

{ Consolidated Statements of Income }

	(millions—except per share amounts)		
For the years ended December 31,	2005	2004	2003
REVENUES			
Net premiums earned	\$ 13,764.4	\$ 13,169.9	\$ 11,341.0
Investment income	536.7	484.4	465.3
Net realized gains (losses) on securities	(37.9)	79.3	12.7
Service revenues	40.2	48.5	41.8
Other income ¹	—	—	31.2
Total revenues	14,303.4	13,782.1	11,892.0
EXPENSES			
Losses and loss adjustment expenses	9,364.8	8,555.0	7,640.4
Policy acquisition costs	1,448.2	1,418.0	1,249.1
Other underwriting expenses	1,312.2	1,238.6	1,010.1
Investment expenses	12.1	13.9	11.5
Service expenses	24.6	25.0	25.7
Interest expense	82.6	80.8	95.5
Total expenses	12,244.5	11,331.3	10,032.3
NET INCOME			
Income before income taxes	2,058.9	2,450.8	1,859.7
Provision for income taxes	665.0	802.1	604.3
Net income	\$ 1,393.9	\$ 1,648.7	\$ 1,255.4
COMPUTATION OF EARNINGS PER SHARE			
Basic:			
Average shares outstanding	196.9	212.9	216.8
Per share	\$ 7.08	\$ 7.74	\$ 5.79
Diluted:			
Average shares outstanding	196.9	212.9	216.8
Net effect of dilutive stock-based compensation	2.9	3.3	3.7
Total equivalent shares	199.8	216.2	220.5
Per share	\$ 6.98	\$ 7.63	\$ 5.69

¹See Note 3—Income Taxes for discussion.

See notes to consolidated financial statements.

{ Consolidated Balance Sheets }

	(millions)	
December 31,	2005	2004
ASSETS		
Investments—Available-for-sale, at market:		
Fixed maturities (amortized cost: \$10,260.7 and \$8,972.6)	\$10,221.9	\$ 9,084.3
Equity securities:		
Preferred stocks (cost: \$1,217.0 and \$749.4)	1,220.3	768.9
Common equities (cost: \$1,423.4 and \$1,314.0)	2,058.9	1,851.9
Short-term investments (amortized cost: \$773.5 and \$1,376.6)	773.6	1,376.9
Total investments	14,274.7	13,082.0
Cash	5.6	20.0
Accrued investment income	133.1	103.5
Premiums receivable, net of allowance for doubtful accounts of \$116.3 and \$83.8	2,500.7	2,287.2
Reinsurance recoverables, including \$58.5 and \$44.5 on paid losses	405.7	381.6
Prepaid reinsurance premiums	103.7	119.8
Deferred acquisition costs	444.8	432.2
Income taxes	138.3	—
Property and equipment, net of accumulated depreciation of \$562.0 and \$562.1	758.7	666.5
Other assets	133.3	91.5
Total assets	<u>\$18,898.6</u>	<u>\$17,184.3</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Unearned premiums	\$ 4,335.1	\$ 4,108.0
Loss and loss adjustment expense reserves	5,660.3	5,285.6
Accounts payable, accrued expenses and other liabilities	1,510.8	1,325.0
Income taxes	—	26.0
Debt ¹	1,284.9	1,284.3
Total liabilities	12,791.1	12,028.9
Shareholders' equity:		
Common Shares, \$1.00 par value (authorized 600.0; issued 213.1 and 213.2, including treasury shares of 15.8 and 12.8)	197.3	200.4
Paid-in capital	848.2	743.3
Unamortized restricted stock	(62.7)	(46.0)
Accumulated other comprehensive income:		
Net unrealized gains on securities	390.1	435.1
Net unrealized gains on forecasted transactions	8.6	9.7
Retained earnings	4,726.0	3,812.9
Total shareholders' equity	6,107.5	5,155.4
Total liabilities and shareholders' equity	<u>\$18,898.6</u>	<u>\$17,184.3</u>

¹Includes current and non-current debt. See *Note 4—Debt* for discussion.

See notes to consolidated financial statements.

{ Consolidated Statements of Changes in Shareholders' Equity }

(millions—except per share amounts)

For the years ended December 31,	2005	2004	2003
RETAINED EARNINGS			
Balance, Beginning of year	\$ 3,812.9	\$ 3,729.8	\$ 2,796.0
Net income	1,393.9	1,648.7	1,255.4
Cash dividends on Common Shares (\$.12, \$.11 and \$.10 per share)	(23.7)	(23.3)	(21.7)
Treasury shares purchased ¹	(457.0)	(1,542.4)	(297.5)
Other, net	(.1)	.1	(2.4)
Balance, End of year	\$ 4,726.0	\$ 3,812.9	\$ 3,729.8
ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX			
Balance, Beginning of year	\$ 444.8	\$ 425.0	\$ 169.3
Changes in:			
Net unrealized gains on securities	(45.0)	16.9	255.8
Net unrealized gains on forecasted transactions	(1.1)	(1.0)	(1.0)
Foreign currency translation adjustment	—	3.9	.9
Other comprehensive income	(46.1)	19.8	255.7
Balance, End of year	\$ 398.7	\$ 444.8	\$ 425.0
Comprehensive Income	\$1,347.8	\$1,668.5	\$1,511.1
COMMON SHARES, \$1.00 PAR VALUE			
Balance, Beginning of year	\$ 200.4	\$ 216.4	\$ 218.0
Stock options exercised	1.6	2.1	2.8
Treasury shares purchased ¹	(5.2)	(18.6)	(5.0)
Restricted stock issued, net of forfeitures	.5	.5	.6
Balance, End of year	\$ 197.3	\$ 200.4	\$ 216.4
PAID-IN CAPITAL			
Balance, Beginning of year	\$ 743.3	\$ 688.3	\$ 584.7
Stock options exercised	42.6	49.6	47.2
Tax benefits from exercise/vesting of stock-based compensation	41.2	44.3	44.0
Treasury shares purchased ¹	(20.6)	(67.5)	(14.3)
Restricted stock issued, net of forfeitures	41.7	27.3	26.7
Other	—	1.3	—
Balance, End of year	\$ 848.2	\$ 743.3	\$ 688.3
UNAMORTIZED RESTRICTED STOCK			
Balance, Beginning of year	\$ (46.0)	\$ (28.9)	\$ —
Restricted stock issued, net of forfeitures	(42.2)	(40.6)	(37.3)
Restricted stock market value adjustment	(8.2)	(.3)	(2.6)
Amortization of restricted stock	33.7	23.8	11.0
Balance, End of year	\$ (62.7)	\$ (46.0)	\$ (28.9)
Total Shareholders' Equity	\$ 6,107.5	\$ 5,155.4	\$ 5,030.6

¹Includes 16.9 million Common Shares purchased pursuant to a “Dutch auction” tender offer in 2004; these shares were purchased at a price of \$88 per share, for a total cost of \$1.5 billion.

There are 20.0 million Serial Preferred Shares authorized; no such shares are issued or outstanding.

There are 5.0 million Voting Preference Shares authorized; no such shares have been issued.

See notes to consolidated financial statements.

{ Consolidated Statements of Cash Flows }

	(millions)		
For the years ended December 31,	2005	2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	\$ 1,393.9	\$ 1,648.7	\$ 1,255.4
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	92.4	99.4	89.3
Amortization of fixed maturities	189.6	168.9	103.2
Amortization of restricted stock	33.7	23.8	11.0
Net realized (gains) losses on securities	37.9	(79.3)	(12.7)
Changes in:			
Unearned premiums	227.1	213.3	590.4
Loss and loss adjustment expense reserves	374.7	709.3	763.3
Accounts payable, accrued expenses and other liabilities	49.5	70.2	124.5
Prepaid reinsurance premiums	16.1	(5.1)	(18.0)
Reinsurance recoverables	(24.1)	(110.3)	(55.6)
Premiums receivable	(213.5)	(207.6)	(336.8)
Deferred acquisition costs	(12.6)	(19.9)	(48.8)
Income taxes	(140.0)	98.5	(1)
Tax benefits from exercise/vesting of stock-based compensation	41.2	44.3	44.0
Other, net	(71.9)	8.3	(72.2)
Net cash provided by operating activities	1,994.0	2,662.5	2,436.9
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchases:			
Fixed maturities	(9,154.4)	(6,686.3)	(9,491.6)
Equity securities	(852.9)	(678.3)	(771.2)
Short-term investments – auction rate securities	(7,935.3)	(6,890.1)	(4,044.4)
Sales:			
Fixed maturities	7,068.6	5,885.7	7,189.3
Equity securities	152.3	876.3	337.8
Short-term investments – auction rate securities	8,053.4	6,552.4	3,907.6
Maturities, paydowns, calls and other:			
Fixed maturities	572.6	639.7	779.2
Equity securities	114.4	78.2	91.7
Net sales (purchases) of short-term investments – other	491.8	(390.9)	56.6
Net unsettled security transactions	126.6	(43.2)	(37.1)
Purchases of property and equipment	(219.3)	(192.0)	(171.1)
Sale of property and equipment	36.1	—	—
Net cash used in investing activities	(1,546.1)	(848.5)	(2,153.2)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from exercise of stock options	44.2	51.7	50.0
Payments of debt	—	(206.0)	—
Dividends paid to shareholders	(23.7)	(23.3)	(21.7)
Acquisition of treasury shares	(482.8)	(1,628.5)	(316.8)
Net cash used in financing activities	(462.3)	(1,806.1)	(288.5)
Increase (decrease) in cash	(14.4)	7.9	(4.8)
Cash, Beginning of year	20.0	12.1	16.9
Cash, End of year	<u>\$ 5.6</u>	<u>\$ 20.0</u>	<u>\$ 12.1</u>

See notes to consolidated financial statements.

{Notes to Consolidated Financial Statements}

December 31, 2005, 2004 and 2003

1) REPORTING AND ACCOUNTING POLICIES

Nature of Operations The Progressive Corporation, an insurance holding company formed in 1965, owned 71 subsidiaries and had 1 mutual insurance company affiliate (collectively, the “Company”) as of December 31, 2005. The insurance companies provide personal automobile insurance and other specialty property-casualty insurance and related services throughout the United States. The Company’s Personal Lines segment writes insurance for private passenger automobiles and recreational vehicles through both an independent insurance agency channel and a direct channel. The Company’s Commercial Auto segment writes primary liability and physical damage insurance for automobiles and trucks owned by small businesses primarily through the independent agency channel.

Basis of Consolidation and Reporting The accompanying consolidated financial statements include the accounts of The Progressive Corporation, its subsidiaries and affiliate. All of the subsidiaries and the affiliate are wholly owned or controlled. All intercompany accounts and transactions are eliminated in consolidation.

Estimates The Company is required to make estimates and assumptions when preparing its financial statements and accompanying notes in conformity with accounting principles generally accepted in the United States of America (GAAP). As estimates develop into fact (e.g., losses are paid), results may, and will likely, differ from those estimates.

Investments The Company’s fixed-maturity, equity securities and short-term investments are accounted for on an available-for-sale basis.

Fixed-maturity securities are debt securities and mandatory redeemable preferred stocks, which may have fixed or variable principal payment schedules, may be held for indefinite periods of time, and may be used as a part of the Company’s asset/liability strategy or sold in response to changes in interest rates, anticipated prepayments, risk/reward characteristics, liquidity needs or similar economic factors. These securities are carried at market value with the corresponding unrealized gains (losses), net of deferred income taxes, reported in accumulated other comprehensive income. Market values are obtained from a recognized pricing service or other quoted sources. The asset-backed portfolio is accounted for under the retrospective method; prepayment assumptions are based on market expectations. The prospective method is used for interest-only and non-investment-grade asset-backed securities as required by the current accounting regulations.

Equity securities include common stocks, nonredeemable preferred stocks and other risk investments and are reported at quoted market values. Changes in the market values of these securities, net of deferred income taxes, are reflected as unrealized gains (losses) in accumulated other comprehensive income. Changes in value of foreign equities due to foreign currency exchange rates are limited by foreign currency hedges and would be recognized in income in the current period. The Company held no foreign equities or foreign currency hedges during 2005 or 2004.

Short-term investments include auction rate securities (i.e., municipal bonds and preferred stocks). Due to the nature of auction rate securities, these securities are classified as short-term based upon their expected auction date (generally 7–49 days) rather than on their contractual obligation (which are greater than one year at original issuance). In addition to auction rate securities, short-term investments include Eurodollar deposits, commercial paper and other securities expected to mature within one year. Changes in market values of these securities, net of deferred income taxes, are reflected as unrealized gains (losses) in accumulated other comprehensive income.

The Company did not hold any trading securities at December 31, 2005 or 2004. Trading securities are securities bought principally for the purpose of sale in the near term. To the extent the Company has trading securities, changes in market value would be recognized in income in the current period. Derivative instruments which may be used for trading purposes or classified as trading derivatives due to the characteristics of the transaction are discussed below.

Derivative instruments may include futures, options, forward positions, foreign currency forwards, interest rate swap agreements and credit default swaps and may be used in the portfolio for risk management or trading purposes or to hedge the exposure to:

- Changes in fair value of an asset or liability (fair value hedge);
- Foreign currency of an investment in a foreign operation (foreign currency hedge); or
- Variable cash flows of a forecasted transaction (cash flow hedge).

The Company had no fair value or foreign currency hedges or derivative instruments held or issued for risk management purposes at December 31, 2005 or 2004. To the extent the Company holds fair value hedges, changes in the hedge, along with the hedged items would be recognized in income in the period of change while the hedge was in effect. Gains and losses on foreign currency hedges would offset the foreign exchange gains and losses on the foreign investments. Derivatives held or issued for risk management purposes would be recognized in income during the period of change. These derivative instruments would be recognized as either assets or liabilities and

measured at fair value with changes in fair value recognized in income in the period of change. Changes in the fair value of the hedged items would be recognized in income while the hedge was in effect.

The Company held no derivatives classified as cash flow hedges at December 31, 2005 or 2004. Changes in fair value of these hedges would be reported as a component of accumulated other comprehensive income and subsequently amortized into earnings over the life of the hedged transaction. Gains and losses on hedges on forecasted transactions are amortized over the life of the hedged item (see *Note 4 – Debt*). Hedges on forecasted transactions that no longer qualify for hedge accounting due to lack of correlation would be considered by the Company as derivatives used for risk management purposes.

At December 31, 2005, the Company held three Credit Default Swaps (CDS) classified as trading derivatives. The Company matched the notional value of these positions with Treasury securities with an equivalent principal and maturity to replicate a long cash bond position. Changes in the fair value of the CDS and the Treasury notes were recognized in income in the current period. The Company held other CDS during 2004, which were all closed prior to December 31, 2004.

Derivatives designated as hedges would also be evaluated on established criteria to determine the effectiveness of their correlation to, and ability to reduce risk of, specific securities or transactions; effectiveness would be reassessed regularly. If a fair value hedge becomes ineffective, the derivative instrument would continue to be adjusted through income while the adjustment in the change in value of the hedged item would no longer be recognized in income during the current period, but rather would be reflected as a change in unrealized gains (losses) as part of accumulated other comprehensive income within shareholders' equity.

For all derivative positions, net cash requirements are limited to changes in market values, which may vary based upon changes in interest rates, currency exchange rates and other factors. Exposure to credit risk is limited to the carrying value; collateral may be required to limit credit risk.

Investment securities are exposed to various risks such as interest rate, market and credit risk. Market values of securities fluctuate based on the magnitude of changing market conditions; significant changes in market conditions could materially affect portfolio value in the near term. The Company continually monitors its portfolio for pricing changes, which might indicate potential impairments, and performs detailed reviews of securities with unrealized losses based on predetermined criteria. In such cases, changes in market value are evaluated to determine the extent to which such changes are attributable to (i) fundamental factors specific to the issuer, such as financial conditions, business prospects or other factors, or (ii) market-related factors, such as interest rates or equity market declines. When a security in the Company's investment portfolio has an unrealized loss in market value that is deemed to be other than temporary, the Company reduces the book value of such security to its current market value, recognizing the decline as a realized loss in the income statement. Any future decreases not determined to be other-than-temporarily impaired, as well as increases in the market value of securities written down, are reflected as changes in unrealized gains (losses) as part of accumulated other comprehensive income within shareholders' equity.

Realized gains (losses) on securities are computed based on the first-in first-out method and include write-downs on available-for-sale securities considered to have other-than-temporary declines in market value.

Property and Equipment Property and equipment are recorded at cost, less accumulated depreciation. Depreciation is provided over the estimated useful lives of the assets using accelerated methods for computer equipment and the straight-line method for all other fixed assets. The useful lives range from 3 to 4 years for computer equipment, 10 to 40 years for buildings and improvements, and 3 to 10 years for all other property and equipment. Property and equipment include capitalized software developed or acquired for internal use. Land and buildings comprised 77% and 75% of total property and equipment at December 31, 2005 and 2004, respectively.

Total interest capitalized was \$1.3 million, \$3.9 million and \$1.5 million in 2005, 2004 and 2003, respectively, relating to both the Company's construction projects and capitalized computer software costs.

Insurance Premiums and Receivables Insurance premiums written are earned into income on a pro rata basis over the period of risk, based on a daily earnings convention. Accordingly, unearned premiums represent the portion of premiums written that is applicable to the unexpired risk. The Company provides insurance and related services to individuals and small commercial accounts throughout the United States, and offers a variety of payment plans. Generally, premiums are collected prior to providing risk coverage, minimizing the Company's exposure to credit risk. The Company performs a policy level evaluation to determine the extent the premiums receivable balance exceeds its unearned premiums balance. The Company then ages this exposure to establish an allowance for doubtful accounts based on prior experience.

Income Taxes The income tax provision is calculated under the balance sheet approach. Deferred tax assets and liabilities are recorded based on the difference between the financial statement and tax bases of assets and liabilities at the enacted tax rates. The principal assets and liabilities giving rise to such differences are net unrealized gains (losses) on securities, loss reserves, unearned premiums reserves, deferred acquisition costs and non-deductible accruals. The Company reviews its deferred tax assets for recoverability. At December 31, 2005, the Company is able to demonstrate that the benefit of its deferred tax assets is fully realizable and, therefore, no valuation allowance is recorded.

Loss and Loss Adjustment Expense Reserves Loss reserves represent the estimated liability on claims reported to the Company, plus reserves for losses incurred but not recorded (IBNR). These estimates are reported net of amounts recoverable from salvage and subrogation. Loss adjustment expense reserves represent the estimated expenses required to settle these claims and losses. The methods of making estimates and establishing these reserves are reviewed regularly, and resulting adjustments are reflected in income currently. Such loss and loss adjustment expense reserves are susceptible to change in the near term.

Reinsurance The Company's reinsurance transactions primarily include premiums written under state-mandated involuntary plans for commercial vehicles (Commercial Auto Insurance Procedures/Plans—"CAIP"), for which the Company retains no loss indemnity risk (see *Note 6—Reinsurance* for further discussion). In addition, the Company cedes auto premiums to state-provided reinsurance facilities. The Company also cedes a portion of the premiums in its non-auto programs to limit its exposure in those particular markets. Prepaid reinsurance premiums are earned on a pro rata basis over the period of risk, based on a daily earnings convention, which is consistent with premiums written. The Company's primary line of business, auto insurance, is written at relatively low limits of liability; as such, the Company does not believe that it needs to mitigate this risk through voluntary reinsurance.

Earnings Per Share Basic earnings per share are computed using the weighted average number of Common Shares outstanding, excluding both time-based and performance-based unvested restricted stock awards. Diluted earnings per share include common stock equivalents assumed outstanding during the period. The Company's common stock equivalents include stock options and time-based restricted stock awards accounted for as equity awards.

Deferred Acquisition Costs Deferred acquisition costs include commissions, premium taxes and other variable underwriting and direct sales costs incurred in connection with writing business. These costs are deferred and amortized over the policy period in which the related premiums are earned. The Company considers anticipated investment income in determining the recoverability of these costs. Management believes that these costs will be fully recoverable in the near term. The Company does not defer any direct-response advertising costs.

Guaranty Fund Assessments The Company is subject to state guaranty fund assessments, which provide for the payment of covered claims or other insurance obligations of insurance companies deemed insolvent. These assessments are accrued after a formal determination of insolvency has occurred, and the Company has written the premiums on which the assessments will be based.

Service Revenues and Expenses Service revenues consist primarily of fees generated from processing business for involuntary plans and are earned on a pro rata basis over the term of the related policies. Acquisition expenses are deferred and amortized over the period in which the related revenues are earned.

Stock Compensation The Company follows the provisions of Statement of Financial Accounting Standards (SFAS) 123, "Accounting for Stock-Based Compensation," to account for its stock compensation activity in the financial statements. Prior to January 1, 2003, the Company followed the provisions of Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," to account for its stock option activity.

The change to the fair value based method of accounting under SFAS 123 was applied prospectively to all non-qualified stock option awards granted, modified, or settled after January 1, 2003. No stock options were granted after December 31, 2002. As a result, there is no compensation cost for stock options included in net income for 2003, 2004 and 2005; however, compensation expense would have been recognized if the fair value based method had been used for all awards since the original effective date of SFAS 123 (January 1, 1995). Prior to 2003, the Company granted all options currently outstanding at an exercise price equal to the market price of the Company's Common Shares at the date of grant and, therefore, under APB 25, no compensation expense was recorded.

The following table shows the effects on net income and earnings per share had the fair value based method been applied to all outstanding and unvested stock option awards for the periods presented. The Company used the modified Black-Scholes pricing model to calculate the fair value of the options awarded as of the date of grant.

(millions, except per share amounts)	2005	2004	2003
Net income, as reported	\$ 1,393.9	\$ 1,648.7	\$ 1,255.4
Deduct: Total stock-based employee compensation expense determined under the fair value based method for all stock option awards, net of related tax effects	(2.6)	(6.3)	(12.8)
Net income, pro forma	\$ 1,391.3	\$ 1,642.4	\$ 1,242.6
Earnings per share			
Basic – as reported	\$ 7.08	\$ 7.74	\$ 5.79
Basic – pro forma	7.07	7.71	5.73
Diluted – as reported	\$ 6.98	\$ 7.63	\$ 5.69
Diluted – pro forma	6.97	7.62	5.65

The current year pro forma expense is not representative of the effect on net income for future years since the Company stopped issuing non-qualified stock option awards as of December 31, 2002.

In 2003, the Company began issuing restricted stock awards. Compensation expense for restricted stock awards is recognized over the respective vesting periods. The current year expense is not representative of the effect on net income for future years since each subsequent year will reflect expense for additional awards.

Supplemental Cash Flow Information Cash includes only bank demand deposits. The Company paid income taxes of \$767.0 million, \$709.0 million and \$579.0 million in 2005, 2004 and 2003, respectively. Total interest paid was \$85.0 million during 2005, \$91.7 million during 2004 and \$99.0 million during 2003. Non-cash activity includes the liability for deferred restricted stock compensation and the changes in net unrealized gains (losses) on investment securities.

New Accounting Standards The Financial Accounting Standards Board (FASB) issued SFAS 123 (revised 2004), “Share-Based Payment,” which requires the Company to expense the fair value at the grant date of unvested outstanding stock options. The Company adopted this statement using the modified prospective application on January 1, 2006. The Company estimates that the effect of adopting this standard on net income will be a reduction of approximately \$.9 million in 2006. The Company will not incur any additional expense relating to currently outstanding stock options in years subsequent to 2006, since the final vesting date of stock options previously granted will be January 1, 2007. The Company does not currently intend to issue additional stock options.

Excluding the new standard discussed above, the other accounting standards recently issued by the FASB, Statements of Position and Practice Bulletins issued by the American Institute of Certified Public Accountants and consensus positions of the Emerging Issues Task Force are currently not applicable to the Company and, therefore, would have no effect on the Company’s financial condition, cash flows or results of operations.

Reclassifications Certain amounts in the Consolidated Statements of Cash Flows were reclassified for 2004 and 2003 to comply with the presentation requirements under SFAS 95, “Statement of Cash Flows,” and SFAS 115, “Accounting for Certain Investments in Debt and Equity Securities.”

2) INVESTMENTS

The composition of the investment portfolio at December 31 was:

(millions)	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value	% of Total Portfolio
2005					
Fixed maturities:					
U.S. government obligations	\$ 2,249.0	\$ 7.3	\$ (11.0)	\$ 2,245.3	15.7%
State and local government obligations	3,637.7	29.6	(31.4)	3,635.9	25.5
Foreign government obligations	30.3	.2	(.2)	30.3	.2
Corporate and U.S. agency debt securities	1,837.6	6.7	(31.7)	1,812.6	12.7
Asset-backed securities	2,386.6	17.9	(28.5)	2,376.0	16.6
Redeemable preferred stock	119.5	3.1	(.8)	121.8	.9
Total fixed maturities	10,260.7	64.8	(103.6)	10,221.9	71.6
Short-term investments:					
Auction rate municipal obligations	280.2	—	—	280.2	2.0
Auction rate preferred stocks	105.0	.2	(.1)	105.1	.7
Other short-term investments	388.3	—	—	388.3	2.7
Total short-term investments	773.5	.2	(.1)	773.6	5.4
Preferred stocks	1,217.0	17.0	(13.7)	1,220.3	8.6
Common equities	1,423.4	650.3	(14.8)	2,058.9	14.4
	\$ 13,674.6	\$ 732.3	\$ (132.2)	\$14,274.7	100.0%
2004					
Fixed maturities:					
U.S. government obligations	\$ 1,970.1	\$ 5.7	\$ (13.3)	\$ 1,962.5	15.0%
State and local government obligations	2,873.2	71.2	(4.0)	2,940.4	22.5
Foreign government obligations	30.8	.6	—	31.4	.2
Corporate and U.S. agency debt securities	1,752.8	35.6	(7.1)	1,781.3	13.6
Asset-backed securities	2,345.7	39.5	(16.5)	2,368.7	18.1
Total fixed maturities	8,972.6	152.6	(40.9)	9,084.3	69.4
Short-term investments:					
Auction rate municipal obligations	262.4	—	—	262.4	2.0
Auction rate preferred stocks	240.9	.3	—	241.2	1.8
Other short-term investments	873.3	—	—	873.3	6.7
Total short-term investments	1,376.6	.3	—	1,376.9	10.5
Preferred stocks	749.4	24.5	(5.0)	768.9	5.9
Common equities	1,314.0	541.8	(3.9)	1,851.9	14.2
	\$ 12,412.6	\$ 719.2	\$ (49.8)	\$13,082.0	100.0%

See Note 10—Other Comprehensive Income for changes in the net unrealized gains (losses) during the period.

At December 31, 2005, bonds in the principal amount of \$122.1 million were on deposit to meet state insurance regulatory and/or rating agency requirements. The Company did not have any securities of any one issuer with an aggregate cost or market value exceeding ten percent of total shareholders' equity at December 31, 2005 or 2004.

The components of net investment income for the years ended December 31 were:

(millions)	2005	2004	2003
Fixed maturities	\$ 399.0	\$ 374.6	\$ 369.5
Preferred stocks	61.5	49.3	53.0
Common equities	37.2	41.2	31.1
Short-term investments:			
Auction rate municipal obligations	5.4	1.8	.2
Auction rate preferred stocks	6.8	4.2	—
Other short-term investments	26.8	13.3	11.5
Investment income	536.7	484.4	465.3
Investment expenses	(12.1)	(13.9)	(11.5)
Net investment income	\$ 524.6	\$ 470.5	\$ 453.8

At December 31, 2005, the Company had \$5.6 million of fixed maturities that were non-income producing during the preceding 12 months.

The components of net realized gains (losses) for the years ended December 31 were:

(millions)	2005	2004	2003
Gross realized gains:			
Fixed maturities	\$ 47.4	\$ 105.5	\$ 108.4
Preferred stocks	—	7.9	7.4
Common equities	15.6	56.1	19.0
Short-term investments:			
Auction rate municipal obligations	.1	.1	.1
Auction rate preferred stocks	—	—	—
Other short-term investments	—	—	—
	63.1	169.6	134.9
Gross realized losses:			
Fixed maturities	(76.2)	(23.8)	(40.5)
Preferred stocks	(2.3)	(9.7)	(4.1)
Common equities	(22.5)	(56.6)	(77.6)
Short-term investments:			
Auction rate municipal obligations	—	—	—
Auction rate preferred stocks	—	(.2)	—
Other short-term investments	—	—	—
	(101.0)	(90.3)	(122.2)
Net realized gains (losses) on securities:			
Fixed maturities	(28.8)	81.7	67.9
Preferred stocks	(2.3)	(1.8)	3.3
Common equities	(6.9)	(.5)	(58.6)
Short-term investments:			
Auction rate municipal obligations	.1	.1	.1
Auction rate preferred stocks	—	(.2)	—
Other short-term investments	—	—	—
	(37.9)	79.3	12.7
Per share	\$ (.12)	\$.24	\$.04

For 2005, 2004 and 2003, net realized gains (losses) on securities include \$16.4 million, \$7.8 million and \$50.3 million, respectively, of write-downs in securities determined to have an other-than-temporary decline in market value for securities held at December 31.

The components of gross unrealized losses at December 31, 2005 and 2004 were:

(millions)	Total Market Value	Unrealized Losses		
		Total	Less than 12 Months	12 months or greater ¹
2005				
Fixed maturities	\$ 6,395.1	\$ (103.6)	\$ (44.2)	\$ (59.4)
Preferred stocks	579.8	(13.7)	(6.1)	(7.6)
Common equities	198.3	(14.8)	(14.6)	(.2)
Short-term investments	50.0	(.1)	(.1)	—
	<u>\$ 7,223.2</u>	<u>\$ (132.2)</u>	<u>\$ (65.0)</u>	<u>\$ (67.2)</u>
2004				
Fixed maturities	\$ 3,909.8	\$ (40.9)	\$ (30.6)	\$ (10.3)
Preferred stocks	216.9	(5.0)	(2.4)	(2.6)
Common equities	86.0	(3.9)	(3.7)	(.2)
	<u>\$ 4,212.7</u>	<u>\$ (49.8)</u>	<u>\$ (36.7)</u>	<u>\$ (13.1)</u>

¹The market value for securities in an unrealized loss position for 12 months or greater was \$2,610.0 million at December 31, 2005 and \$547.3 million at December 31, 2004.

None of the securities presented in the table above were deemed to have any fundamental issues that would lead the Company to believe that they were other-than-temporarily impaired. The Company has the intent and ability to hold the fixed-maturity securities and preferred stocks to maturity/redemption, and will do so, as long as the securities continue to remain consistent with its investment strategy. The Company may retain the common stocks to maintain correlation to the Russell 1000 Index as long as the portfolio and index correlation remain similar. If the Company's strategy was to change and these securities were determined to be other-than-temporarily impaired, the Company would recognize a write-down in accordance with its stated policy.

At December 31, 2005 and 2004, the Company did not hold any trading securities. Net realized gains (losses) on trading securities for the years ended December 31, 2005, 2004 and 2003 were \$0, \$0 and \$.1 million, respectively. Results from trading securities are not material to the Company's financial condition, cash flows or results of operations and are reported within the available-for-sale portfolio, rather than separately disclosed.

Derivative instruments may be used for trading purposes or classified as trading derivatives due to characteristics of the transaction. During 2005, the Company held three CDS, which were sold on three separate issuers and matched with Treasury securities with an equivalent principal and maturity to replicate cash bond positions. These positions had a notional amount of \$90.0 million at December 31, 2005. The Company held similar investments in 2004, all of which were closed during the third quarter 2004. For 2005, the combined positions generated a net gain (loss) of \$(7.6) million, compared to \$(1.4) million and \$4.9 million for 2004 and 2003, respectively. The amount and results of the derivative and Treasury positions are immaterial to the Company's financial condition, cash flows and results of operations and are reported as part of the available-for-sale portfolio, with the net gains (losses) reported as a component of net realized gains (losses) on securities.

The composition of fixed maturities by maturity at December 31, 2005, was:

(millions)	Cost	Market Value
Less than one year	\$ 1,218.2	\$ 1,211.5
One to five years	5,629.3	5,586.8
Five to ten years	3,385.1	3,392.5
Ten years or greater	28.1	31.1
	10,260.7	10,221.9
Auction rate municipal obligations	280.2	280.2
	<u>\$10,540.9</u>	<u>\$10,502.1</u>

Asset-backed securities are classified in the maturity distribution table based upon their projected cash flows. All other securities which do not have a single maturity date are reported at expected average maturity. Contractual maturities may differ from expected maturities because the issuers of the securities may have the right to call or prepay obligations.

Auction rate municipal obligations generally have contractual maturities of 10 years or more at original issuance. The securities have interest reset periods of up to 7 days, which allow for early liquidation.

3) INCOME TAXES

The components of the Company's income tax provision were as follows:

(millions)	2005	2004	2003
Current tax provision	\$ 696.7	\$ 794.0	\$ 543.6
Deferred tax expense (benefit)	(31.7)	8.1	60.7
Total income tax provision	<u>\$ 665.0</u>	<u>\$ 802.1</u>	<u>\$ 604.3</u>

The provision for income taxes in the accompanying consolidated statements of income differed from the statutory rate as follows:

(millions)	2005		2004		2003	
Income before income taxes	<u>\$ 2,058.9</u>		<u>\$ 2,450.8</u>		<u>\$ 1,859.7</u>	
Tax at statutory rate	\$ 720.6	35%	\$ 857.8	35%	\$ 650.9	35%
Tax effect of:						
Exempt interest income	(34.8)	(2)	(29.8)	(1)	(26.9)	(1)
Dividends received deduction	(22.2)	(1)	(19.1)	(1)	(16.6)	(1)
Other items, net	1.4	—	(6.8)	—	(3.1)	—
Total income tax provision	<u>\$ 665.0</u>	<u>32%</u>	<u>\$ 802.1</u>	<u>33%</u>	<u>\$ 604.3</u>	<u>33%</u>

In July 2003, the Company received notice from the Internal Revenue Service that the Joint Committee of Taxation of Congress had completed its review of a Federal income tax settlement agreed to by the Internal Revenue Service, primarily attributable to the amount of loss reserves deductible for tax purposes. As a result, the Company received an income tax refund of approximately \$58 million during 2004, which was reflected as a tax recoverable as a component of the Company's "Income Taxes" item on the balance sheet in 2003. In addition, the Company received \$31.2 million, or \$.09 per share, of interest in 2004.

Deferred income taxes reflect the effect for financial statement reporting purposes of temporary differences between the financial statement carrying amounts and the tax bases of assets and liabilities. At December 31, 2005 and 2004, the components of the net deferred tax assets were as follows:

(millions)	2005	2004
Deferred tax assets:		
Unearned premiums reserve	\$ 299.5	\$ 282.4
Non-deductible accruals	129.0	100.7
Loss reserves	128.8	123.4
Write-downs on securities	16.4	12.7
Other	4.6	2.2
Deferred tax liabilities:		
Deferred acquisition costs	(155.7)	(151.3)
Net unrealized gains on securities	(210.0)	(234.3)
Hedges on forecasted transactions	(4.6)	(5.3)
Depreciable assets	(52.0)	(35.4)
Other	(19.1)	(14.9)
Net deferred tax assets	136.9	80.2
Net income taxes (payable) recoverable	1.4	(106.2)
Income taxes	\$ 138.3	\$ (26.0)

4) DEBT

Debt at December 31 consisted of:

(millions)	2005		2004	
	Cost	Market Value	Cost	Market Value
7.30% Notes due 2006 (issued: \$100.0, May 1996)	\$ 100.0	\$ 101.0	\$ 99.9	\$ 105.2
6.375% Senior Notes due 2012 (issued: \$350.0, December 2001)	348.0	372.7	347.7	384.6
7% Notes due 2013 (issued: \$150.0, October 1993)	149.0	166.6	148.9	171.1
6½% Senior Notes due 2029 (issued: \$300.0, March 1999)	294.2	331.5	294.1	324.2
6.25% Senior Notes due 2032 (issued: \$400.0, November 2002)	393.7	424.1	393.7	417.0
	\$ 1,284.9	\$ 1,395.9	\$ 1,284.3	\$ 1,402.1

Debt includes amounts the Company has borrowed and contributed to the capital of its insurance subsidiaries or borrowed for other long-term purposes. Market values are obtained from publicly quoted sources. Interest on all debt is payable semiannually and all principal is due at maturity. There are no restrictive financial covenants or credit rating triggers.

The 6.375% Senior Notes, the 6 5/8% Senior Notes and the 6.25% Senior Notes (collectively, "Senior Notes") may be redeemed in whole or in part at any time, at the option of the Company, subject to a "make whole" provision. All other debt is noncallable.

Prior to issuance of the Senior Notes, the Company entered into forecasted debt issuance hedges against possible rises in interest rates. Upon issuance of the applicable debt securities, the hedges were closed. The Company recognized, as part of accumulated other comprehensive income, unrealized gains (losses) of \$18.4 million, \$(4.2) million and \$5.1 million associated with the 6.375% Senior Notes, the 6 5/8% Senior Notes and the 6.25% Senior Notes, respectively. The gains (losses) on these hedges are recognized as adjustments to interest expense and are amortized over the life of the related debt issuances.

In December 2005, the Company entered into an uncommitted line of credit with National City Bank in the principal amount of \$125 million, replacing a prior credit facility with National City Bank for \$100 million, which had the same material terms. Interest on amounts borrowed accrues at a rate related to the London interbank offered rate (LIBOR). No commitment fees are required to be paid. There are no rating triggers under this line of credit. The Company had no borrowings under these arrangements at December 31, 2005 or 2004.

In January 2004, the Company entered into a revolving credit arrangement with National City Bank. Under this agreement, the Company had the right to borrow up to \$10.0 million. By selecting from available credit options, the Company could elect to pay interest at the prime rate or rates related to LIBOR. A commitment fee was payable on any unused portion of the committed amount at the rate of .125% per annum. The Company had no borrowings under this arrangement at December 31, 2004. In January 2005,

the Company elected to allow this revolving credit arrangement to expire at its contractual termination date, due to the fact that the Company maintains the uncommitted line of credit with National City Bank, as discussed above.

Aggregate principal payments on debt outstanding at December 31, 2005, are \$100.0 million for 2006, \$0 for 2007, 2008, 2009 and 2010 and \$1.2 billion thereafter.

5) LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES

Activity in the loss and loss adjustment expense reserves, prepared in accordance with GAAP, is summarized as follows:

(millions)	2005	2004	2003
Balance at January 1	\$ 5,285.6	\$ 4,576.3	\$ 3,813.0
Less reinsurance recoverables on unpaid losses	337.1	229.9	180.9
Net balance at January 1	4,948.5	4,346.4	3,632.1
Incurred related to:			
Current year	9,720.7	8,664.1	7,696.5
Prior years	(355.9)	(109.1)	(56.1)
Total incurred	9,364.8	8,555.0	7,640.4
Paid related to:			
Current year	6,644.7	5,719.2	5,065.4
Prior years	2,355.5	2,233.7	1,860.7
Total paid	9,000.2	7,952.9	6,926.1
Net balance at December 31	5,313.1	4,948.5	4,346.4
Plus reinsurance recoverables on unpaid losses	347.2	337.1	229.9
Balance at December 31	\$ 5,660.3	\$ 5,285.6	\$ 4,576.3

The Company's objective is to establish case and IBNR reserves that are adequate to cover all loss costs, while sustaining minimal variation from the date that the reserves are initially established until losses are fully developed. The Company's reserves developed favorably in 2005, 2004 and 2003. Total development consists of net changes made by the Company's actuarial department to both current and prior accident year reserves, based on regularly scheduled reviews, claims settling for more or less than reserved, emergence of unrecorded claims at rates different than reserved and changes in reserve estimates by claim representatives. The continued recognition of more modest increases in loss severity for prior accident years, than had been previously estimated, contributed to the Company's favorable prior year reserve development in both 2005 and 2004. In addition to favorable claims settlement during 2003, the Company benefited from a change in its estimate of the Company's future operating losses due to business assigned from the New York Automobile Insurance Plan.

Because the Company is primarily an insurer of motor vehicles, it has limited exposure to environmental, asbestos and general liability claims. The Company has established reserves for such exposures, in amounts which it believes to be adequate based on information currently known. These claims will not have a material effect on the Company's liquidity, financial condition, cash flows or results of operations.

The Company writes personal and commercial auto insurance in the coastal states, which could be exposed to hurricanes or other natural catastrophes. Although the occurrence of a major catastrophe could have a significant effect on the Company's monthly or quarterly results, the Company believes, based on historical performance, such an event would not be so material as to disrupt the overall normal operations of the Company. The Company is unable to predict the frequency or severity of any such events that may occur in the near term or thereafter.

6) REINSURANCE

Reinsurance contracts do not relieve the Company from its obligations to policyholders. Failure of reinsurers to honor their obligations could result in losses to the Company. The Company evaluates the financial condition of its reinsurers and monitors concentrations of credit risk to minimize its exposure to significant losses from reinsurer insolvencies.

The Company's ceded premiums are primarily attributable to premiums written under state-mandated involuntary Commercial Auto Insurance Procedures/Plans (CAIP) and premiums ceded to state-provided reinsurance facilities, for which the Company retains no loss indemnity risk.

The effect of reinsurance on premiums written and earned for the years ended December 31 was as follows:

(millions)	2005		2004		2003	
	Written	Earned	Written	Earned	Written	Earned
Direct premiums	\$14,293.4	\$14,066.2	\$13,694.1	\$13,480.8	\$12,187.9	\$11,597.5
Ceded	(285.8)	(301.8)	(316.0)	(310.9)	(274.5)	(256.5)
Net premiums	\$14,007.6	\$13,764.4	\$13,378.1	\$13,169.9	\$11,913.4	\$11,341.0

At December 31, 2005, 53% of the “prepaid reinsurance premiums” were comprised of CAIP, compared to 58% at December 31, 2004. As of December 31, 2005 and 2004, approximately 45% of the “reinsurance recoverables” were comprised of CAIP. Reinsurance related to state-mandated and non-auto programs comprised the remainder of the “prepaid reinsurance premiums” and “reinsurance recoverables.”

Losses and loss adjustment expenses are net of reinsurance ceded of \$197.9 million in 2005, \$271.9 million in 2004 and \$185.8 million in 2003.

7) STATUTORY FINANCIAL INFORMATION

At December 31, 2005, \$505.7 million of consolidated statutory policyholders’ surplus represents net admitted assets of the Company’s insurance subsidiaries and affiliate that are required to meet minimum statutory surplus requirements in such entities’ states of domicile. The companies may be licensed in states other than their states of domicile, which may have higher minimum statutory surplus requirements. Generally, the net admitted assets of insurance companies that, subject to other applicable insurance laws and regulations, are available for transfer to the parent company cannot include the net admitted assets required to meet the minimum statutory surplus requirements of the states where the companies are licensed.

During 2005, the insurance subsidiaries paid aggregate cash dividends of \$1,614.7 million to the parent company. Based on the dividend laws currently in effect, the insurance subsidiaries may pay aggregate dividends of \$1,092.1 million in 2006 without prior approval from regulatory authorities, provided the dividend payments are not within 12 months of previous dividends paid by the applicable subsidiary.

Consolidated statutory policyholders’ surplus was \$4,663.3 million and \$4,671.8 million at December 31, 2005 and 2004, respectively. Statutory net income was \$1,386.6 million, \$1,659.4 million and \$1,260.5 million for the years ended December 31, 2005, 2004 and 2003, respectively.

8) EMPLOYEE BENEFIT PLANS

Retirement Plans The Company has a two-tiered Retirement Security Program. The first tier is a defined contribution pension plan covering all employees who meet requirements as to age and length of service. Contributions vary from 1% to 5% of annual eligible compensation up to the Social Security wage base, based on years of eligible service. Company contributions were \$19.5 million in 2005, \$17.2 million in 2004 and \$15.4 million in 2003.

The second tier is a long-term savings plan under which the Company matches, up to a maximum of 3% of the employee’s eligible compensation, amounts contributed to the plan by an employee. Company matching contributions are not restricted and may be invested by a participant in any of the investment funds available under the plan. Company matching contributions were \$26.8 million in 2005, \$23.4 million in 2004 and \$19.9 million in 2003.

Postemployment Benefits The Company provides various postemployment benefits to former or inactive employees who meet eligibility requirements, their beneficiaries and covered dependents. Postemployment benefits include salary continuation and disability-related benefits, including workers’ compensation, and, if elected, continuation of health-care benefits. The Company’s liability was \$21.0 million at December 31, 2005, compared to \$15.5 million in 2004.

Postretirement Benefits The Company provides postretirement health and life insurance benefits to all employees who met requirements as to age and length of service at December 31, 1988. This group of employees represents less than one-half of one percent of the Company’s current workforce. The Company’s funding policy is to contribute annually the maximum amount that can be deducted for Federal income tax purposes. Contributions are intended to provide not only for benefits attributed to services to date, but also for those expected to be earned in the future.

Incentive Compensation Plans The Company's incentive compensation includes both cash and stock-based plans. The cash incentive compensation includes a cash bonus program for a limited number of senior executives and gainsharing programs for other employees; the bases of these programs are similar in nature. The other stock-based incentive compensation includes time-based and performance-based restricted stock awards granted to key members of management and the non-employee directors. Prior to 2003, the Company granted non-qualified stock options as stock-based incentive compensation (see below). The amounts charged to income for the incentive compensation plans for the years ended December 31 were:

(millions)	2005	2004	2003
Cash	\$ 235.9	\$ 260.7	\$ 233.5
Stock-based (restricted stock awards)	33.7	23.8	11.0

The Company's 2003 Incentive Plan, which provides for the granting of stock-based awards, including restricted stock awards, to key employees of the Company, has 5.0 million shares authorized. The Company's 1995 Incentive Plan and 1989 Incentive Plan have expired; however, awards made under those plans prior to the plan's expiration are still in effect.

Beginning in 2003, the Company began issuing restricted stock awards in lieu of stock options. The restricted stock awards are issued as either time-based or performance-based awards. The time-based awards vest in equal installments upon the lapse of a period of time, typically over three, four and five year periods. The vesting period must be a minimum of six months and one day. The performance-based awards vest upon the achievement of predetermined performance criteria. The restricted stock awards are expensed pro rata over their respective vesting periods based on the market value of the awards at the time of grant. For restricted stock awards granted in 2003 and 2004, which were deferred pursuant to the Company's deferred compensation plan (see below), the Company records expense on a pro rata basis based on the current market value of Common Shares at the end of the reporting period.

Prior to 2003, the Company issued nonqualified stock options, which were granted for periods up to ten years, become exercisable at various dates not earlier than six months after the date of grant, and remain exercisable for specified periods thereafter. All options granted had an exercise price equal to the market value of the Common Shares on the date of grant and, under the then applicable accounting guidance, no compensation expense was recorded. Beginning in January 2006, the Company will expense the remaining unvested stock option awards under the current accounting guidance (see *Note 1 – Reporting and Accounting Policies* for further discussion). All option exercises are settled in Common Shares.

A summary of all employee restricted stock activity during the years ended December 31 follows:

Restricted Shares	2005		2004		2003	
	Number of Shares	Weighted Average Grant Price	Number of Shares	Weighted Average Grant Price	Number of Shares	Weighted Average Grant Price
Beginning of year	915,841	\$75.57	549,648	\$ 65.81	—	—
Add (deduct):						
Granted	485,696	90.48	492,416	84.16	553,290	\$ 65.81
Vested	(682)	73.79	(99,868)	65.55	(655)	65.55
Cancelled	(40,108)	77.48	(26,355)	70.60	(2,987)	65.55
End of year	<u>1,360,747</u>	<u>\$ 80.83</u>	<u>915,841</u>	<u>\$ 75.57</u>	<u>549,648</u>	<u>\$ 65.81</u>

A summary of all employee stock option activity during the years ended December 31 follows:

Options Outstanding	2005		2004		2003	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Beginning of year	6,589,501	\$ 32.04	8,725,037	\$ 30.43	11,947,271	\$ 27.44
Add (deduct):						
Exercised	(1,645,316)	26.67	(2,025,156)	24.94	(2,826,420)	17.47
Cancelled	(38,816)	43.29	(110,380)	35.42	(395,814)	32.66
End of year	<u>4,905,369</u>	<u>\$ 33.76</u>	<u>6,589,501</u>	<u>\$ 32.04</u>	<u>8,725,037</u>	<u>\$ 30.43</u>
Exercisable, end of year	<u>3,847,314</u>	<u>\$ 31.28</u>	<u>3,926,214</u>	<u>\$ 30.02</u>	<u>3,749,453</u>	<u>\$ 25.49</u>
Available, end of year ¹	<u>3,816,454</u>		<u>11,443,867</u>		<u>11,825,903</u>	

¹Represents shares available under the 2003 Incentive Plan, after the granting of restricted stock awards; the 1995 Incentive Plan expired in February 2005, and the remaining 7,141,717 shares thereunder are no longer available for future issuance.

The following employee stock options were outstanding or exercisable as of December 31, 2005:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number of Shares	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
\$ 15 < 30	1,747,272	3.24 years	\$ 20.34	1,746,144	\$ 20.33
30 < 40	1,306,542	4.95 years	30.74	845,854	30.77
40 < 50	890,340	2.61 years	44.60	876,830	44.58
50 < 60	961,215	5.99 years	52.21	378,486	52.16
\$ 15 < 60	<u>4,905,369</u>			<u>3,847,314</u>	

In addition to the employee incentive plans disclosed above, the Company registered 350,000 Common Shares for issuance under the 2003 Directors Equity Incentive Plan, which provides for the granting of equity-based incentive awards to non-employee directors of the Company, and 600,000 Common Shares under the 1998 Directors' Stock Option Plan. During 2005, 2004 and 2003, the Company granted 12,561, 12,242 and 16,102, respectively, shares of time-based restricted stock awards under the 2003 Directors Equity Incentive Plan; these awards vest within one year from the date of grant. As of December 31, 2005, 2004 and 2003, the directors stock options outstanding and exercisable were 218,277 shares, 242,277 shares and 311,061 shares, respectively. These awards have the same exercise and contract terms as the employee stock option awards.

The Company elected to account for terminations when they occur rather than include an attrition factor into its model.

Deferred Compensation The Company maintains The Progressive Corporation Executive Deferred Compensation Plan (Deferral Plan), that permits eligible executives to defer receipt of some or all of their annual bonuses or all of their annual restricted stock awards. Deferred cash compensation is deemed invested in one or more investment funds, including Common Shares of the Company, offered under the Deferral Plan. All distributions from the Deferral Plan pursuant to deferred cash compensation will be paid in cash. Prior to February 2004, distributions representing cash amounts deemed invested in Common Shares were made in-kind.

For all restricted stock awards granted on or after March 17, 2005, and deferred pursuant to the Deferral Plan, the deferred amounts will be deemed invested in Common Shares and ineligible for transfer to other investment funds in the Deferral Plan; all distributions will be made in-kind. For all awards granted prior to March 17, 2005, the deferred amounts are eligible to be transferred to all funds in the Deferral Plan; distributions of these deferred awards will be made in cash.

The Company reserved 900,000 Common Shares for issuance under the Deferral Plan. Included in the Company's balance sheets is an irrevocable grantor trust established to provide a source of funds to assist the Company in meeting its liabilities under the Deferral Plan. At December 31, 2005 and 2004, the trust held assets of \$75.4 million and \$59.3 million, respectively, of which \$17.2 million and \$12.4 million were held in the Company's Common Shares, to cover its liabilities.

9) SEGMENT INFORMATION

The Company writes personal automobile and other specialty property-casualty insurance and provides related services throughout the United States. The Personal Lines segment writes insurance for private passenger automobiles and recreational vehicles. The Personal Lines segment includes both the Drive and Direct channels. The Drive channel includes business written by the Company's network of more than 30,000 independent insurance agencies and strategic alliance business relationships (other insurance companies, financial institutions, employers and national brokerage agencies). The Direct channel includes business written through 1-800-PROGRESSIVE and online at progressivedirect.com.

The Company's Commercial Auto segment writes primary liability and physical damage insurance for automobiles and trucks owned by small businesses and is primarily distributed through the independent agency channel.

The Company's other-indemnity businesses primarily include writing professional liability insurance for community banks and managing the Company's run-off businesses.

The Company's service businesses include providing insurance-related services, primarily processing CAIP business.

All revenues are generated from external customers and the Company does not have a reliance on any major customer.

The Company evaluates segment profitability based on pretax underwriting profit (loss) for the Personal Lines, Commercial Auto and other-indemnity businesses and pretax profit (loss) for the service businesses. Underwriting profit (loss) is calculated as net premiums earned less loss and loss adjustment expenses, policy acquisition costs and other underwriting expenses. Service business profit (loss) is the difference between service business revenues and service business expenses. Expense allocations are based on certain assumptions and estimates related to revenue; stated segment operating results would change if different methods were applied. The Company does not allocate assets or income taxes to operating segments. In addition, the Company does not separately identify depreciation and amortization expense by segment and such disclosure would be impractical. Companywide depreciation expense was \$92.4 million in 2005, \$99.4 million in 2004 and \$89.3 million in 2003. The accounting policies of the operating segments are the same as those described in *Note 1 – Reporting and Accounting Policies*.

Following are the operating results for the years ended December 31:

(millions)	2005		2004		2003	
	Revenues	Pretax Profit (Loss)	Revenues	Pretax Profit (Loss)	Revenues	Pretax Profit (Loss)
Personal Lines						
Drive	\$ 7,993.1	\$ 857.6	\$ 7,893.7	\$1,108.2	\$ 6,948.0	\$ 836.0
Direct	4,076.2	475.7	3,718.2	525.6	3,103.0	383.0
Total Personal Lines ¹	12,069.3	1,333.3	11,611.9	1,633.8	10,051.0	1,219.0
Commercial Auto	1,667.8	298.0	1,524.1	321.4	1,226.7	214.2
Other – indemnity	27.3	7.9	33.9	3.1	63.3	8.2
Total underwriting operations	13,764.4	1,639.2	13,169.9	1,958.3	11,341.0	1,441.4
Service businesses	40.2	15.6	48.5	23.5	41.8	16.1
Investments ²	498.8	486.7	563.7	549.8	478.0	466.5
Interest expense	—	(82.6)	—	(80.8)	—	(95.5)
Other income ³	—	—	—	—	31.2	31.2
	<u>\$ 14,303.4</u>	<u>\$2,058.9</u>	<u>\$13,782.1</u>	<u>\$2,450.8</u>	<u>\$11,892.0</u>	<u>\$1,859.7</u>

¹Personal automobile insurance accounted for 92% of the total Personal Lines segment net premiums earned in 2005 and 93% in both 2004 and 2003; recreational vehicles accounted for the balance of the Personal Lines net premiums earned.

²Revenues represent recurring investment income and net realized gains (losses) on securities; pretax profit is net of investment expenses.

³Represents interest income related to an income tax refund the Company received in 2004. See *Note 3 – Income Taxes* for further discussion.

The Company's management uses underwriting margin and combined ratio as primary measures of underwriting profitability. The underwriting margin is the pretax underwriting profit (loss) expressed as a percent of net premiums earned (i.e., revenues). Combined ratio is the complement of the underwriting margin. Following are the underwriting margins/combined ratios for the Company's underwriting operations for the years ended December 31:

	2005		2004		2003	
	Underwriting Margin	Combined Ratio	Underwriting Margin	Combined Ratio	Underwriting Margin	Combined Ratio
Personal Lines						
Drive	10.7%	89.3	14.0%	86.0	12.0%	88.0
Direct	11.7	88.3	14.1	85.9	12.3	87.7
Total Personal Lines	11.0	89.0	14.1	85.9	12.1	87.9
Commercial Auto	17.9	82.1	21.1	78.9	17.5	82.5
Other – indemnity ¹	NM	NM	NM	NM	NM	NM
Total underwriting operations	11.9	88.1	14.9	85.1	12.7	87.3

¹Underwriting margins/combined ratios are not meaningful (NM) for the Company's other-indemnity businesses due to the insignificant amount of premiums earned by such businesses.

10) OTHER COMPREHENSIVE INCOME

The components of other comprehensive income for the years ended December 31 were as follows:

(millions)	2005			2004			2003		
	Pretax	Tax (Provision) Benefit	After Tax	Pretax	Tax (Provision) Benefit	After Tax	Pretax	Tax (Provision) Benefit	After Tax
Unrealized gains (losses) arising during period:									
Fixed maturities	\$ (138.7)	\$ 48.6	\$ (90.1)	\$ (48.0)	\$ 16.8	\$ (31.2)	\$ 2.8	\$ (.9)	\$ 1.9
Equity securities	135.8	(47.5)	88.3	241.4	(84.5)	156.9	431.6	(151.1)	280.5
Reclassification adjustment: ¹									
Fixed maturities	(12.0)	4.2	(7.8)	(74.4)	26.0	(48.4)	(71.5)	25.0	(46.5)
Equity securities	(54.4)	19.0	(35.4)	(93.0)	32.6	(60.4)	30.6	(10.7)	19.9
Change in unrealized gains	(69.3)	24.3	(45.0)	26.0	(9.1)	16.9	393.5	(137.7)	255.8
Net unrealized gains on forecasted transactions ²	(1.7)	.6	(1.1)	(1.5)	.5	(1.0)	(1.5)	.5	(1.0)
Foreign currency translation adjustment ³	—	—	—	3.9	—	3.9	.9	—	.9
Other comprehensive income	\$ (71.0)	\$ 24.9	\$ (46.1)	\$ 28.4	\$ (8.6)	\$ 19.8	\$ 392.9	\$ (137.2)	\$ 255.7

¹Represents adjustments for gains/losses realized in net income for securities held in the portfolio at December 31 of the preceding year.

²Entered into for the purpose of managing interest rate risk associated with the Company's debt issuances. See *Note 4 – Debt*. The Company expects to reclassify \$1.8 million into income within the next 12 months.

³Foreign currency translation adjustments have no tax effect.

11) LITIGATION

The Company is named as a defendant in various lawsuits arising out of its insurance operations. All legal actions relating to claims made under insurance policies are considered by the Company in establishing its loss and loss adjustment expense reserves.

In addition, the Company is named as defendant in a number of class action or individual lawsuits. Other insurance companies face many of these same issues. The lawsuits discussed below are in various stages of development. The Company plans to contest these suits vigorously, but may pursue settlement negotiations if appropriate in some cases. The outcomes of these cases are uncertain at this time. In accordance with GAAP, the Company is only permitted to establish loss reserves for lawsuits when it is probable that a loss has been incurred and the Company can reasonably estimate its potential exposure (referred to as a loss that is both “probable and estimable” in the discussion below). As to lawsuits that do not satisfy both parts of this GAAP standard, the Company has not established reserves at this time. However, in the event that any one or more of these cases results in a judgment against or settlement by the Company, the resulting liability could have a material effect on the Company’s financial condition, cash flows and results of operations.

As required by the GAAP standard, the Company has established loss reserves for lawsuits as to which the Company has determined that a loss is both probable and estimable. Certain of these cases are mentioned in the discussion below. Based on currently available information, the Company believes that its reserves for these lawsuits are reasonable and that the amounts reserved did not have a material effect on the Company’s financial condition or results of operations. However, if any one or more of these cases results in a judgment against or settlement by the Company for an amount that is significantly greater than the amount so reserved, the resulting liability could have a material effect on the Company’s financial condition, cash flows and results of operations.

Following is a discussion of the Company’s potentially significant pending cases at December 31, 2005.

There are five putative class action lawsuits challenging the Company’s use of certain automated database vendors or software to assist in the adjustment of bodily injury claims. Plaintiffs allege that these databases or software systematically undervalue the claims. The Company does not consider a loss from these cases to be probable and estimable, and is unable to estimate a range of loss, if any, at this time.

There is one putative class action lawsuit challenging the Company’s installment fee program. The Company has successfully defended similar cases in the past, including one case that was dismissed in 2005. The Company does not consider a loss from the currently pending case to be probable and estimable, and is unable to estimate a range of loss, if any, at this time.

There is one putative class action lawsuit challenging the Company’s practice of specifying aftermarket (non-original equipment manufacturer) replacement parts in the repair of insured or claimant vehicles. Plaintiffs in these cases generally allege that aftermarket parts are inferior to replacement parts manufactured by the vehicle’s original manufacturer and that the use of such parts fails to restore the damaged vehicle to its “pre-loss” condition, as required by their insurance policies. The Company does not consider a loss from this case to be probable and estimable, and is unable to estimate a range of loss, if any, at this time.

The Company is defending one putative class action lawsuit alleging that the Company’s rating practices at renewal are improper. The Company prevailed in a similar putative class action in December 2004. The Company does not consider a loss from this case to be probable and estimable, and is unable to estimate a range of loss, if any, at this time.

There is one certified class action lawsuit and eight putative class action lawsuits pending against the Company, alleging that the Company failed to adjust MRI bills to a Consumer Price Index in violation of a statute. The Company does not consider a loss from these cases to be probable and estimable, and is unable to estimate a range of loss, if any, at this time.

There is one putative class action lawsuit pending against the Company, alleging that the Company fails to notify its policyholders of the availability of uninsured/underinsured coverage at every renewal, modification, etc., as required by law. The Company does not consider a loss from this case to be probable and estimable, and is unable to estimate a range of loss, if any, at this time.

The Company is a party to an individual unfair competition claim in which the plaintiff claims that the Company violates the “make-whole” and “common-fund” doctrines. Specifically, it is alleged that the Company may obtain reimbursement of medical payments made on behalf of an insured only when the insured has been made whole by a third-party tortfeasor and that the Company further must deduct from the reimbursement amount a proportionate share of the insured’s legal fees for pursuing the third-party tortfeasor. The Company understands that there are a number of similar class actions against others in the insurance industry and that this case may be amended to be brought as a class action against the Company. The Company does not consider a loss from this case to be probable and estimable, and is unable to estimate a range of loss, if any, at this time.

There are three putative class action lawsuits pending against the Company in Florida, challenging the legality of the Company’s payment of preferred provider rates on personal injury protection (PIP) claims. The primary issue is whether the Company violated Florida law by paying PIP medical expense claims at preferred provider rates. The Company has been engaged in extensive settlement negotiations to resolve the claims raised in these cases and has established a loss reserve for these cases. Also, during 2004, the Company settled an individual bad faith lawsuit in Florida, which alleged similar issues; the settlement did not have a material effect on the Company’s financial condition, cash flows or results of operations.

There are two putative class action lawsuits and one individual action challenging the Company's use of certain automated database vendors to assist in the evaluation of total loss claims. Plaintiffs allege that these databases systematically undervalue total loss claims to the detriment of insureds. The Company engaged in extensive settlement negotiations and reached a settlement on a nationwide basis. The settlement has received trial court approval. Accordingly, the Company has established a loss reserve for this resolution.

In July 2005, the Company settled a state class action lawsuit alleging that the Company used non-conforming uninsured/underinsured motorist rejection forms. The settlement received trial court approval in October 2005, and a loss reserve has been established.

There are eight class action lawsuits challenging certain aspects of the Company's use of credit information and compliance with notice requirements under the federal Fair Credit Reporting Act. The Company had entered into a settlement agreement to resolve these cases, had received preliminary court approval of the settlement, and had established a reserve accordingly. In February 2005, the Company was advised that the court denied final approval of the proposed settlement, and the Company is in the process of negotiating a revised settlement. There also are six individual actions and an additional class action lawsuit against the Company that challenge the Company's use of credit. The six individual actions are stayed pending the outcome of the class actions. The Company does not consider a loss from these cases to be probable and estimable, and is unable to estimate a range of loss, if any, at this time. During 2004, the Company settled a state-specific case concerning these issues within the reserve amount established for that case in prior years.

The Company has prevailed in four putative class action lawsuits, in various Texas state courts, alleging that the Company is obligated to reimburse insureds, under their auto policies, for the inherent diminished value of their vehicles after they have been involved in an accident. Plaintiffs defined inherent diminished value as the difference between the market value of the insured automobile before an accident and the market value after proper repair. The Supreme Court of Texas has ruled that diminished value recovery is not available under the Texas automobile policy.

During 2004, the Company settled a federal collective action lawsuit involving worker classification issues under the federal Fair Labor Standards Act (FLSA) and five state class actions, which were consolidated with the federal case. All of such lawsuits challenged the Company's classification of its claims representatives as "exempt" under the FLSA and/or various state laws. In October 2004, the Company reached an agreement under which it funded an account for all potential claims of class member claims representatives and eligible claims representative trainees. This settlement did not have a material effect on the Company's financial condition, cash flows or results of operations.

During 2004, the Company settled two groups of individual cases related to the Company's alternative commission programs, one in Alabama and one in Mississippi, within the reserve amount established in prior years for these groups of cases. These cases were filed by individuals who opted out of the nationwide class action settlement, which was completed in 2003, within the reserve amount that was established in the year prior to settlement.

There was one national putative class action lawsuit, brought on behalf of medical providers, disputing the legality of the Company's practice of paying first-party medical benefits pursuant to a preferred provider agreement. The class allegations were dismissed in January 2006, leaving only the named plaintiff's individual claim pending. This individual claim has been settled for an immaterial amount.

12) COMMITMENTS AND CONTINGENCIES

The Company has certain noncancelable operating lease commitments and service contracts with terms greater than one year. The minimum commitments under these agreements at December 31, 2005, are as follows:

(millions)			
Year	Operating Leases	Service Contracts	Total
2006	\$ 99.7	\$ 54.6	\$ 154.3
2007	83.4	38.6	122.0
2008	54.7	6.3	61.0
2009	34.4	1.3	35.7
2010	20.7	1.1	21.8
Thereafter	47.9	.1	48.0

Some of the agreements have options to renew at the end of the contract periods. The expense incurred by the Company for the agreements disclosed above, as well as other operating leases that may be cancelable or have terms less than one year, was:

(millions)				
Year	Operating Leases	Service Contracts	Total	
2005	\$ 126.4	\$ 98.3	\$ 224.7	
2004	116.0	89.4	205.4	
2003	101.6	80.1	181.7	

During 2005, the Company incurred \$7.0 million of guaranty fund assessments, compared to \$11.4 million in 2004 and \$12.2 million in 2003. At December 31, 2005 and 2004, the Company had \$10.8 million and \$10.7 million, respectively, reserved for future assessments on current insolvencies. Management believes that any assessment in excess of its current reserves will not materially affect the Company's financial condition, cash flows or results of operations.

As of December 31, 2005, the Company had open investment funding commitments of \$4.1 million; the Company had no uncollateralized lines or letters of credit as of December 31, 2005 or 2004.

13) FAIR VALUE OF FINANCIAL INSTRUMENTS

Information about specific valuation techniques and related fair value detail is provided in *Note 1 – Reporting and Accounting Policies*, *Note 2 – Investments* and *Note 4 – Debt*. The cost and market value of the financial instruments as of December 31 are summarized as follows:

(millions)	2005		2004	
	Cost	Market Value	Cost	Market Value
Investments – Available-for-sale:				
Fixed maturities	\$10,260.7	\$10,221.9	\$ 8,972.6	\$ 9,084.3
Preferred stocks	1,217.0	1,220.3	749.4	768.9
Common equities	1,423.4	2,058.9	1,314.0	1,851.9
Short-term investments	773.5	773.6	1,376.6	1,376.9
Debt	(1,284.9)	(1,395.9)	(1,284.3)	(1,402.1)

The value of the Company's investment portfolio is obtained through market level sources for 99.6% of the securities; the remaining securities are valued using private market valuation sources.

14) RELATED PARTY TRANSACTIONS

The following table summarizes the Company's repurchase of its Common Shares, \$1.00 par value, from Peter B. Lewis, the Company's Chairman of the Board, or through an entity owned and controlled, directly or indirectly, by Mr. Lewis, during the three-year period ended December 31, 2005. The Company did not make any repurchases from Mr. Lewis in 2005. The 2004 transaction was part of the Company's "Dutch auction" tender offer and the price per share was the same price given to all shareholders who elected to participate in the tender offer. The 2003 purchases were made at the then current market price of the Company's stock as quoted on the New York Stock Exchange and were part of the Company's ongoing repurchase program.

Date of Purchase	Number of Shares	Price per Share
October 2004	1,100,000	\$ 88.00
September 2003	200,000	71.00
January 2003	400,000	52.23