paid by Pinnacol to Ms. Wanstrath.

Axiom Strategies, Inc.

Throughout 2009, Axiom Strategies disclosed to the Colorado Secretary of State between 25% and 50% of the total amounts requested and received monthly from Pinnacol. For example, on April 9, 2009, Pinnacol issued a check to Axiom in the amount of \$30,000 for “Lobbyist Services.” On April 13, 2009, however, Axiom disclosed to the Secretary of State that it had received \$15,000 from Pinnacol. Axiom’s disclosures to the Secretary of State for May and June 2009 did not disclose any payments made to it by Pinnacol that potentially could account for the remaining \$15,000. Beginning in July, Axiom entered into a lobbying agreement with Pinnacol for a flat rate of \$8,500 per month. While Pinnacol paid the agreed-upon flat rate of \$8,500 from

²⁵Letter of Agreement between Steve Farber and Snell & Wilmer LLP, dated February 22, 2010. Farber was retained by the law firm of Snell & Wilmer LLP, which in turn was retained by Pinnacol. Although Snell & Wilmer technically retained Farber, invoices for the services he performed were submitted to, and paid by, Pinnacol.

²⁶C.R.S § 24-6-302.

²⁷C.R.S § 24-6-301.

July through December 2009, Axiom disclosed half of that amount, or \$4,250 per month, from July through November 2009, and \$2,125 for December 2009.

Similarly in 2010, while Pinnacol issued checks to Axiom for approximately \$8,500 per month, Axiom's monthly disclosures to the Secretary of State were for amounts between 25% and 50% of the amounts paid by Pinnacol. For example, from January through April 2010, Axiom disclosed receiving \$17,000 or \$4,250 per month for lobbying efforts on behalf of Pinnacol. In that same time period, Pinnacol issued four separate checks for \$35,233 or \$8,808 per month to Axiom. The disclosed amounts decreased further for the remainder of 2010, with Axiom reporting lobbying income from Pinnacol of \$14,875 or \$2,125 per month from June through December 2010. Pinnacol issued seven separate checks to Axiom for that same time period, totaling \$59,926 or \$8,561 per month.

The difference in dollar amounts between Axiom's Secretary of State disclosures and Pinnacol's payments could be accounted for in the lobbying agreements. According to the Office of the Secretary of State, professional lobbyists sometimes delineate between "consulting" and direct lobbying, with only the latter required to be disclosed to the Secretary of State. A review of both Lobbying Service Agreements between Pinnacol and Axiom for 2009 and 2010 reveals that the agreements contain provisions for "lobbying services" and "legislative strategy." The latter included tasks beyond direct lobbying, such as participation in Pinnacol's Legislative Strategy Group, and would consequently not be required to be disclosed to the Secretary of State.²⁸ However, without documentation clearly delineating tasks performed under "lobbying services" or "legislative strategy," the Special Committee could not determine whether the total amounts disclosed by Axiom to the Secretary of State were appropriate.

It should be noted that the responsibility for disclosure of all income received for lobbying purposes from a client rests with the professional lobbyist. There is no indication that Pinnacol was aware of any inconsistencies between payments it made to Axiom and Axiom's disclosures to the Colorado Secretary of State.

Steve Farber - Brownstein Hyatt Farber Schreck LLP

Mr. Farber, having been retained in late February 2010, billed Pinnacol for services rendered in March, April, and May. A review of the Secretary of State website found no disclosures for direct lobbying conducted by Mr. Farber on behalf of Pinnacol. His letter of agreement outlines his scope broadly, including assisting in "strategic communications and negotiation." Given the broad scope, Mr. Farber may have assisted Pinnacol in matters apart from direct lobbying and consequently would not be required to disclose those matters with the Secretary of State. Without documentation of specific activities conducted by Mr. Farber beyond the letter of agreement, the Special Committee could not comment on the appropriateness of disclosures with the Office of Secretary of State.

²⁸ The Legislative Strategy Group meets every other Monday during the legislative session to discuss pending bills and overall strategy. Axiom Strategies and Cathy Wanstrath participate in these meetings.

Lobbyist Expenses

The Special Committee reviewed the invoices of all lobbyists from 2006 through 2010, examining the activity conducted on behalf of Pinnacol and the appropriateness of expenses (beyond a retainer or hourly wage) submitted for reimbursement. Of note, Colorado state law prohibits lobbyists from giving gifts, including meals, to any elected state official.²⁹

Cathy Wanstrath

In 2006, Ms. Wanstrath was paid a flat retainer of \$5,000 per month; she did not provide Pinnacol with any documentation of her lobbying activities. Beginning after she shifted to an hourly agreement in 2007, however, Ms. Wanstrath included in her invoices a time and task log with a detailed accounting of services provided as justification for the hours billed to Pinnacol. This documentation continued through 2010. Ms. Wanstrath's invoices did not include additional expenses for reimbursement.

Axiom Strategies, Inc.

In Axiom's Lobbying Service Agreements with Pinnacol for 2009 and 2010, the following language is included:

“In addition, the CLIENT agrees to reimburse the LOBBYIST for properly receipted expenses incurred by the LOBBYIST for working with members of the Colorado General Assembly or with CLIENT'S officers and members during the contract period. Such expenses will be submitted for payment on a monthly basis.”

Throughout 2009 and 2010, Axiom submitted monthly invoices containing three primary categories: services rendered (monthly retainer); postage and photocopies; and meetings. Axiom's invoices seeking reimbursement for meetings, which typically occurred in a restaurant or coffee shop, included the date of the meeting, the attendees, the topic, and the amount to be reimbursed. Even though the Lobbying Service Agreements contemplated reimbursement only for “properly receipted expenses,” Axiom invoices did not attach receipts for expenses incurred during meetings, including meetings conducted with elected officials. Because receipts showing specific food or beverage items purchased during meetings were not submitted with Axiom's invoices, Pinnacol cannot confirm compliance with the state statute prohibiting lobbyists from giving gifts or meals to any elected state officials.

Additionally, in 2009 and 2010 Axiom submitted eighteen invoices for “services rendered.” The invoices did not contain time and task logs, briefing documents, monthly/annual reports, or any other detail regarding the specific lobbying activities performed by Axiom. While there are no laws or formal rules requiring Axiom to submit a breakdown of the services that it provided, because Axiom did not detail its lobbying activities on behalf of Pinnacol, transparency and accountability issues may arise.

²⁹ C.R.S. § 24-6-203(3.7).

Finally, regarding the legislative welcoming receptions that Pinnacol sponsored at Axiom’s request in 2009 and 2010, Axiom did not submit any documentation to Pinnacol regarding those events such as the events’ agendas, total cost, or legislators and/or staff in attendance.

Steve Farber - Brownstein Hyatt Farber Schreck LLP

In the case of Mr. Farber, Pinnacol retained his services from late February through May 2010. According to the Letter of Agreement between Mr. Farber and Snell & Wilmer LLP, which in turn represented Pinnacol, Mr. Farber was retained to “assist in certain aspects of a coordinated communications campaign with identified members of the State Legislature and certain identified business interests concerning current and anticipated legislative proposals during the current Colorado legislative Session impacting Pinnacol.”

As part of that effort, Mr. Farber billed Pinnacol a total of \$30,250. All three invoices submitted by Mr. Farber contained a one-line request for “professional services rendered.” Documentation regarding the specific tasks performed or written communication either via email or in briefing memos/reports as to activity undertaken on behalf of Pinnacol was not included in the invoices. Because documentation detailing lobbying activities was not provided, accountability and transparency issues may arise.

Lobbyist Political Contributions

In light of concerns brought to the Board of Directors’ attention regarding potentially inappropriate contributions made to elected officials on behalf of Pinnacol through its contract lobbyists, the Special Committee examined political contributions of all lobbyist firms and their principal employees. The Special Committee reviewed all political contributions made by Cathy Wanstrath, Axiom Strategies, Inc. and its principals Margaret O’Keefe and Micki Hackenberger, as well as Brownstein Hyatt Farber Schreck LLP and Steve Farber individually. The Special Committee found no irregular political contributions as related to Pinnacol lobbyists and elected officials.

Recommendations

As Pinnacol retains third-party lobbyists, service agreements with lobbyists should be augmented to include the following provisions:

- A clause acknowledging that lobbyists are familiar with all laws and regulations governing lobbyist activity and agreeing that violation of any such laws or regulations shall be grounds for immediate termination of their contracts and indemnification of Pinnacol for damages caused by lobbyist violations of laws or regulations
- Requirement that receipts for all expenses incurred by the lobbyist be included in invoices for reimbursement and approved by the General Counsel
- Inclusion of time and task logs and/or periodic written reports/memos to senior management detailing lobbying activities

- Description of specific lobbying activities to be undertaken (e.g. direct lobbying, general consultancy, communication strategy) in order to clearly delineate activity required to be disclosed to the Secretary of State
- Proof of lobbyist registration with the Secretary of State to be attached to the signed lobbying agreement

Given the lack of receipts submitted to Pinnacol for lobbyist meals with elected officials, the Special Committee recommends the full Board immediately review the current lobbying contracts and past lobbying activities for compliance with Amendment 41.

In addition, to ensure proper oversight beyond Pinnacol senior management, the Board should create responsibility within the Governance and Ethics Sub-Committee for review of contract lobbyist performance.

ADVERTISING

In the advertising realm, Pinnacol has hired two firms to assist in advertising efforts: Duet Media and Karsh Hagan. The former handles all advertising buys for print, television and radio. Duet has worked with Pinnacol from 2008 through 2010. Karsh Hagan handles the development of all Pinnacol’s advertising campaigns and was brought on in 2009.

2006-2010 Third-Party Advertising Vendors

Vendor	2006	2007	2008	2009	2010	Vendor Total
Duet Media	N/A	N/A	\$131,500	\$72,000	\$72,000	\$275,500
Karsh Hagan	N/A	N/A	N/A	\$90,000	\$90,000	\$180,000
Annual Total	N/A	N/A	\$131,500	\$162,000	\$162,000	\$455,500

COMMUNICATIONS

Since 2006, Pinnacol has contracted with four companies to assist in communication matters: Webb PR, SE2, Rockford Gray, and Galloway Group. The longest tenured contractor, Webb PR, assists in media efforts, including developing a yearly media plan, story pitching, tracking media coverage, and distribution of and follow up on all press releases. As the legislature began discussions related to control of Pinnacol and the disposition of surplus funds, in 2009 the Company hired SE2 to provide public relations counsel related to legislative matters. In particular, SE2 assisted with the development of materials and messaging for the legislative interim committee tasked with reviewing Pinnacol’s operations. In 2010, SE2 aided Pinnacol with messaging related to legislation impacting the Company.

Also in 2009, the Galloway Group was brought on to provide public relations counsel related to Pinnacol’s corporate citizenship efforts. Finally in 2010, Pinnacol contracted with Rockford Gray for general public relations counsel and specifically to assist in the preparation of testimony to be given before the Legislative Audit Committee.

The following table provides the communication expenses for third-party vendors from 2006 through 2010.

2006-2010 Third-Party Communication Vendors

Vendor	2006	2007	2008	2009	2010	Vendor Totals
Webb PR	\$88,472	\$37,088	\$94,525	\$189,728	\$191,526	\$601,339
SE2	N/A	N/A	N/A	\$48,204	\$65,968	\$114,172
Rockford Gray	N/A	N/A	N/A	N/A	\$11,125	\$11,125
Galloway Group	N/A	N/A	N/A	\$15,000	\$60,000	\$75,000
Annual Totals	\$88,472	\$37,088	\$94,525	\$252,932	\$328,619	\$801,636

The 2010 communications expenditures for Pinnacol are nearly four times the amount from 2006. This increase should be considered in light of four factors that resulted in intense media and government scrutiny; discussion during the 2009 session regarding control of Pinnacol and its surplus funds, the State Auditor’s May 2010 performance audit, the Pebble Beach incentive trip also in May 2010, and Pinnacol testimony before the Legislative Audit Committee in June 2010. Beyond third party contracts, Pinnacol employs eight full time employees as part of their communication team.

APPENDIX A



Forensic Analysis of Travel and Other Expenditures

Prepared at the Request of the:
Special Task Force Committee for
Pinnacol Assurance
7501 E. Lowry Blvd.
Denver, CO 80230

By:
Mark W. Pedigo, CPA/ABV/CVA
GHP HORWATH, P.C.
May 24, 2011

TABLE OF CONTENTS

	<u>Page</u>
I. Introduction	1
II. Pinnacol Financial Performance and Stability	2
A. Scope of Work.....	2
B. E&Y Internal Audit Reports	2
C. Annual Statements	2
D. Financial Audits	3
E. May 2010 Performance Audit	3
F. DORA Reviews.....	4
III. Pinnacol’s Response to the May 2010 Performance Audit.....	5
A. State Auditor’s Findings, Conclusions, & Recommendations.....	5
B. Pinnacol’s Revision to its Travel & Entertainment Policies	6
C. Pinnacol’s Compliance with Its New Travel & Expense Policies	8
IV. Appropriateness of Pinnacol Board Member/Sr. Management Expenses	10
V. Agent Incentive Trip Costs.....	11
A. Pinnacol Club History	11
B. Agent Incentive Trip Historic Costs	12
C. Industry Information	12
D. Changes in Attendees from 2003 to 2010	14
E. Factors Causing Agent Incentive Trip Cost Increases	14
F. Potential Excessive Pinnacol Club Costs	16
G. Observations and Recommendations	17
 Appendices	
GHP Horwath’s Forensic Analysis (Appendix A)	A

I. INTRODUCTION

GHP HORWATH, P.C. (“GHP Horwath”) has been retained by Pinnacol Assurance (“Pinnacol”) to provide forensic analysis and accounting services to the Special Task Force Committee (“the Committee”) for Pinnacol. The Committee was established by the Pinnacol board of directors (collectively, “the Board” and individually, “board members”) ...*to assist the board in fulfilling its oversight responsibilities...The purpose of the Special Task Force Committee (the “Committee”) is to perform a general review of the agent incentive trip in May 2010 and other relevant matters and provide a report to the Governor...*¹ Our scope of work as specifically requested by the Committee was as follows:

- A. Read and analyze certain third-party audits of Pinnacol, and provide a summary of Pinnacol’s financial results and the third-party auditors’ conclusions regarding the financial performance and stability of Pinnacol (“*Pinnacol Financial Performance and Stability*”).
- B. Follow-up on Pinnacol’s response to the Office of the State Auditor’s (“State Auditor”) May 2010 Performance Audit travel & expense report findings, conclusions, and recommendations (“*Pinnacol’s Response to the May 2010 Performance Audit*”).
- C. Analyze board Member and senior management travel and expense reports for appropriateness (“*Appropriateness of Pinnacol Board Member and Senior Management Expenses*”).
- D. Analysis of agent incentive trip costs (“*Agent Incentive Trip Costs*”).

This report summarizes GHP Horwath’s procedures performed and conclusions reached as of May 24, 2011. To the extent that there are events that occur and/or additional documentation or information is provided subsequent to our report issuance that may affect our conclusions, we reserve the right to revise and/or supplement this report. The procedures we performed are summarized within each of the four sections that follow.

¹ Special Task Force Committee Charter, p. 1.

II. PINNACOL FINANCIAL PERFORMANCE AND STABILITY

A. SCOPE OF WORK

As stated previously in *Section I* to this report, we were requested by the Committee to read and analyze certain third-party audits of Pinnacol, and provide a summary of Pinnacol's financial results and the third-party auditors' conclusions regarding the financial performance and stability of Pinnacol. The specific audits and annual statements that we read and analyzed are as follows:

1. Ernst & Young LLP's ("E&Y") Internal Audit Reports for 2009 and 2010 ("E&Y Internal Audit Reports");
2. Annual Statements for 2007 to 2009;
3. 2006 and 2007 Financial Audits Performed by KPMG LLP ("KPMG") and 2008 to 2010 Financial Audits Performed by Deloitte & Touche, LLP ("Deloitte") (collectively, "Financial Audits");
4. The State Auditor's May 2010 Performance Audit ("May 2010 Performance Audit"); and,
5. The Colorado State Department of Insurance's ("DORA") Reviews for 2007 to 2009 ("DORA Reviews").

B. E&Y INTERNAL AUDIT REPORTS

During the years 2009 through 2010, E&Y provided internal audit services to Pinnacol that covered various implementation and internal control objectives that had been identified by the Pinnacol audit committee through an internal audit program and established by the Board. E&Y made various recommendations to which the audit committee was able to respond, however, E&Y did not raise any concerns regarding Pinnacol's financial performance and/or stability.

C. ANNUAL STATEMENTS

Annual statements issued to the Insurance Department of the State of Colorado for the years 2006 through 2010 raised no concerns regarding the financial performance and/or stability of Pinnacol for those periods. *Figure 1* below is a summary of Pinnacol's results from operations and financial position for the years 2006 through 2010, as set forth in the Annual Statements:

Figure 1:²

\$	2006	2007	2008	2009	2010
Net Admitted Assets	2,011,005,045	2,141,126,744	2,090,100,699	2,016,666,435	1,978,763,805
Unassigned Funds (Surplus)	607,473,454	722,072,212	698,000,992	732,527,187	548,119,400
Premiums Earned	588,376,311	567,283,531	521,081,899	398,502,463	344,611,658
Net Income(loss)	117,322,621	109,229,774	86,018,591	(91,230,526)	(121,568,538)
<i>Net Income(loss) as a % of Premiums Earned</i>	19.9%	19.3%	16.5%	N/A	N/A
% Change from Prior Year		2007	2008	2009	2010
Net Admitted Assets		6%	-2%	-4%	-2%
Unassigned Funds (Surplus)		19%	-3%	5%	-25%
Premiums Earned		-4%	-8%	-24%	-14%
Net Income(loss)		-7%	-21%	-206%	33%

D. FINANCIAL AUDITS

The financial audits performed by KPMG and Deloitte issued to the Legislative Audit Committee and to Pinnacol's Board made various recommendations related to the internal controls of Pinnacol (e.g., *Pinnacol should improve its information technology general controls, Pinnacol should establish a process and thoroughly test any new system to ensure payments are processed correctly prior to implementation, etc.*). The financial audits did not raise any concerns regarding the financial performance and/or stability of Pinnacol for the periods audited or any previous period. Additionally, Pinnacol's operating results and financial position as set forth in the Financial Audits were materially the same as the operating results and financial position set forth in Pinnacol's Annual Statements and summarized in *Figure 1* above.

E. MAY 2010 PERFORMANCE AUDIT

The May 2010 Performance Audit conducted by the State Auditor outlined various findings related to Pinnacol's executive compensation practices, Pinnacol's premiums, reserves, and surplus practices, injured workers' claims experience, and Pinnacol's travel and entertainment policies. The May 2010 Performance Audit did not raise any concerns regarding Pinnacol's financial performance or stability. See our separate analysis of Pinnacol's Response to the State Auditor's travel and entertainment related findings and recommendations as set forth in the May 2010 Performance Audit in *Section III* to this report, which follows.

² Net admitted assets are total assets less non-admitted assets. Admitted assets are defined by Investopedia (<http://www.investopedia.com/terms/a/admitted-assets.asp>) as *Assets of an insurance company that are permitted by state law to be included in the company's financial statements... Admitted assets generally include assets that are liquid and whose value can be assessed, or receivables that can reasonably be expected to be paid...*

F. DORA REVIEWS

It is our understanding that DORA reviews are not available for 2007 and 2008. We have, however, read and analyzed the 2009 DORA review. The purpose of the 2009 DORA review was to opine as to the accuracy of Pinnacol's 2009 Annual Statement. The DORA report stated the following:

The results of this examination disclosed that as of December 31, 2009, the Company had admitted assets of \$2,016,666,435, liabilities of \$1,284,139,248 and capital and surplus of \$732,527,187. As a result of this examination, there was no adjustment to the capital and surplus, as reported in the Company's 2009 Annual Statement.

The DORA report did not raise any concerns regarding Pinnacol's financial performance and/or stability.

III. PINNACOL'S RESPONSE TO THE MAY 2010 PERFORMANCE AUDIT

We were requested by the Committee to (A) determine the State Auditor's findings, conclusions, and recommendations (with respect to travel and entertainment expenses) in the May 2010 Performance Audit; (B) read and analyze Pinnacol's new travel and expense policies, identify significant changes, and conclude as to the new policies' responsiveness to the May 2010 Performance Audit; and (C) analyze Pinnacol's 2011 expense reports to-date for board members, officers, and other key employees for compliance with the new travel and expense policies.

A. STATE AUDITOR'S FINDINGS, CONCLUSIONS, & RECOMMENDATIONS

The Office of the State Auditor ("State Auditor") reviewed Pinnacol's controls over travel and entertainment expenses and performed audit work from June 2009 through May 2010.³ The State Auditor found weaknesses in Pinnacol's policies and controls over (1) travel and entertainment expenses and (2) third-party payments made on behalf of Pinnacol personnel and Board members. With respect to travel and entertainment expenses, the State Auditor also found that 45 of its sample of 60 travel and entertainment expenses Pinnacol approved for staff and Board members did not comply with one or more of Pinnacol's own travel and entertainment expense policies. The State Auditor concluded that the *...routine reimbursement of expenses that violate Pinnacol's expense policies renders the policies virtually meaningless as controls over spending on travel and entertainment...* Additionally, the State Auditor determined that Pinnacol had not established firm limits on lodging and non-business meal expenses.⁴ Exceptions included unallowable expenses such as alcohol purchases when a business partner was not being entertained, no proof of payment for expenses in excess of \$50, missing evidence of prior approval or expense justification, missing information regarding business topic and incomplete information regarding attendees, and erroneous account coding.⁵

The State Auditor also concluded that *...the fact that 75 percent of the sample we tested contained violations of the travel and entertainment expense policies borders on abuse under Government Auditing Standards...* The State Auditor defined abuse as *...behavior that is deficient or improper when compared with behavior that a prudent person would consider a reasonable and necessary business practice given the facts and circumstances...*⁶ The State Auditor provided the following recommendations regarding travel and entertainment expenses, which Pinnacol management agreed to implement by December 2010:

³ May 2010 Pinnacol Assurance Performance Audit ("May 2010 Audit"), p. 1.

⁴ May 2010 Audit, pp. 4-5.

⁵ May 2010 Audit, pp. 82-85.

⁶ May 2010 Audit, p. 85.

- *...Adhere to established policies over travel and entertainment expenses by (a) establishing a meaningful review process to enforce all policy requirements and disciplining managers that do not uphold policies, and (b) implementing a policy that requires an independent review of Board member and CEO travel and entertainment expenses.*⁷
- *Strengthen controls over lodging and non-business meal expenses by establishing clear “not to exceed” spending guidelines in the expense policies and requiring employees and Board members to follow the guidelines.*⁸

With respect to third-party payments made on behalf of Pinnacol personnel and Board members, the State Auditor observed that all of Pinnacol’s executives and about half of its Board members received gifts and/or travel and entertainment expenses paid by third parties between January 1, 2008, and September 30, 2009. The State Auditor could not determine the total amount of such expenses for executives and Board members because Pinnacol’s policies did not clearly define, or require tracking of, gifts or third-party expenses that employees and Board members must disclose.⁹ The State Auditor recommended that Pinnacol strengthen its *employee and Board business ethics and conflict of interest policies by defining the type and dollar value of gifts, benefits, or expenses paid by Pinnacol’s business partners that employees and Board members must disclose*. Pinnacol’s management agreed to implement this recommendation by December 2010.¹⁰

B. PINNACOL’S REVISION TO ITS TRAVEL & ENTERTAINMENT POLICIES

In response to the May 2010 Audit, Pinnacol developed two new policies. The revised policies and their effective dates are as follows:

- Travel And Expense Reimbursement Policy – Board Of Directors And Committee Members (“Board Travel Policy”) (Effective December 1, 2010)
- Travel And Expense Reimbursement Policy (“Employee Travel Policy”) (Effective January 25, 2011)

⁷ Specifically, the State Auditor recommended that Pinnacol establish policies to require the Board or a designated Board member to review the CEO’s expenses and require the Board Chair to review Board member expenses. (May 2010 Audit, p. 85).

⁸ May 2010 Audit, p. 8.

⁹ May 2010 Audit, p. 5.

¹⁰ May 2010 Audit, p. 9.

1. Board Travel Policy

As stated previously, the State Auditor recommended that Pinnacol establish policies to require the Board or a designated Board member to review the CEO's expenses and require the Board Chair to review Board member expenses.¹¹ Also, as noted above, the State Auditor recommended that Pinnacol strengthen controls over lodging and non-business meal expenses by establishing clear "not to exceed" spending guidelines and requiring employees and Board members to follow the guidelines.¹² With respect to Board member expense reports, the Board Travel Policy stated: *...Board Members' expense reports will be reviewed for processing by the CEO. On a quarterly basis, the Chair of the Audit Committee will review and approve the processed expense reports and any adjustments noted will be corrected by the Board Member. The Chairman of the Board will review and approve the expense reports submitted by the Chair of the Audit Committee. Items reviewed include:*

- *Business purpose*
- *Accuracy of totals*
- *Supporting documentation and receipts*
- *Policy compliance*
- *Appropriateness in relationship to budget*

The Finance department will periodically review reports for compliance and report any issues to the Board Member for correction. Inaccurate and/or incomplete expense reports will be returned for correction and may cause a delay in reimbursement... The Board Travel Policy also states that inaccurate and/or incomplete expense reports will be returned for correction and may cause a delay in reimbursement.¹³

The Board Travel Policy also addresses requirements and restrictions for receipts, air travel, lodging rates, non-reimbursable travel expenses, telephone and internet usage while traveling, ground transportation, business meals and entertainment, use of personal auto for business purposes, other reimbursable expenses, and other non-reimbursable expenses.

With respect to lodging costs, the Board Travel policy stated *...Nightly hotel rates should not exceed \$141 per night, exclusive of applicable taxes and fees. If a rate higher than \$141 per night is incurred, the Board Member must explain the reason in the expense report...*¹⁴

¹¹ May 2010 Audit, p. 85.

¹² Specifically, the State Auditor recommended that Pinnacol establish policies to require the Board or a designated Board member to review the CEO's expenses and require the Board Chair to review Board member expenses. (May 2010 Audit, p. 85).

¹³ Board Travel Policy, p. 3.

¹⁴ Board Travel Policy, p. 4.

In our opinion based on our reading and analysis of the May 2010 Audit and our accounting and auditing experience, the Board Travel Policy adequately incorporates the recommendations of the State Auditor.

2. Employee Travel Policy

As stated previously, the State Auditor recommended that Pinnacol establish a meaningful expense report review process to enforce all policy requirements. The State Auditor also recommended that Pinnacol strengthen controls over lodging and non-business meal expenses by establishing clear “not to exceed” spending guidelines and requiring employees and Board members to follow the guidelines.¹⁵ The Board Travel Policy has already been addressed in the previous section of this report.

With respect to employee expense reports, the Employee Travel Policy has similar restrictions and requirements as the Board Travel Policy except that it requires manager approval of employee expense reports. The Employee Travel Policy also requires the Chair of the Audit Committee to review the CEO’s expense report and states that inaccurate and/or incomplete expense reports will be returned for correction and may cause a delay in reimbursement.¹⁶

The Employee Travel Policy also addresses requirements and restrictions for receipts, air travel, lodging rates, non-reimbursable travel expenses, telephone and internet usage while traveling, ground transportation, business meals and entertainment, use of personal auto for business purposes, other reimbursable expenses, and other non-reimbursable expenses.

With respect to lodging costs, the Employee Travel policy stated *...Nightly hotel rates should not exceed \$141 per night, exclusive of applicable taxes and fees. If a rate higher than \$141 per night is incurred, the employee must explain the reason in the expense report...*¹⁷

In our opinion based on our reading and analysis of the May 2010 Audit and our accounting and auditing experience, the Employee Travel Policy adequately incorporates the recommendations of the State Auditor.

C. PINNACOL’S COMPLIANCE WITH ITS NEW TRAVEL & EXPENSE POLICIES

GHP Horwath analyzed approximately 700 expenses in expense reports for board members and senior management for the months of January 2011 to March 2011 for compliance with the new travel and expense policies. Of the approximately 700 expenses that we analyzed, we noted 13

¹⁵ Specifically, the State Auditor recommended that Pinnacol establish policies to require the Board or a designated Board member to review the CEO’s expenses and require the Board Chair to review Board member expenses. (May 2010 Audit, p. 85).

¹⁶ Employee Travel Policy, p. 4.

¹⁷ Employee Travel Policy, p. 6.

exceptions where the new travel and expense policies were not properly adhered to. These exceptions are summarized as follows:

- In four instances, Pinnacol employees stayed at hotels with nightly room rates exceeding \$141 but did not provide the explanation in the expense report as to why the room rates exceeded \$141;¹⁸
- In five instances, employees incurred expenses that exceeded \$50 but failed to provide a receipt;
- In three instances, the required breakdown of mileage was not provided; and,
- In one instance, an employee miscalculated the amount of her mileage reimbursement and as a result was reimbursed \$9.18 more than she should have been.

We also examined each expense report and the information provided by Pinnacol regarding approvals to determine if the expense report had the proper approval and all expense reports that we examined were approved by the appropriate person.

Based on the above results of our testing, it is our opinion that Pinnacol has significantly improved its internal controls and approval process since the May 2010 Performance Audit. While there were still exceptions (13 out of approximately 700 or less than two percent), the exception rates noted in the May 2010 Performance Audit were substantially higher.

¹⁸ It should be noted that three of the four expenses pertained to initial deposits for hotel costs at a conference. In these situations the conferences had not yet occurred and the explanation of the reason why the hotel cost per night exceeded \$141 may be forthcoming in a subsequent expense report. For one of the expenses, however, the expense was for lodging that occurred in February 2011 and there was no explanation provided for the higher hotel rate.

IV. Appropriateness of Pinnacol Board Member/Sr. Management Expenses

GHP Horwath analyzed approximately 10,700 expenses in expense reports for board members and senior management for the period from August 2006 to March 2011 for expenses involving board members or expenses involving potentially excessive expenses. The results of our analysis are summarized as follows:

- We noted 14 expenses by employees for meals and entertainment (excluding Pinnacol Club trips) that involved board members and agents or other guests that may or may not be agents.
- We noted 71 expenses for employees that involved meals and/or entertainment with board members. The total cost of these expenses was \$5,228. The majority of these expenses appeared to be for business meals. Of these expenses, 6 were for meals where the cost per person exceeded \$50 with a cost of \$106 per person in one instance and an average cost of \$76 per person.
- There were six expenses for employees totaling \$1,300 for gift cards or other gifts for board members and one expense totaling \$1,609 for Kindle wireless reading devices that were referred to in the expense report as “gifts for executive team.” We understand based on representations by Pinnacol’s board of directors that these Kindle gifts were reported as additional compensation for the recipients.
- There were nine expenses for Pinnacol events such as holiday celebrations or management/board retreats totaling \$20,110.

There were limited instances of board member travel and instances of reimbursements of board member mileage. None of these expenses appeared unreasonable and we noted no other expenses that may be unreasonable other than those noted above.

V. AGENT INCENTIVE TRIP COSTS

See Analysis in Appendix A

As stated previously in *Section I* to this report, we were requested by the Committee to analyze the Agent Incentive Trip costs. Agent incentive trips consist primarily of Pinnacol Club trips, Peak Performers trips, and other various incentive trips. Our analysis, which varied in scope by year because of the availability of information, was for the years 2003 through 2010. Our scope of work included (A) discussions with Don Collins, Pinnacol's Chief Marketing Officer & VP of Communications, regarding the history of the Pinnacol Club trips; (B) an analysis of Agent Incentive Trip historic costs from 2003 to 2010; (C) obtaining comparative industry information from the Ward Group for the years 2004 to 2009; (D) analyzing changes in the number and composition of attendees from 2003 to 2010; (E) analyze primary factors causing Agent Incentive Trip cost increases; and, (F) identify costs incurred by Pinnacol for potentially excess costs such as spa charges, excessive meal and wine costs, etc.

A. PINNACOL CLUB HISTORY

According to Mr. Collins, the Pinnacol Club trips began in 1999 following a change to begin using independent agents in 1997 or 1998. Pinnacol subsequently underwent an organization change to operate as a mutual insurance company with a focus on attracting and retaining business through customer service and retention of agents. According to Mr. Collins, agents have historically generated 87 percent of Pinnacol's premium business and 76 percent of its customers made their purchasing decision based upon a recommendation from their agent.

Pinnacol's independent agents, all located in Colorado, also contract with other insurance carriers who give incentive trips. This was confirmed in teleconferences with two of Pinnacol's independent agents. According to one of the agents, agents are typically awarded between five and eight trips per year in addition to the Pinnacol Club trip and the trip lengths are typically between three and six days. Pinnacol's objective in planning trips is to attract its top agents for a short trip (approximately five days) that is within a relatively close proximity to Colorado. Attendees of trips have historically included guests as well as representatives from the agents and Pinnacol. Pinnacol's requirements for agents to be awarded Pinnacol Club trips is total business of \$10 million, new business of \$1 million, a retention ratio of at least 90 percent, and a loss ratio not exceeding 55 percent. According to the agents interviewed, these requirements by Pinnacol are more stringent than the requirements of other carriers for their agent incentive award trips.

Mr. Collins stated that agents wanted to interact with Pinnacol's board members and senior management during the trips and that typically the Board committee chairs attend the Pinnacol Club trips. During the Pinnacol Club trips, there are dinner or breakfast meetings almost every day and topics such as competition and the marketplace are discussed. Pinnacol marketing representatives who work with agents on achieving sales goals also attend the Pinnacol Club events. According to Mr. Collins, decisions regarding the trip location and extravagance are based on what is currently going on in the marketplace at the time. Mr. Collins stated that if the

Pinnacol Club trips were not offered there would be less incentive for agents to refer business to Pinnacol and there would be an adverse impact on the relationship as there are no other meetings in a year where agents are present.

B. AGENT INCENTIVE TRIP HISTORIC COSTS

2003 was the first year that Pinnacol captured all of its costs for the Pinnacol Club trip. In 2003, the total cost of the Pinnacol Club trip was \$131,068. By 2009 the total cost for the Pinnacol Club trip had increased 150 percent to \$327,615. The cost of the Pinnacol Club trip declined five percent from 2009 to 2010 to \$310,626. Significant years of increase were 2006, when the cost of the trip increased by approximately \$95 thousand and 2009 when the cost of the trip increased by approximately \$98 thousand. We also calculated Pinnacol Club costs as a percentage of premium revenue and determined that the Pinnacol Club costs increased 237 percent from 0.027 percent in 2003 to 0.090 percent in 2010.

Information was available for Peak Performers and other agent incentive trips for 2004 through 2010. The costs varied every year and ranged from a high of \$147,221 in 2008 to a low of \$10,600 in 2009. There were no agent incentive trips in 2010 other than the Pinnacol Club trip. Total agent incentive trip costs increased 188 percent between 2003 and 2008 and peaked at a total cost of \$377,237 before declining 10 percent in 2009 and another eight percent in 2010. See detailed analysis at *Schedule 1* to *Appendix A*.

C. INDUSTRY INFORMATION

The Ward Group is a consulting firm that focuses solely on the insurance industry and is a leading provider of industry benchmarking information as well as other information. Pinnacol engaged the Ward group to analyze industry trends for independent agency incentive trips as well as provide other information. The Ward Group analysis of comparative industry information included two industry groups: workers compensation companies (12 companies, 9 of which are affiliated with state government) and commercial lines companies (35 companies of which 30 percent of their book of business is workers compensation). Ward Group's analysis of agent incentive trips addressed the following questions:

1. How prevalent are incentive trips in the insurance industry and what are typical destinations?
2. How much do these trips cost on average?
3. What company personnel typically attend these trips with the agents?

1. Prevalence of Incentive Trips and Trip Destinations

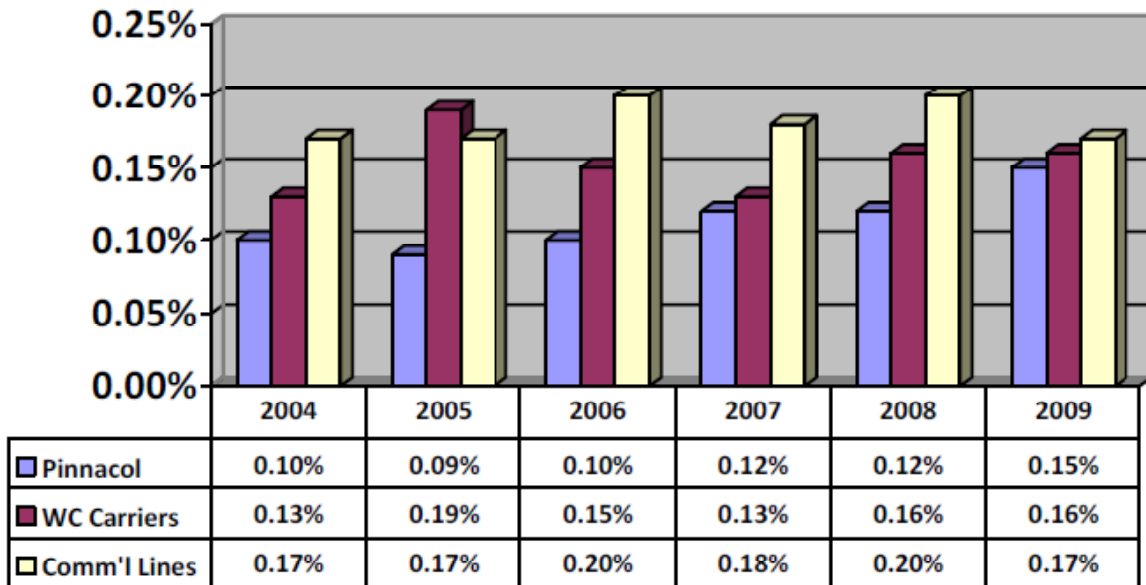
According to the Ward Group analysis the percentage of workers compensation companies that held an agency incentive trip declined from 55 percent in 2004 to 51 percent in 2009. For commercial lines companies, the percentage of companies that held agency incentive trips declined from 59 percent in 2004 to 52 percent in 2009. Even with the decline, most companies currently hold agency incentive trips. The vast majority of trips (84 percent in 2004 and 74 percent in 2009) were to domestic locations. As discussed previously, based on discussions with two of Pinnacol’s independent agents, other carriers also offer incentive trips. International trips, if any, tended to be to Mexico or the Caribbean.

2. Average Cost of Trips as a Percentage of Premiums

Figure 2 below, which is excerpted from the Ward Group analysis, presents agent trip costs as an average percent of premiums for Pinnacol, workers compensation carriers, and commercial line carriers for the years 2004 through 2009.¹⁹ The costs stated for Pinnacol include all agent related costs, not just costs for the Pinnacol Club trips.

Figure 2

Agent trip expense as a % of written premium



¹⁹ Ward Group April 15, 2011 Report, p. 2.

As *Figure 2* indicates, Pinnacol's total agent incentive trip costs (including other trips such as golf or sporting event outings), as a percentage of premiums, were consistently lower than industry averages.

3. Who Attends the Trips from Carriers

According to the Ward Group analysis, typical carrier personnel who attend the trips include *...the President/CEO, COO, VP of Sales & Marketing, VP of Underwriting, and a few of the top Marketing/Agency Management personnel (regional VPs, field VPs, etc.). The ratio of agents to company personnel is usually around 5-8 agents per company personnel. Board members usually do not attend the trips.*²⁰ The independent agents that GHP Horwath interviewed both confirmed that board members typically do not attend agent incentive trips and that there are typically more agents than representatives from the carrier. With the exception of Colorado Casualty, which has approximately the same number of company personnel as agents, the ratio for other carriers is typically two to three agents per company representative.

D. CHANGES IN ATTENDEES FROM 2003 TO 2010

While the total number of agent attendees at Pinnacol Club events, including guests, have not changed significantly from 2003 to 2010 (from 18 to 20 with 18 attending most years), the number of Pinnacol attendees has increased 35 percent from 37 attendees, including guests, in 2003 to 50 attendees with guests in 2010. The primary reason for the increase in Pinnacol attendees has been the increase in marketing representatives (from 10 in 2003 to between 13 and 15 in the years 2004 to 2009 and 17 in 2010) and board members (from 1 in 2003 to eight in the years 2005 to 2008 and a high of 10 in 2009). In 2003, there were 19 Pinnacol attendees and 18 agent attendees or approximately one Pinnacol attendee for each agent attendee. By 2010, there were 20 agent attendees and 30 Pinnacol attendees or 1.5 Pinnacol attendees for each agent attendee.

Attendees for other agent incentive trips fluctuated each year as did the costs. Total agent attendees peaked at 46 attendees in 2008 and total Pinnacol attendees peaked at 55 attendees in 2009. Average agent attendees from 2004 to 2009 were 38 attendees and average Pinnacol attendees for the same period were 45 attendees resulting in an average ratio of 1.2 Pinnacol attendees for each agent attendee.

E. FACTORS CAUSING AGENT INCENTIVE TRIP COST INCREASES

The two primary factors causing increases in the cost of the Agent Incentive Trip trips are (1) the number of attendees and (2) the cost of the trip per attendee.

²⁰ Ward Group April 15, 2011 Report, p. 2.

1. Impact of Number of Attendees on Costs

As noted previously, according to the Ward Group analysis, on agent incentive trips ... *The ratio of agents to company personnel is usually around 5-8 agents per company personnel...*²¹ In addition, according to the two Pinnacol's independent agents we interviewed, their experience with other carriers was that there was never more than one company representative per agent and typically two to three agents per company representative. In 2003 there was approximately one Pinnacol representative for each agent. By 2010 there were 1.5 company representatives per agent. Therefore, the portion of the Agent Incentive Trip cost attributable to Pinnacol increased by 50 percent from 2003 to 2010 as the relative number of Pinnacol representatives increased by approximately 50 percent. By way of example, 20 agents and guests attended the 2010 Pinnacol Club trip at Pebble Beach, California and 30 Pinnacol representatives and guests attended. If the ratio of Pinnacol representatives to agents was reduced to 1:1, 20 Pinnacol representatives and guests would have attended. At an average trip cost of \$6,213 per attendee, a reduction of 10 attendees (including guests) from Pinnacol would have reduced the cost of the 2010 Pinnacol Club trip by \$62,130 or 20 percent of the total 2010 cost of \$310,626. Stated another way, 35 percent of the increase in the cost of the Pinnacol Club trips from 2003 to 2010 can be attributed to the increase in the ratio of Pinnacol Club representatives to agents from 2003 to 2010.²² As noted previously, the ratio of Pinnacol attendees to agent attendees for 2004 to 2009 was 1.2 for all incentive trips combined, which still exceeds the typical ratio of carrier attendees to agent attendees in the industry based on the Ward Group study and our discussions with Pinnacol's agents.

2. Increase in the Cost per Attendee

In addition to the increase in the Agent Incentive Trip cost being attributable to an increase in attendees, the cost of the Pinnacol Club trip per attendee also increased significantly. The cost per attendee was \$3,542 in 2003 and almost doubled by 2009 to \$6,971 before decreasing 11 percent to \$6,213 in 2010. While a portion of the increase can be attributable to inflation, the cost of airfare and lodging increased only 21 percent and 18 percent respectively from 2003 to 2010.²³ Therefore, just over 25 percent of the increase in the cost per attendee can be attributable to inflation.²⁴ Given that the total cost of agent related trips at Pinnacol as a percentage of premiums has been less than industry averages and given the types of trips that other carriers offer to agents (e.g., Alaskan cruise, Grand Cayman Islands, Torrey Pines, etc.)²⁵, the increase in the cost per attendee may be attributable to Pinnacol improving the venue and amenities of its trips to be more comparable to trips offered by other carriers. Because the scope and cost of other agent incentive trips varied significantly from year to year it is not possible to meaningfully

²¹ Ward Group April 15, 2011 Report, p. 2.

²² \$62,130/\$179,558 (2010 cost of \$310,626 less the 2003 cost of \$131,068).

²³ Consumer price index for airfare and Host Study (average revenue per rented room) for lodging.

²⁴ Midpoint of 2003 to 2010 increase in airfare and lodging (19.5 percent) divided by 75 percent increase in the Pinnacol Club cost per attendee during the same period equals 26 percent.

²⁵ Discussions with Pinnacol's independent agents.

analyze the cost per attendee of other agent incentive trips. In total, the average cost of attendee for all agent incentive trips during the period 2004 to 2009 varied from a low of \$1,972 in 2005 to a high of \$3,930 in 2008 with an overall average of \$3,012.

F. POTENTIAL EXCESSIVE PINNACOL CLUB COSTS

In addition to our other analyses of the Pinnacol Club costs, we were requested to determine the extent to which the Pinnacol Club costs, especially for Pinnacol representatives, included what may be viewed by some as “excessive” costs. The categories of these costs included spa charges, massage charges, overly expensive bottles of wine, etc. In our analysis of the Pinnacol expense reports we did not note any costs that might be classified as excessive costs at Pinnacol Club trips.

We also analyzed the itemized invoices from the resorts where the Pinnacol Club events were held for potentially excessive costs. Pinnacol was able to provide us these invoices for the period 2006 to 2010. Detailed invoices were provided for 2009 and 2010 which indicated room and taxes, food and beverage, recreation, spa, telephone, and other retail costs by person. Based on our detailed reading and analysis of the food and beverage invoices, it did not appear as if any overly expensive bottles of wine (i.e., over \$100 per bottle) were purchased. Spa costs in total and per attendee for board members Pinnacol employees, and agents are summarized below in *Figure 3* for 2009 and 2010.

Figure 3

	2010		2009	
	Spa Costs	Spa Cost per Attendee	Spa Costs	Spa Cost per Attendee
Board Members	\$ 910.40	\$ 151.73	\$ 3,715.00	\$ 371.50
Pinnacol Employees	8,415.41	350.64	4,806.00	252.95
Agents	4,218.18	210.91	4,835.00	268.61
Total	\$ 13,543.99	\$ 270.88	\$ 13,356.00	\$ 284.17

Spa costs were not broken out by person for prior years. Total spa costs for 2008 were \$15,202 or \$338 per attendee. Spa costs were not available for 2006 and 2007.

G. OBSERVATIONS AND RECOMMENDATIONS

Based on the analyses summarized in sections *V.A.* through *V.F.* above, it is our conclusion that while the total cost of the Pinnacol Club trips and Pinnacol's agent related trips as a whole are in line with industry averages, it appears as if there may be too many Pinnacol representatives at the Pinnacol Club events for the number of agents that are invited and that it may not be necessary for board members to attend. As noted previously, if Pinnacol limited the number of its representatives so that the agent to Pinnacol representative ratio was 1:1, Pinnacol could reduce the cost of its Pinnacol Club trips by approximately 20 percent.

Therefore, in order to better control its costs for the Pinnacol Club trips and maximize the incentives it provides to agents, we recommend that Pinnacol consider determining the number of Pinnacol representatives that attend Pinnacol Club events based on targeted agent to Pinnacol representative ratios of between 1:1 and 2:1.

APPENDIX A
GHP Horwath's Forensic Analysis

Pinnacol Assurance

Analysis of Agent Incentive Trip Costs for 2003 through 2010

	Note Ref.	2002	2003	2004	2005	2006	2007	2008	2009	2010
Premiums Earned	[A]	\$ 470,119,000	\$ 490,108,000	\$ 515,471,000	\$ 566,470,000	\$ 588,376,000	\$ 567,283,531	\$ 521,081,899	\$ 398,502,463	\$ 344,611,658
Payroll Insured	[B]	17,541,225,981	18,436,428,585	20,352,872,704	20,955,418,110	21,913,995,916	23,341,110,597	23,718,423,125	22,700,623,927	22,835,796,870
Average Premium Percentage			2.658%	2.533%	2.703%	2.685%	2.430%	2.197%	1.755%	1.509%
Pinnacol Club Trip Cost	[B]		\$ 131,068	\$ 109,312	\$ 110,000	\$ 204,798	\$ 221,572	\$ 230,016	\$ 327,615	\$ 310,626
Other Agent Incentive Trip Cost	[B]		N/A	51,161	30,000	63,354	18,569	147,221	10,600	N/A
Total Agent Incentive Trip Cost			\$ 131,068	\$ 160,474	\$ 140,000	\$ 268,152	\$ 240,141	\$ 377,237	\$ 338,215	\$ 310,626
Percent Change from Prior Year			22%	-13%	92%	-10%	57%	-10%	-8%	
Percent Change Since 2003			22%	7%	105%	83%	188%	158%	137%	
Agent Incentive Trip Cost as a Percent of Premiums Earned			0.027%	0.031%	0.025%	0.046%	0.042%	0.072%	0.085%	0.090%
Percent Change from Prior Year			16%	-21%	84%	-7%	71%	84%	6%	
Percent Change Since 2003			16%	-8%	70%	58%	171%	217%	237%	
Ward Group Workers Compensation										
Percent of Premium Industry Averages	[C]									
Pinnacol			N/A	0.100%	0.090%	0.100%	0.120%	0.120%	0.150%	N/A
Workers' Compensation Carriers			N/A	0.130%	0.190%	0.150%	0.130%	0.160%	0.160%	N/A
Commercial Lines			N/A	0.170%	0.170%	0.200%	0.180%	0.200%	0.170%	N/A
Agent Incentive Trip Cost as a Percent of Payroll Insured			0.0007%	0.0008%	0.0007%	0.0012%	0.0010%	0.0016%	0.0015%	0.0014%
Percent Change from Prior Year			11%	-15%	83%	-6%	55%	63%	-9%	
Percent Change Since 2003			11%	-6%	72%	45%	124%	110%	91%	
Agent Incentive Trip Cost as a Percent of Prior Year Premiums Earned			0.028%	0.033%	0.027%	0.047%	0.041%	0.066%	0.065%	0.078%
Percent Change from Prior Year			17%	-17%	74%	-14%	63%	-2%	20%	
Percent Change Since 2003			17%	-3%	70%	46%	139%	133%	180%	
Agent Incentive Trip Cost as a Percent of Prior Year Payroll Insured			0.0007%	0.0009%	0.0007%	0.0013%	0.0011%	0.0016%	0.0014%	0.0014%
Percent Change from Prior Year			16%	-21%	86%	-14%	47%	-12%	-4%	
Percent Change Since 2003			16%	-8%	71%	47%	116%	91%	83%	
Pinnacol Attendees, Including Guests	[B]		19	38	34	47	43	50	55	30
Percent Change from Prior Year				100%	-11%	38%	-9%	16%	10%	-45%
Percent Change Since 2003				100%	79%	147%	126%	163%	189%	58%
Agent Attendees, Including Guests	[B]		18	41	37	41	32	46	32	20
Percent Change from Prior Year				128%	-10%	11%	-22%	44%	-30%	-38%
Percent Change Since 2003				128%	106%	128%	78%	156%	78%	11%
Total Attendees, Including Guests	[B]		37	79	71	88	75	96	87	50
Percent Change from Prior Year				114%	-10%	24%	-15%	28%	-9%	-43%
Percent Change Since 2003				114%	92%	138%	103%	159%	135%	35%
Cost per Attendee			\$ 3,542	\$ 2,031	\$ 1,972	\$ 3,047	\$ 3,202	\$ 3,930	\$ 3,888	\$ 6,213
Percent Change from Prior Year				-43%	-3%	55%	5%	23%	-1%	60%
Percent Change Since 2003				-43%	-44%	-14%	-10%	11%	10%	75%
Airfare CPI	[D]	\$ 231.60	\$ 231.30	\$ 227.20	\$ 236.60	\$ 247.30	\$ 251.69	\$ 282.00	\$ 279.22	\$ 280.43
Percent Change from Prior Year			0%	-2%	4%	5%	2%	12%	-1%	0%
Percent Change Since 2003				-2%	2%	7%	9%	22%	21%	21%
Host Study Average Revenue per Rented Room	[E]	\$ 82.68	\$ 82.80	\$ 86.26	\$ 91.06	\$ 97.96	\$ 104.23	\$ 107.15	\$ 97.86	\$ 98.08
Percent Change from Prior Year			0%	4%	6%	8%	6%	3%	-9%	0%
Percent Change Since 2003				4%	10%	18%	26%	29%	18%	18%

Notes:

[A] Pursuant to Pinnacol Assurance Annual Statements and/or financial statements.

[B] Pursuant to various spreadsheets and other supporting documentation provided by Pinnacol.

[D] Pursuant to the Agency Incentive Trip Analysis performed by Ward Group dated April 13, 2011.

[E] Pursuant to consumer price index tables located at <http://www.bls.gov/cpi/tables.htm> (Table 8A) for the years 2002 through 2010.

[F] Pursuant to the 2010 STR Host Study.

Pinnacol Assurance

Schedule 2

Pinnacol Club Trip Attendee Analysis

Source: Agent incentive trip annual summaries including list of attendees provided by Pinnacol.

	2003	2004	2005	2006	2007	2008	2009	2010
<u>Attendees, Including Guests</u>								
Agency Attendees	18	17	19	16	18	18	18	20
Pinnacol Attendees:								
Board Members	1	-	8	8	8	8	10	6
CEO	2	2	2	2	2	2	2	4
Chief Marketing Officer & VP of Communications	2	2	2	2	2	2	2	2
Vice President	2	2	2	2	2	2	2	-
Vice President of Business Operations & General Counsel	-	-	-	-	-	-	-	1
Marketing Representatives	10	13	14	14	15	13	13	17
Vice President of Underwriting	2	-	-	-	-	-	-	-
Total Pinnacol Attendees	19	19	28	28	29	27	29	30
Total Pinnacol Club Trip Attendees	37	36	47	44	47	45	47	50
<u>Attendees, Excluding Guests</u>								
Agency Attendees	9	9	10	8	9	10	9	11
Pinnacol Attendees:								
Board Members	1	-	4	4	4	4	5	3
CEO	1	1	1	1	1	1	1	1
Chief Marketing Officer & VP of Communications	1	1	1	1	1	1	1	1
Vice President	1	1	1	1	1	1	1	-
Vice President of Business Operations & General Counsel	-	-	-	-	-	-	-	1
Marketing Representatives	8	8	9	9	9	9	10	10
Vice President of Underwriting	1	-	-	-	-	-	-	-
Total Pinnacol Attendees	13	11	16	16	16	16	18	16
Total Pinnacol Club Trip Attendees	22	20	26	24	25	26	27	27

Pinnacol Assurance

Schedule 3
Other Incentive Trip Attendee Analysis

Attendees, Including Guests

Source: Other agent incentive trip costs and attendee information pursuant to documents provided by Don Collins.

	2003	2004	2005	2006	2007	2008	2009	2010
	[A]					[B]	[B]	[A]
Agency Attendees	-	24	18	25	14	28	14	-
Pinnacol Attendees	-	19	6	19	14	23	26	-
Total Pinnacol Club Trip Attendees	-	43	24	44	28	51	40	-

Notes:

[A] According to representations made by Pinnacol representatives, Pinnacol did not host any other agent incentive trips in 2003 or 2010.

[B] Detailed listings of attendees were not provided for the years 2008 and 2009.