

**Public Education Employees' Health
Insurance Fund**

(A Component Unit of the State of Alabama)

FINANCIAL STATEMENTS

For the Fiscal Year Ended September 30, 2012

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INDEPENDENT AUDITORS' REPORT

To the Public Education Employees'
Health Insurance Board

We have audited the accompanying balance sheet of the Public Education Employees' Health Insurance Fund (a component unit of the State of Alabama) as of September 30, 2012, and the related statement of revenues, expenses and changes in fund equity and cash flows for the year then ended. These financial statements are the responsibility of the Public Education Employees' Health Insurance Fund. Our responsibility is to express an opinion on these financial statements based on our audit. The prior year partial comparative information has been derived from the Public Education Employees' Health Insurance Fund's 2011 financial statements and, in our report dated January 31, 2012, we expressed an unqualified opinion on such financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the 2012 financial statements referred to above present fairly, in all material respects, the financial position of the Public Education Employees' Health Insurance Fund (a component unit of the State of Alabama) as of September 30, 2012, and its changes in fund equity and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 2 through 4 and the claims development information on page 19 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Carr, Riggs & Ingram, L.L.C.

January 28, 2013
Montgomery, Alabama

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Management's Discussion and Analysis
September 30, 2012

The Public Education Employees' Health Insurance Fund (PEEHIF) is a health insurance plan for active and retired employees of state and local educational institutions. The contributions and benefit payments related to retirees that are processed through the PEEHIF are segregated from the PEEHIF and reported as part of the Alabama Retired Education Employees' Health Care Trust (Trust). The following discussion provides an overview of the financial position and results of operations for the PEEHIF as of and for the fiscal year ended September 30, 2012. For more detailed information, please refer to the financial statements, including the *Notes to the Financial Statements* and the *Required Supplementary Information*.

Overview of the Financial Statements and Required Supplementary Information

The financial statements include the *Balance Sheet*, the *Statement of Revenues, Expenses and Changes in Fund Equity*, and the *Statement of Cash Flows*. The *Notes to the Financial Statements* are considered an integral part of the financial statements and should be read in conjunction with the financial statements. The financial statements are prepared under the accrual basis of accounting using the economic resources measurement focus. Revenues are recognized when earned and expenses are recognized when incurred, regardless of when cash is received or expended. Investments are reported at fair value.

The *Balance Sheet* includes the assets and liabilities of the PEEHIF and provides a snapshot of the financial position of the PEEHIF as of the end of the fiscal year. Assets primarily consist of cash, receivables, and short-term investments. Liabilities primarily consist of claims-related payables.

The *Statement of Revenues, Expenses and Changes in Fund Equity* includes the revenues and expenses of the PEEHIF for the fiscal year. Revenues primarily consist of premiums and interest income. Expenses primarily consist of claims.

The *Statement of Cash Flows* provides information about the cash receipts and payments of the PEEHIF during the fiscal year. The *Statement of Cash Flows* is divided into three sections – operating, investing, and non-capital financing activities. A reconciliation of operating income to net cash provided by operating activities is also presented. The PEEHIF had no activities related to non-capital or capital financing during the fiscal year. The PEEHIF's *Statement of Cash Flows* was prepared using the direct method, as required by GASB Statement 34. Under the direct method, major classes of receipts and payments are displayed. The net change in cash during the fiscal year plus the cash at the beginning of the fiscal year equals the cash at the end of the fiscal year.

The *Notes to the Financial Statements* include a description of the PEEHIF, a summary of significant accounting policies, a description of contract administrators and their respective fees, and other disclosures related to credit risks, concentrations of investments, unpaid claims liabilities, employee pension plans, and other postemployment benefits.

The *Required Supplementary Information* following the *Notes to the Financial Statements* provides a claims development table illustrating historical trend information on how the PEEHIF's earned revenues and interest income compare to the related costs of claims and other expenses assumed by the PEEHIF as of the fiscal year-end.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Management's Discussion and Analysis
September 30, 2012

Comparative Financial Statements

Summary Comparative Balance Sheet

As of September 30, 2012 and 2011

(Amounts in Thousands)

	2012	2011	Variance	% Increase (Decrease)
Assets				
Cash	\$ 6,800	\$ 5,843	\$ 957	16.38
Receivables	5,219	23,371	(18,152)	(77.67)
Deposit with Claims-Paying Agent	387	1,403	(1,016)	(72.42)
Investments	203,447	192,781	10,666	5.53
Total Assets	\$ 215,853	\$ 223,398	\$ (7,545)	(3.38)
Liabilities				
Payables	\$ 27,281	\$ 37,997	\$ (10,716)	(28.20)
Claims Incurred but Not Reported	38,384	35,452	2,932	8.27
Total Liabilities	65,665	73,449	(7,784)	(10.60)
Fund Equity - unrestricted	150,188	149,949	239	0.16
Total Liabilities and Fund Equity	\$ 215,853	\$ 223,398	\$ (7,545)	(3.38)

Summary Comparative Statement of Revenues, Expenses and Changes in Fund Equity

For the Fiscal Years Ended September 30, 2012 and 2011

(Amounts in Thousands)

	2012	2011	Variance	% Increase (Decrease)
Operating Revenue				
Premiums	\$ 742,224	\$ 862,764	\$ (120,540)	(13.97)
Early Retiree Reinsurance Program	-	21,196	(21,196)	(100.00)
Total Operating Revenues	742,224	883,960	(141,736)	(16.03)
Operating Expenses				
Claims	739,984	750,951	(10,967)	(1.46)
Administrative	2,779	2,587	192	7.42
Total Operating Expenses	742,763	753,538	(10,775)	(1.43)
Operating (Loss)/Income	(539)	130,422	(130,961)	(100.41)
Investment Revenues				
Interest Income	778	456	322	70.61
Total Investment Revenues	778	456	322	70.61
Total Income	239	130,878	(130,639)	(99.82)
Fund Equity				
Beginning of Year	149,949	19,071	130,878	686.27
End of Year	\$ 150,188	\$ 149,949	\$ 239	0.16

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Management's Discussion and Analysis

September 30, 2012

Financial Highlights

- Cash on hand at September 30, 2012 was primarily held for the payment of administrative expenses of the PEEHIF.
- The PEEHIF's investments increased by 5.53% during the 2012 fiscal year. As a result of favorable claims experience and the implementation of additional cost saving strategies, the PEEHIF generated additional investable funds during the current fiscal year.
- Premium revenue decreased by 13.97% compared to the previous fiscal year, primarily as a result of a reduction in state funding. The monthly employer rate established by the Alabama Legislature was reduced from \$752 to \$714 per active member for the 2012 fiscal year.
- Claims expenses decreased by 1.46% during the fiscal year compared with that of the previous fiscal year. This reduction was mainly a result of favorable claims experience, the implementation of additional cost saving strategies, and slight benefit changes made during the fiscal year.
- Administrative expenses increased during the fiscal year by 7.42%, primarily as a result of an increase in the amount of professional services performed for the PEEHIF.
- The increase in the PEEHIF's investments also correspondingly increased the investment income that the PEEHIF received during the 2012 fiscal year by 70.61% compared to the prior fiscal year.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

BALANCE SHEET

September 30, 2012 with comparative amounts shown for 2011

(Amounts in Thousands)

	2012	2011
Assets		
Cash (Note 1)	\$ 6,800	\$ 5,843
Receivables		
Premiums	1,836	1,290
Rebates - Prescription Drug Plan Manufacturer Rebates	3,318	3,029
Early Retiree Reinsurance Program	-	19,029
Interest	65	23
Total Receivables	5,219	23,371
Deposit with Claims-Paying Agent	387	1,403
Investments, at Fair Value (Note 3)	203,447	192,781
Total Assets	\$ 215,853	\$ 223,398
Liabilities		
Accounts Payable	\$ 254	\$ 197
Employee Benefits Payable	416	467
Other Postemployment Benefits (Note 5)	494	364
Reported Claims Payable (Note 4)	26,117	36,969
Claims Incurred but Not Reported (Note 4)	38,384	35,452
Total Liabilities	65,665	73,449
Fund Equity - unrestricted	150,188	149,949
Total Liabilities and Fund Equity	\$ 215,853	\$ 223,398

See accompanying Notes to the Financial Statements.

**PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
STATEMENT OF REVENUES, EXPENSES AND CHANGES IN FUND EQUITY
For the Fiscal Year Ended September 30, 2012 with comparative amounts shown for 2011**

(Amounts in Thousands)

	2012	2011
<i>Operating Revenue</i>		
Premiums	\$ 742,224	\$ 862,764
Early Retiree Reinsurance Program	-	21,196
Total Operating Revenue	742,224	883,960
<i>Operating Expenses</i>		
Claims (Notes 2 and 4)	739,984	750,951
Administrative	2,779	2,587
Total Operating Expenses	742,763	753,538
Operating (Loss) Income	(539)	130,422
<i>Investment Revenues</i>		
Interest Income	778	456
Total Investment Revenues	778	456
Total Income	239	130,878
<i>Fund Equity</i>		
Beginning of Year	149,949	19,071
End of Year	\$ 150,188	\$ 149,949

See accompanying Notes to the Financial Statements.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

STATEMENT OF CASH FLOWS

For the Fiscal Year Ended September 30, 2012 with comparative amounts shown for 2011

(Amounts in Thousands)

	2012	2011
<i>Cash Flows From Operating Activities</i>		
Receipts from Participants	\$ 741,678	\$ 863,350
Receipts from Other Sources	19,029	2,167
Payments to Suppliers	(526)	(389)
Payments to Employees	(2,119)	(2,288)
Claims Paid	(747,175)	(750,274)
Net Cash Provided by Operating Activities	<u>10,887</u>	<u>112,566</u>
<i>Cash Flows from Investing Activities</i>		
Interest from Investments	736	445
Purchases of Investments	(3,533,908)	(3,430,742)
Sales and Maturities of Investments	<u>3,523,242</u>	<u>3,318,685</u>
Net Cash Used in Investing Activities	<u>(9,930)</u>	<u>(111,612)</u>
Net Increase in Cash	957	954
Cash at Beginning of Year	<u>5,843</u>	<u>4,889</u>
<i>Cash at End of Year</i>	<u>\$ 6,800</u>	<u>\$ 5,843</u>
<i>Reconciliation of Operating (Loss) Income to Net Cash Provided by Operating Activities</i>		
Operating (Loss) Income	\$ (539)	\$ 130,422
Adjustments to Reconcile Operating (Loss) Income to Net Cash Provided by Operating Activities:		
(Increase)/Decrease in Assets:		
Premium Receivable	(546)	586
Early Retiree Reinsurance Program Reimbursement Receivable	19,029	(19,029)
Rebates Receivable	(289)	3,042
Deposit with Claims Paying Agent	1,016	2,008
Increase/(Decrease) in Liabilities:		
Accounts Payable	57	(115)
Employee Benefits Payable	(51)	(22)
Other Postemployment Benefits	130	46
Reported Claims Payable	(10,852)	2,185
Claims Incurred but Not Reported	2,932	(6,557)
Net Cash Provided by Operating Activities	<u>\$ 10,887</u>	<u>\$ 112,566</u>
<i>Noncash Investing Activities</i>		
(Increase)/ Decrease in Interest Receivable	\$ (42)	\$ (10)

See accompanying Notes to the Financial Statements.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2012

1) Organization and Summary of Significant Accounting Policies

A. General

The Public Education Employees' Health Insurance Fund (PEEHIF) was established in 1983 under the provisions of Act 83-455 of the Alabama Legislature to provide a uniform plan of health insurance for active and retired employees of state and local educational institutions which provide instruction at any combination of grades K-14 (collectively, eligible employees), and to provide a method for funding the benefits related to the plan. The four-year universities are eligible and may elect to participate in the plan. At this time, Jacksonville State is the only university with active and retired members that has elected to participate in the plan. Responsibility for the establishment of the health insurance plan and its general administration and operations is vested in the Public Education Employees' Health Insurance Board (Board). The Board is a corporate body for purposes of management of the health insurance plan. All assets of the PEEHIF are held in trust for the payment of health insurance benefits. The Teachers' Retirement System of Alabama (TRS) has been appointed as the administrator of the PEEHIF. In accordance with the Governmental Accounting Standards Board (GASB), the PEEHIF is considered a component unit of the State of Alabama (State) and is included in the State's *Comprehensive Annual Financial Report*.

In order to comply with the reporting requirements set by GASB Statement 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, the contributions (employer, plan member, and the Medicare Part D Retiree Drug Subsidy) and benefit payments related to retirees that are processed through the PEEHIF are segregated from the PEEHIF and reported as part of the Alabama Retired Education Employees' Health Care Trust (Trust).

The Public Education Employees' Health Insurance Plan (PEEHIP) offers a basic hospital medical plan to active members and non-Medicare eligible retirees. Benefits include inpatient hospitalization for a maximum of 365 days without a dollar limit, inpatient rehabilitation, outpatient care, physician services, and prescription drugs.

Active employees and non-Medicare eligible retirees who do not have Medicare eligible dependents can enroll in a health maintenance organization (HMO) in lieu of the basic hospital medical plan. The HMO includes hospital medical benefits, dental benefits, vision benefits, and an extensive formulary. However, participants in the HMO are required to receive care from a participating physician in the HMO plan.

The PEEHIP offers four optional plans (Hospital Indemnity, Cancer, Dental, and Vision) that may be selected in addition to or in lieu of the basic hospital medical plan or HMO. The Hospital Indemnity Plan provides a per-day benefit for hospital confinement, maternity, intensive care, cancer, and convalescent care. The Cancer Plan covers cancer disease only and benefits are provided regardless of other insurance. Coverage includes a per-day benefit for each hospital confinement related to cancer.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2012

A. General, Continued

The Dental Plan covers diagnostic and preventative services, as well as basic and major dental services. Diagnostic and preventative services include oral examinations, teeth cleaning, x-rays, and emergency office visits. Basic and major services include fillings, general aesthetics, oral surgery not covered under a Group Medical Program, periodontics, endodontics, dentures, bridgework, and crowns. Dental services are subject to a maximum of \$1,250 per year for individual coverage and \$1,000 per person per year for family coverage. The Vision Plan covers annual eye examinations, eye glasses, and contact lens prescriptions.

PEEHIP members may opt to elect the PEEHIP Supplemental Plan for hospital medical coverage in lieu of the PEEHIP Hospital Medical Plan. The PEEHIP Supplemental Plan provides secondary benefits to the member's primary plan provided by another employer. Only active and non-Medicare retiree members and dependents are eligible for the PEEHIP Supplemental Plan. There is no premium required for this plan, and the plan covers most out-of-pocket expenses not covered by the primary plan. The plan cannot be used as a supplement to Medicare, the PEEHIP Hospital Medical Plan, or the State or Local Governmental Plans administered by the State Employees' Insurance Board (SEIB).

The State specifies the monthly employer rate that participating school systems must contribute for each active employee. The monthly employer rate for fiscal year 2012 was \$714 per active participant. In accordance with the 2012 budget established by the Alabama Legislature, participating school systems paid the required monthly employer rate of \$714 on behalf of each active employee. Act 2003-473 requires universities who do not participate in the PEEHIP to pay the required monthly rate for each university retiree who participates in the plan. The required monthly employer rate for fiscal year 2012 was \$370 per university retiree. In addition to the employer payments each month, employees are required to pay certain premium amounts. Participants should refer to the PEEHIP's contracts for a more complete description of the PEEHIP's provisions.

B. Basis of Accounting

The PEEHIF is a proprietary fund that operates under the accrual basis of accounting using the economic resources measurement focus. The PEEHIF has elected to exercise paragraph 6 of GASB Statement 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*. This Statement requires that all proprietary activities apply all applicable GASB pronouncements, as well as any Financial Accounting Standards Board (FASB) Statements and Interpretations, Accounting Principles Board (APB) Opinions, and Accounting Research Bulletins (ARBs) of the Committee on Accounting Procedure (CAP) issued on or before November 30, 1989, unless such FASB, APB, and CAP pronouncements conflict with or contradict GASB pronouncements. FASB pronouncements issued after November 30, 1989, even if they modify an applicable FASB, APB, or CAP pronouncement, are not applicable unless adopted by a GASB pronouncement. Subsequent events were evaluated by management through the date the financial statements were issued.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2012

C. Cash

Cash consists of deposits held by the State Treasurer in the PEEHIF's name. Deposits are entirely insured by federal depository insurance or protected under the Security for Alabama Funds Enhancement (SAFE) Program. The *Code of Alabama 1975* requires all State organizations to participate in the SAFE Program. The SAFE Program is a multiple financial institution collateral pool. The SAFE Program requires all public funds to be deposited in a financial institution designated by the State Treasurer as a qualified public depository. Each qualified public depository is required to pledge collateral in accordance with the rules established by the SAFE Board of Directors. In the event that a qualified public depository defaults or becomes insolvent and the pledged collateral is insufficient to satisfy the claims of public depositors, the *Code of Alabama 1975, Section 41-14A-9(3)* authorizes the State Treasurer to make assessments against the other qualified public depositories in the pool so that there will be no loss of public funds. Cash designated for the payment of administrative expenses at September 30, 2012 was \$6,798,215.

D. Expense Fund

The Board designated \$3,600,000 of premiums received during the fiscal year ended September 30, 2012 to be used for the payment of administrative expenses. The administrative costs incurred directly for the operation of the PEEHIF are paid from the expense fund. Indirect costs are not allocated to the PEEHIF by the TRS.

E. Investments

The Board of Control of the PEEHIF has the responsibility and authority to invest and reinvest available funds, through the Secretary-Treasurer and Investment Committee, in bonds, mortgage-backed securities, mortgages, common and preferred stock, and other investment vehicles with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use. All plan assets are carried at fair value except commercial paper and money market funds which are reported at cost, which approximates fair value. U.S. agency obligations and corporate bonds are reported at the last reported sales price. Generally, private placements are valued based on the selling price of similar investments sold in the open market. In those instances where there are no similar investments sold in the open market, an appraisal is performed to determine the fair value of the private placements.

F. Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts on the financial statements. Actual results may differ from these estimates.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2012

G. Premiums

Premium revenue is recognized in the period in which the related coverage is provided. Premium payments that have not been received by the end of a coverage period are recorded as a receivable.

H. Medicare Part D Retiree Drug Subsidy

Medicare Part D reimbursements are the result of the PEEHIF continuing prescription drug coverage for Medicare beneficiaries and qualifying for the Medicare Part D subsidy. In order to comply with GASB Statement 43, Medicare Part D reimbursements are reported in the Alabama Retired Education Employees' Health Care Trust.

I. Early Retiree Reinsurance Program Reimbursement

The PEEHIF received funds during fiscal year 2011 from its participation in the Early Retiree Reinsurance Program (ERRP), which was established as part of the Patient Protection and Affordable Care Act. EERP is a temporary program whereby Congress appropriated \$5 billion in order to provide reimbursements to sponsors for 80% of the claims costs associated with providing health coverage to qualifying early retirees under the age of 65 (and their eligible dependents). While funds can only be received for the claims of qualifying early retirees (and dependents), reimbursements can be used for all plan participants, therefore a portion of the reimbursements has been allocated to the PEEHIF and the Alabama Retired Education Employees' Health Care Trust.

J. Unpaid Claims Liabilities

Claims liabilities are established based on the actual cost of claims reported but not settled and estimates of claims that have been incurred but not reported. Actual claims costs ultimately incurred may vary from estimated claims liabilities should the nature and frequency of actual claims vary from historical claims experience on which the estimates are based. Adjustments to claims liabilities are charged or credited to expense in the periods in which they are made.

Unpaid claims liabilities are material estimates that are particularly susceptible to changes in the near term. Management believes the liabilities established for unpaid claims at September 30, 2012 are adequate to cover the ultimate net cost of claims, but the liabilities are necessarily based on estimates and accordingly, the amount ultimately paid will be more or less than such estimates.

K. Employee Benefits

The PEEHIF records a liability and a charge to expense for all compensated absences attributable to services already rendered that are not contingent on specific events outside the control of the employer or employee.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2012

L. Equity

Insurance equity is allocated for the payment of insurance benefits. Expense fund equity is allocated for the payment of administrative expenses. As of September 30, 2012, unrestricted equity was allocated as follows:

Fund Equity - unrestricted		
(Amounts in Thousands)		
Insurance Fund	\$	144,554
Expense Fund		<u>5,634</u>
Total Fund Equity	\$	<u>150,188</u>

M. Comparative Statements

The basic financial statements include the prior fiscal year *Balance Sheet*, the *Statement of Revenues, Expenses and Changes in Fund Equity*, and the *Statement of Cash Flows* for comparative purposes only. Prior fiscal year note disclosures are not included. Therefore, the prior fiscal year basic financial statement presentation does not meet the minimum level of detail required for a presentation in conformity with generally accepted accounting principles. Accordingly, the prior fiscal year statements should be read in conjunction with the PEEHIF's prior fiscal year financial report from which the prior fiscal year statements were derived.

2) Contract Administrators

Blue Cross and Blue Shield of Alabama (BCBS), under contract with the Board, administered medical claims incurred in accordance with the plan. The BCBS administrative fee was \$10.45 per month per contract. The \$10.45 per member per month fee was charged to the PEEHIF.

BCBS, under contract with the Board, administered participant requests for reimbursement covered under flexible employee benefit plans. BCBS charged the PEEHIF an administrative fee of \$3.00 per month per contract.

MedImpact, under contract with the Board, administered claims under the prescription drug plan. The MedImpact administrative fee was \$0.75 per prescription. The \$0.75 per prescription fee was charged to the PEEHIF.

Southland Benefit Solutions, LLC (Southland), under contract with the Board, administered claims under the optional plans. The PEEHIF paid Southland an amount equal to covered charges plus processing fees. The processing fees per month per contract were \$0.75 for Group Hospital Indemnity, \$0.61 for Group Cancer, \$1.08 for Group Vision, and \$1.40 for Group Dental.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2012

3) Investments

A. Investment Risks

Investments are subject to certain types of risks, including interest rate risk, custodial credit risk, credit quality risk, and foreign currency risk. The following describes those risks and the PEEHIF's policies regarding those risks:

Interest Rate Risk – The fair value of fixed-maturity investments fluctuate in response to changes in market interest rates. Increases in prevailing interest rates generally translate into decreases in the fair value of those instruments. The fair value of interest sensitive instruments may also be affected by the creditworthiness of the issuer, prepayment options, relative values of alternative investments, and other general market conditions. Certain fixed maturity investments have call provisions that could result in shorter maturity periods.

Custodial Credit Risk – Custodial credit risk is the risk that an entity will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party if the counterparty fails. The PEEHIF's custodial credit risk policy requires the custodial agent to hold or direct its agents or sub custodians to hold, for the account of the PEEHIF, all securities and other non-cash property other than securities in the Federal Reserve book-entry system, in a clearing agency which acts as a securities depository, or in another book-entry system. The PEEHIF's safekeeping agent holds all investments of the PEEHIF in the PEEHIF's name.

Credit Quality – Nationally recognized statistical rating organizations provide ratings of debt securities quality based on a variety of factors, such as the financial condition of the issuers, which provide investors with some idea of the issuer's ability to meet its obligations. Domestic fixed-maturity investments may consist of rated or non-rated securities. The PEEHIF may hedge against the possible adverse effects of currency fluctuations on its portfolio of international fixed income obligations when it is considered appropriate. Short-term investments may consist of commercial paper rated at least A-2 and/or P-2, repurchase agreements, short-term U.S. securities, and other money market investments.

Foreign Currency Risk – Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. In order for an international security to be eligible for purchase by the PEEHIF, the issuing company must be incorporated in a country whose debt securities are eligible for purchase as discussed above, and the fair value of the aggregate outstanding equity of the issuing company must be at least \$100 million.

Concentration of Credit Risk – The PEEHIF's investment policies limit the aggregate amount that can be invested in each class of investments. The policy limits are as follows:

- Domestic Fixed Income – Limited to 50% of the fair value of the PEEHIF's aggregate portfolio.
- International Fixed Income – Limited to 10% of the fair value of the PEEHIF's total portfolio.
- Domestic Equity – Limited to 65% of the fair value of the PEEHIF's aggregate portfolio.

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2012

A. Investment Risks, Continued

- International Equity – Limited to 25% of the aggregate fair value of the PEEHIF's total portfolio. The PEEHIF also may not purchase or hold more than 5% of any class of the outstanding stock of a company.
- Real Estate – Limited to 15% of the book value of the PEEHIF's portfolio.
- Alternative Investments (mezzanine financing, LBO's, venture capital, limited partnerships, futures, commodities and derivative investments) - Limited to 10% of the book value of the PEEHIF's aggregate portfolio.
- Short-term Investments – Limited to 20% of the fair value of the PEEHIF's aggregate portfolio.

The PEEHIF's investments at the fiscal year-end were all held in short-term investments, as they will be used to cover cash flow requirements in the short-term.

The following table provides information concerning the fair value and the interest rate risk of the PEEHIF's investments as of September 30, 2012.

Type of Investment	INVESTMENTS						Maturity in Years at Fair Value			
	(Amounts in Thousands)								Total Fair Value	Cost
	Less Than 1	1-5	6-10	More Than 10						
Money Market Funds	\$ 9,452	\$ -	\$ -	\$ -					\$ 9,452	\$ 9,452
Commercial Paper	193,995	-	-	-					193,995	193,995
Total Investments	\$ 203,447	\$ -	\$ -	\$ -					\$ 203,447	\$ 203,447

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2012

A. Investment Risks, Continued

The following table provides information concerning the credit risk of the PEEHIF's investments as of September 30, 2012.

RATINGS OF FIXED MATURITIES

(Amounts in Thousands)

Moody's Ratings	Fair Value	Cost	Fair Value as a Percent of Total Fixed Maturity
P-1	\$ 9,452	\$ 9,452	4.65%
P-2	193,995	193,995	95.35%
Total Fixed Maturity	\$ 203,447	\$ 203,447	100.00%

Fair Value as a
Percent of Total
Fixed Maturity

Standard & Poor's Ratings	Fair Value	Cost	Fair Value
A-1+	\$ 9,452	\$ 9,452	4.65%
A-2	193,995	193,995	95.35%
Total Fixed Maturity	\$ 203,447	\$ 203,447	100.00%

B. Concentration of Investments

As of September 30, 2012, the PEEHIF owned investment securities that constituted more than 5% of the total fair value of investments in the following issuers:

Issuer	Percentage of Total Investments
Marriott International	19.65%
FMC Technologies Inc.	18.67%
Dominion Resources Inc.	17.20%
American Electric Power Co. Inc.	7.37%
Dairy Farmers of America	6.41%
Great Plains Energy Inc.	6.39%
American Water Works Co. Inc.	5.41%

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2012

4) Unpaid Claims Liabilities

As discussed in Note 1, the PEEHIF establishes a liability for both reported and unreported insured claims. This liability includes provisions for the future payment of losses and related claim adjustment expenses. The following represents changes in those aggregate liabilities for the PEEHIF during fiscal year 2012.

UNPAID CLAIMS LIABILITIES
(Amounts in Thousands)

Unpaid Claims and Claim Adjustment Expenses at Beginning of Year	\$ 72,421
Incurred Claims and Claim Adjustment Expenses:	
Provision for Insured Events of the Current Year	741,836
Decrease in Provision for Insured Events of Prior Years	(1,852)
Total Incurred Claims and Claim Adjustment Expenses	\$ 739,984
Payments:	
Claims and Claim Adjustment Expenses Attributable to Insured Events of the Current Year	\$ 677,334
Claims and Claim Adjustment Expenses Attributable to Insured Events of the Prior Years	70,570
Total Payments	<u>747,904</u>
Total Unpaid Claims and Claim Adjustment Expenses at the End of the Year	<u>\$ 64,501</u>

5) Other Postemployment Benefits

The PEEHIF employees and retirees participate in the State Employees' Health Insurance Plan (SEHIP) administered by the State Employees' Health Insurance Board (SEIB). The State Employees' Insurance Fund (SEIF) was established by the Alabama Legislature in 1965 under the provisions of Act 833 to provide health insurance benefits for active and retired employees of the State of Alabama. In addition, the *Code of Alabama, Section 36-36-1*, established the Alabama Retired State Employees' Health Care Trust for the purpose of accumulating assets to fund retiree benefits.

The Trust is a single-employer plan. The Trust issues financial statements that may be obtained by writing to:

State Employees' Insurance Board
P.O. Box 304900
Montgomery, AL 36130

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND

Notes to the Financial Statements

For the Fiscal Year Ended September 30, 2012

5) Other Postemployment Benefits, Continued

The *Code of Alabama 1975, Section 36-29-7* authorizes the employer contributions to the plan. Each year, the Legislature sets the premium rate in the annual appropriation bill required to be paid by employers on behalf of each active member. A portion of the premium is used to assist in funding retiree benefits. The fiscal year 2012 rate was \$805 per active member per month, except for the month of October 2011. For October 2011, the rate was \$325 per employee to allow the average monthly employer premium to equal the \$765 appropriation approved by the Legislature and Governor.

In addition to the required monthly employer payments, participating retirees are required to pay certain monthly premium amounts. The *Code of Alabama, Section 36-29-19.7* authorizes the retiree contributions to the plan. The required monthly contribution rates for fiscal year 2012 are as follows:

Retired Member Rates (after applying the \$40.00 non-tobacco usage discount)

- Individual Coverage/Non-Medicare Eligible - \$ 206.00
- Family Coverage/Non-Medicare Eligible Retired Member and Non-Medicare Eligible Dependent(s) -\$ 438.00
- Family Coverage/Non-Medicare Eligible Retired Member and Dependent Medicare Eligible - \$327.00
- Individual Coverage/Medicare Eligible Retired Member - \$0
- Family Coverage/Medicare Eligible Retired Member and Non-Medicare Eligible Dependent(s) \$232.00
- Family Coverage/Medicare Eligible Retired Member and Dependent Medicare Eligible - \$121.00

Surviving Spouse Rates (after applying the \$40.00 non-tobacco usage discount)

- Surviving Spouse Non-Medicare Eligible - \$322.00
- Surviving Spouse Non-Medicare Eligible and Dependent Non-Medicare Eligible - \$554.00
- Surviving Spouse Non-Medicare Eligible and Dependent Medicare Eligible - \$463.00
- Surviving Spouse Medicare Eligible - \$141.00
- Surviving Spouse Medicare Eligible and Dependent Non-Medicare Eligible - \$373.00
- Surviving Spouse Medicare Eligible and Dependent Medicare Eligible - \$282.00

The State Employees' Health Insurance Plan (SEHIP) is a single-employer defined benefit healthcare plan for the active and retired employees of the State of Alabama. An actuarial valuation is performed at least biannually to determine the other postemployment benefits liability and the annual required contribution (ARC) for state agencies participating in the State's health benefit plan. Each fiscal year, the State Comptroller's office performs an allocation to determine each agency's share of the ARC. The following table details the PEEHIF's ARC and the percentage of the ARC contributed (amounts in thousands).

Fiscal Year	Annual Required Contribution	Percentage Contributed
2012	\$ 127	39.78 %
2011	\$ 71	70.21 %
2010	\$ 76	87.79 %

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Notes to the Financial Statements
For the Fiscal Year Ended September 30, 2012

6) Pension Plan for the PEEHIF Employees

The employees of the PEEHIF participate in the Teachers' Retirement System of Alabama (TRS), a cost-sharing multiple-employer public employee retirement plan administered by the Retirement Systems of Alabama (RSA). Contributions to the plan were made in accordance with actuarially determined contribution requirements. The Schedule of Employer Contributions is shown below (amounts in thousands).

Fiscal Year	Annual Required Contribution	Percentage Contributed
2012	\$ 155	100.00 %
2011	\$ 206	100.00 %
2010	\$ 220	100.00 %

PUBLIC EDUCATION EMPLOYEES' HEALTH INSURANCE FUND
Required Supplementary Information
September 30, 2012

Ten -Year Claims Development Information

(Amounts in Thousands)

The following table illustrates how the PEEHIF's earned revenue and interest income compare to the related costs of claims and other expenses assumed by the PEEHIF as of the end of each of the past ten fiscal years. The lines of the table are defined as follows: (1) This line shows the total earned contribution and investment revenues for each fiscal year. (2) This line shows each fiscal year's other operating costs of the PEEHIF including overhead and claims expense not allocable to individual claims. (3) This line shows the PEEHIF's incurred claims and allocated claim adjustment expenses (both paid and accrued) as originally reported at the end of the first year in which the event that triggered coverage under the contract occurred (called policy year). (4) This line shows the cumulative amounts paid as of the end of successive years for each policy year. (5) This line shows how the incurred claims for each policy year increased or decreased as of the end of successive years. The annual re-estimated amount results from new information received on known claims, the re-evaluation of existing information on known claims as well as the emergence of previously unknown claims. (6) This line compares the latest reestimated incurred claims amount to the amount originally established (line 3) and shows whether this latest estimate of claims cost is greater or less than originally thought. As data for each policy year matures, the correlation between original estimates and reestimated amounts commonly is used to evaluate the accuracy of estimated incurred claims currently recognized.

	Fiscal and Policy Year Ended									
	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003
1) Net Earned Required Contribution & Investment Revenue	743,002	884,416	764,313	806,691	870,330	851,238	1,033,162	873,373	718,716	634,410
2) Unallocated Expenses	2,779	2,587	3,160	2,566	2,731	2,199	2,609	3,343	1,261	1,026
3) Estimated Incurred Claims & Expense at End of Policy Year	741,836	750,966	790,024	775,205	699,409	636,854	858,906	802,624	743,387	669,578
4) Paid (Cumulative) As Of:										
End of Policy Year	677,334	678,546	713,231	696,658	629,815	585,303	788,907	724,720	652,929	596,616
One Year Later		749,114	790,009	772,397	699,370	636,391	854,905	788,939	725,418	661,598
5) Reestimated Incurred Claims & Expense:										
End of Policy Year	741,836	750,966	790,024	775,205	699,409	636,854	858,906	802,624	743,387	669,578
One Year Later		749,114	790,009	772,397	699,370	636,974	854,323	788,939	725,418	661,598
6) Increase/(Decrease) in Estimated Incurred Claims & Expenses at End of Policy Year		(1,852)	(15)	(2,808)	(39)	120	(4,583)	(13,685)	(17,969)	(7,980)

Note: 2007 was the first year that retirees were segregated from the active employees. As a result, 2007 includes the amounts only attributable to the active employees. This schedule is presented prospectively.