

SAFETY INSURANCE GROUP INC  
Form 10-Q  
August 09, 2006

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2006

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-50070

**SAFETY INSURANCE GROUP, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**13-4181699**

(I.R.S. Employer Identification No.)

**20 Custom House Street, Boston, Massachusetts 02110**

(Address of principal executive offices including zip code)

**(617) 951-0600**

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

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Indicate by check mark whether the registrant is large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of August 4, 2006, there were 16,002,411 shares of common stock with a par value of \$0.01 per share outstanding.

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## SAFETY INSURANCE GROUP, INC.

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## Safety Insurance Group, Inc. and Subsidiaries

## Consolidated Balance Sheets

(Dollars in thousands, except share data)

|   | June 30,<br>2006<br>(Unaudited) | December 31,<br>2005 |
|---|---------------------------------|----------------------|
| <b>Assets</b>   |                                 |                      |
| Investment securities available for sale:   |                                 |                      |
| Fixed maturities, at fair value (amortized cost: \$876,134 and \$713,930)   | \$ 856,476                      | \$ 712,538           |
| Equity securities, at fair value (cost: \$3,887 and \$1,895)  | 3,983                           | 2,005                |
| Total investment securities   | 860,459                         | 714,543              |
| Cash and cash equivalents   | 31,543                          | 163,027              |
| Accounts receivable, net of allowance for doubtful accounts   | 162,075                         | 154,421              |
| Accrued investment income   | 9,046                           | 7,856                |
| Taxes recoverable   | 1,339                           | 318                  |
| Receivable from reinsurers related to paid loss and loss adjustment expenses  | 17,382                          | 18,750               |
| Receivable from reinsurers related to unpaid loss and loss adjustment expenses  | 76,068                          | 80,550               |
| Prepaid reinsurance premiums  | 36,853                          | 37,174               |
| Deferred policy acquisition costs   | 50,500                          | 45,480               |
| Deferred income taxes   | 24,694                          | 18,120               |
| Equity and deposits in pools  | 30,257                          | 14,631               |
| Other assets  | 3,559                           | 2,805                |
| <b>Total assets</b>   | <b>\$ 1,303,775</b>             | <b>\$ 1,257,675</b>  |
| <b>Liabilities</b>  |                                 |                      |
| Loss and loss adjustment expense reserves   | \$ 429,621                      | \$ 450,716           |
| Unearned premium reserves   | 362,845                         | 341,562              |
| Accounts payable and accrued liabilities  | 30,063                          | 44,372               |
| Outstanding claims drafts   | 18,128                          | 19,825               |
| Payable to reinsurers   | 27,591                          | 12,985               |
| Capital lease obligations   | 153                             | 266                  |
| <b>Total liabilities</b>  | <b>868,401</b>                  | <b>869,726</b>       |
| <b>Commitments and contingencies (Note 7)</b>   |                                 |                      |
| <b>Shareholders' equity</b>   |                                 |                      |
| Common stock: \$0.01 par value; 30,000,000 shares authorized; 15,989,203 and 15,787,947 shares issued and outstanding, respectively | 160                             | 158                  |
| Additional paid-in capital  | 125,537                         | 120,451              |
| Accumulated other comprehensive loss, net of taxes  | (12,715)                        | (833)                |
| Retained earnings   | 322,392                         | 268,173              |
| <b>Total shareholders' equity</b>   | <b>435,374</b>                  | <b>387,949</b>       |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 1,303,775</b>             | <b>\$ 1,257,675</b>  |

The accompanying notes are an integral part of these financial statements.

## Safety Insurance Group, Inc. and Subsidiaries

## Consolidated Statements of Operations

(Unaudited)

(Dollars in thousands, except per share and share data)

|  | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|--|--------------------------------|------------|------------------------------|------------|
|  | 2006                           | 2005       | 2006                         | 2005       |
| Net earned premiums  | \$ 156,261                     | \$ 156,514 | \$ 314,039                   | \$ 312,930 |
| Net investment income  | 9,834                          | 7,653      | 19,212                       | 15,112     |
| Net realized (losses) gains on investments                   | (187 )                         | (11 )      | (261 )                       | 396        |
| Finance and other service income                             | 3,720                          | 3,977      | 7,579                        | 7,946      |
| Total revenue  | 169,628                        | 168,133    | 340,569                      | 336,384    |
| Losses and loss adjustment expenses                          | 84,604                         | 93,802     | 170,355                      | 203,972    |
| Underwriting, operating and related expenses                 | 41,757                         | 39,975     | 82,152                       | 76,566     |
| Interest expenses  | 20                             | 225        | 44                           | 448        |
| Total expenses   | 126,381                        | 134,002    | 252,551                      | 280,986    |
| Income before income taxes                                   | 43,247                         | 34,131     | 88,018                       | 55,398     |
| Income tax expense   | 14,109                         | 10,885     | 28,078                       | 17,650     |
| Net income   | \$ 29,138                      | \$ 23,246  | \$ 59,940                    | \$ 37,748  |
| <b>Earnings per weighted average common share:</b>           |                                |            |                              |            |
| Basic  | \$ 1.84                        | \$ 1.49    | \$ 3.80                      | \$ 2.43    |
| Diluted  | \$ 1.81                        | \$ 1.46    | \$ 3.75                      | \$ 2.38    |
| <b>Cash dividends paid per common share</b>                  | \$ 0.18                        | \$ 0.12    | \$ 0.36                      | \$ 0.24    |
| <b>Weighted average number of common shares outstanding:</b> |                                |            |                              |            |
| Basic  | 15,826,992                     | 15,583,473 | 15,769,133                   | 15,512,120 |
| Diluted  | 16,056,362                     | 15,874,315 | 15,992,337                   | 15,845,024 |

The accompanying notes are an integral part of these financial statements.

## Safety Insurance Group, Inc. and Subsidiaries

## Consolidated Statements of Changes in Shareholders' Equity

(Unaudited)

(Dollars in thousands)

|  | Common<br>Stock | Additional<br>Paid-in<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income/(Loss),<br>Net of Taxes | Retained<br>Earnings | Total<br>Shareholders<br>Equity |
|--|-----------------|----------------------------------|---|----------------------|---------------------------------|
| Balance at December 31, 2004   | \$ 155          | \$ 114,070                       | \$ 8,709  | \$ 182,400           | \$ 305,334                      |
| Net income, January 1 to June 30, 2005   |                 |                                  |   | 37,748               | 37,748                          |
| Other comprehensive loss, net of deferred<br>federal income taxes  |                 |                                  | (1,736 )  |                      | (1,736 )                        |
| Exercise of options and unearned<br>compensation on restricted stock net of<br>deferred federal income taxes | 2               | 3,934                            |   |                      | 3,936                           |
| Dividends paid   |                 |                                  |   | (3,742 )             | (3,742 )                        |
| Balance at June 30, 2005   | \$ 157          | \$ 118,004                       | \$ 6,973  | \$ 216,406           | \$ 341,540                      |

|  | Common<br>Stock | Additional<br>Paid-in<br>Capital | Other<br>Comprehensive<br>Income/(Loss),<br>Net of Taxes | Retained<br>Earnings | Total<br>Shareholders<br>Equity |
|--|-----------------|----------------------------------|--|----------------------|---------------------------------|
| Balance at December 31, 2005   | \$ 158          | \$ 120,451                       | \$ (833 )  | \$ 268,173           | \$ 387,949                      |
| Net income, January 1 to June 30, 2006   |                 |                                  |  | 59,940               | 59,940                          |
| Other comprehensive loss, net of deferred<br>federal income taxes  |                 |                                  | (11,882 )  |                      | (11,882 )                       |
| Exercise of options and unearned<br>compensation on restricted stock net of<br>deferred federal income taxes | 2               | 5,086                            |  |                      | 5,088                           |
| Dividends paid   |                 |                                  |  | (5,721 )             | (5,721 )                        |
| Balance at June 30, 2006   | \$ 160          | \$ 125,537                       | \$ (12,715 )   | \$ 322,392           | \$ 435,374                      |

The accompanying notes are an integral part of these financial statements.

**Safety Insurance Group, Inc. and Subsidiaries**  
**Consolidated Statements of Comprehensive Income**  
**(Unaudited)**  
**(Dollars in thousands)**

|  | Three Months Ended |           | Six Months Ended |           |
|--|--------------------|-----------|------------------|-----------|
|  | June 30,<br>2006   | 2005      | June 30,<br>2006 | 2005      |
| <b>Net income</b>  | <b>\$ 29,138</b>   | \$ 23,246 | <b>\$ 59,940</b> | \$ 37,748 |
| <b>Other comprehensive (loss) income, net of tax:</b>  |                    |           |                  |           |
| Change in unrealized holding gains, net of tax expense (benefit) of \$(3,004), \$3,131, \$(6,489) and \$(796)                      | (5,578 )           | 5,813     | (12,052 )        | (1,479 )  |
| Reclassification adjustment for losses (gains) included in net income, net of tax expense (benefit) of \$65, \$3, \$91 and \$(139) | 122                | 8         | 170              | (257 )    |
| Unrealized (losses) gains on securities available for sale   | (5,456 )           | 5,821     | (11,882 )        | (1,736 )  |
| <b>Comprehensive income</b>  | <b>\$ 23,682</b>   | \$ 29,067 | <b>\$ 48,058</b> | \$ 36,012 |

The accompanying notes are an integral part of these financial statements.

## Safety Insurance Group, Inc. and Subsidiaries

## Consolidated Statements of Cash Flows

(Unaudited)

(Dollars in thousands)

|   | Six Months Ended<br>June 30, |                   |
|---|------------------------------|-------------------|
|   | 2006                         | 2005              |
| <b>Cash flows from operating activities:</b>                                      |                              |                   |
| Net income  | \$ 59,940                    | \$ 37,748         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |                   |
| Depreciation and amortization, net  | 4,286                        | 4,177             |
| Benefit for deferred income taxes   | (176 )                       | (1,330 )          |
| Net realized losses (gains) on investments  | 261                          | (396 )            |
| Changes in assets and liabilities:  |                              |                   |
| Accounts receivable   | (7,654 )                     | (20,171 )         |
| Accrued investment income   | (1,190 )                     | (220 )            |
| Receivable from reinsurers  | 5,850                        | (1,588 )          |
| Prepaid reinsurance premiums  | 321                          | 1,200             |
| Deferred policy acquisition costs   | (5,020 )                     | (6,680 )          |
| Other assets  | (16,902 )                    | (21,287 )         |
| Loss and loss adjustment expense reserves   | (21,095 )                    | 11,832            |
| Unearned premium reserves   | 21,283                       | 40,248            |
| Accounts payable and accrued liabilities  | (14,309 )                    | (18,047 )         |
| Payable to reinsurers   | 14,606                       | 14,003            |
| Other liabilities   | (1,810 )                     | 4,747             |
| Net cash provided by operating activities   | 38,391                       | 44,236            |
| <b>Cash flows from investing activities:</b>                                      |                              |                   |
| Fixed maturities purchased  | (270,442 )                   | (57,485 )         |
| Equity securities purchased   | (2,455 )                     | (1,132 )          |
| Proceeds from sales of fixed maturities   | 93,154                       | 25,673            |
| Proceeds from maturities of fixed maturities                                      | 12,200                       | 4,975             |
| Proceed from sales of equity securities   | 485                          | 134               |
| Fixed assets purchased  | (501 )                       | (494 )            |
| Net cash used for investing activities  | (167,559 )                   | (28,329 )         |
| <b>Cash flows from financing activities:</b>                                      |                              |                   |
| Proceeds and excess tax benefits from exercise of stock options                   | 3,405                        | 2,164             |
| Dividends paid to shareholders  | (5,721 )                     | (3,742 )          |
| Net cash used for financing activities  | (2,316 )                     | (1,578 )          |
| <b>Net (decrease) increase in cash and cash equivalents</b>                       | <b>(131,484 )</b>            | <b>14,329</b>     |
| Cash and cash equivalents at beginning of year                                    | 163,027                      | 155,673           |
| <b>Cash and cash equivalents at end of period</b>                                 | <b>\$ 31,543</b>             | <b>\$ 170,002</b> |

The accompanying notes are an integral part of these financial statements.





**Safety Insurance Group, Inc. and Subsidiaries**  
**Notes to Unaudited Consolidated Financial Statements**  
**(Dollars in thousands except per share and share data)**

**1. Basis of Presentation**

The consolidated financial statements have been prepared on the basis of accounting principles generally accepted in the United States of America ( GAAP ). GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates.

The consolidated financial statements include Safety Insurance Group, Inc. and its subsidiaries (the Company ). The subsidiaries consist of Safety Insurance Company, Safety Indemnity Insurance Company, Whiteshirts Asset Management Corporation ( WAMC ), and Whiteshirts Management Corporation, which is WAMC 's holding company. All intercompany transactions have been eliminated. Prior period amounts have been reclassified to conform to the current period presentation.

The financial information as of June 30, 2006 and for the three and six months ended June 30, 2006 and 2005 is unaudited; however, in the opinion of the Company, the information includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the financial condition and results of operations for the periods. These unaudited consolidated financial statements may not be indicative of financial results for the full year and should be read in conjunction with the audited financial statements included in the Company 's annual report on Form 10-K filed with the U.S. Securities and Exchange Commission ( SEC ) on March 16, 2006.

The Company is a leading provider of personal lines property and casualty insurance focused exclusively on the Massachusetts market. The Company 's principal product line is private passenger automobile insurance, which accounted for 80.3% of its direct written premiums in 2005. The Company operates through its insurance company subsidiaries, Safety Insurance Company and Safety Indemnity Insurance Company.

**2. New Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109 ( FIN 48 ). This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company does not believe the adoption of FIN No. 48 will have a material impact on its consolidated results of operations or financial position.

**3. Earnings Per Weighted Average Common Share**

Basic earnings per weighted average common share ( EPS ) are calculated by dividing net income by the weighted average number of basic common shares outstanding during the period. Diluted EPS are calculated by dividing net income by the weighted average number of basic common shares outstanding and the net effect of potentially dilutive common shares. At June 30, 2006 and 2005, the Company 's potentially dilutive instruments consisted of common shares under options of 480,797 and 611,295, respectively, and common shares under restriction of 118,790 and 105,960, respectively.

|  | Three Months Ended |            | Six Months Ended |            |
|--|--------------------|------------|------------------|------------|
|  | June 30,<br>2006   | 2005       | June 30,<br>2006 | 2005       |
| <b>Earnings per weighted average common share:</b>           |                    |            |                  |            |
| Basic  | \$ 1.84            | \$ 1.49    | \$ 3.80          | \$ 2.43    |
| Diluted  | \$ 1.81            | \$ 1.46    | \$ 3.75          | \$ 2.38    |
| <b>Weighted average number of common shares outstanding:</b> |                    |            |                  |            |
| Basic  | 15,826,992         | 15,583,473 | 15,769,133       | 15,512,120 |
| Effect of dilutive securities                                |                    |            |                  |            |
| Stock options  | 196,168            | 268,642    | 197,381          | 311,252    |
| Restricted stock   | 33,202             | 22,200     | 25,823           | 21,652     |
| Diluted  | 16,056,362         | 15,874,315 | 15,992,337       | 15,845,024 |

Diluted EPS excludes stock options with exercise prices greater than the average market price of the Company's common stock during the period because their inclusion would be anti-dilutive. The number of anti-dilutive stock options for both the three and six months ended June 30, 2006 was 191,225. The number of anti-dilutive stock options for both the three and six months ended June 30, 2005 was 78,000.

#### 4. Stock-Based Compensation

##### Management Omnibus Incentive Plan

Long-term incentive compensation is provided under the Company's 2002 Management Omnibus Incentive Plan (the Incentive Plan) which provides for a variety of stock-based compensation awards, including nonqualified stock options (NQSOs), incentive stock options, stock appreciation rights and restricted stock (RS) awards.

On March 10, 2006, the Board of Directors (Board) of the Company approved amendments to the Incentive Plan, subject to shareholder approval, to (i) increase the number of shares of common stock available for issuance by 1,250,000 shares, (ii) remove obsolete provisions, and (iii) make other non-material changes. A total of 1,250,000 shares of common stock had previously been authorized for issuance under the Incentive Plan. The Incentive Plan, as amended, was approved by the shareholders at the 2006 Annual Meeting of Shareholders which was held on May 19, 2006. Under the Incentive Plan, as amended, the maximum number of shares of common stock with respect to which awards may be granted is 2,500,000. At June 30, 2006, there were 1,289,991 shares available for future grant. The Board and the Compensation Committee intend to issue more awards under the Incentive Plan in the future. There were no grants made under the Incentive Plan during the quarter ended June 30, 2006.

A summary of stock-based awards granted under the Incentive Plan during the six months ended June 30, 2006 is as follows:

| Type of Equity Awarded | Effective Date | Number of Awards Granted | Exercise Price (1) or Fair Value (2) per Share | Vesting Terms         | Expiration Date |
|------------------------|----------------|--------------------------|--|-----------------------|-----------------|
| NQSOs                  | March 10, 2006 | 126,225                  | \$ 42.85 (1)                                   | 5 years, 20% annually | March 10, 2016  |
| RS                     | March 10, 2006 | 58,342                   | 42.85 (2)                                      | 3 years, 30%-30%-40%  | N/A             |
| RS                     | March 10, 2006 | 4,000                    | 42.85 (2)                                      | No vesting period (3) | N/A             |

(1) The exercise price of the stock option grant is equal to the closing price of the Company's common stock on the grant effective date.

(2) The fair value of the restricted stock grant is equal to the closing price of the Company's common stock on the grant effective date.

(3) The shares cannot be sold, assigned, pledged, or otherwise transferred, encumbered or disposed of until the recipient is no longer a member of the Board of Directors.



### Accounting and Reporting for Stock-Based Awards

Prior to January 1, 2006, the Company accounted for share-based compensation to employees and non-employee directors in accordance with the recognition and measurement principles of Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees , as allowed by Statement of Financial Accounting Standard No. ( FAS ) 123, Accounting for Stock-Based Compensation and as amended by FAS 148, Accounting for Stock-Based Compensation Transition and Disclosure . Accordingly, no compensation cost related to stock options was reflected in net income, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The Company historically reported pro forma results under the disclosure-only provisions of FAS123.

Effective January 1, 2006, the Company adopted FAS 123R (revised 2004), Share-Based Payment, which requires the Company to measure and recognize the cost of employee services received in exchange for an award of equity instruments. Under the provisions of FAS 123R, share-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period (generally the vesting period of the equity grant).

As permitted by FAS 123R, the Company elected the modified prospective transition method. Under the modified prospective transition method, (i) compensation expense for share-based awards granted prior to January 1, 2006 is recognized over the remaining service period using the compensation cost calculated for pro forma disclosure purposes under FAS 123 as adjusted to incorporate forfeiture assumptions under FAS123R, and (ii) compensation expense for all share-based awards granted subsequent to December 31, 2005 is based on the grant date fair value estimated in accordance with the provisions of FAS 123R. Results for periods prior to January 1, 2006 have not been restated.

As a result of adopting FAS 123R on January 1, 2006, the Company's net income for the three and six months ended June 30, 2006 was lowered by \$137 and \$275, net of income tax benefit of \$73 and \$148, respectively. The impact on both basic and diluted EPS for the three and six months ended June 30, 2006 was a reduction of \$0.01 and \$0.02 per share, respectively.

FAS123R requires the disclosure of pro forma information for periods prior to the adoption. The following table illustrates the effect on net income and EPS if the Company had applied the fair value recognition provisions of FAS 123 for all share-based awards:

|  | <b>Three Months Ended<br/>June 30, 2005</b> | <b>Six Months Ended<br/>June 30, 2005</b> |
|--|---|---|
| Net income, as reported  | \$ 23,246                                   | \$ 37,748                                 |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects | (143)                                       | (285)                                     |
| Net income, pro forma  | \$ 23,103                                   | \$ 37,463                                 |
| Earnings per weighted average share:   |   |   |
| Basic, as reported   | \$ 1.49                                     | \$ 2.43                                   |
| Basic, pro forma   | \$ 1.48                                     | \$ 2.42                                   |
| Diluted, as reported   | \$ 1.46                                     | \$ 2.38                                   |
| Diluted, pro forma   | \$ 1.45                                     | \$ 2.37                                   |

## Stock Options

The fair value of stock options used to compute pro forma net income and earnings per share disclosures for the three and six months ended June 30, 2006 and 2005 is the estimated fair value at grant effective date using the Black-Scholes option-pricing model with the following assumptions:

|                         | Three and Six Months Ended June 30, |               |
|-------------------------|-------------------------------------|---------------|
|                         | 2006                                | 2005          |
| Expected dividend yield | 1.36% - 2.52%                       | 1.36% - 2.52% |
| Expected volatility     | 0.20 - 0.36                         | 0.20 - 0.31   |
| Risk-free interest rate | 3.23% - 4.76%                       | 3.23% - 4.35% |
| Expected holding period | 6.5 - 7 years                       | 7 years       |

Expected dividend yield is the Company's dividend yield on the measurement date and is based on the assumption that the current yield will continue in the future. Expected volatility is based on historical volatility of the Company's common stock as well as the volatility of a peer group of property and casualty insurers measured for a period equal to the expected holding period of the option. The risk-free interest rate is based upon the yield on the measurement date of a zero-coupon U.S. Treasury bond with a maturity period equal to the expected holding period of the option. The expected holding period is based upon the simplified method provided in SEC Staff Accounting Bulletin No. 107

Share-Based Payment, which utilizes the mid-points between the vesting dates and the expiration date of the option award to calculate the overall expected term.

A summary of option activity under the Incentive Plan during the six months ended June 30, 2006 is presented below:

| Options                        | Shares    | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|--------------------------------|-----------|---------------------------------|---|---------------------------|
| Outstanding at January 1, 2006 | 496,086   | \$ 17.04                        |   |                           |
| Granted during the period      | 126,225   | 42.85                           |   |                           |
| Forfeited during the period    | (2,600)   | 27.07                           |   |                           |
| Exercised during the period    | (138,914) | 14.25                           |   |                           |
| Outstanding at June 30, 2006   | 480,797   | 24.57                           | 7.9 years                                   | \$ 11,047                 |
| Exercisable at June 30, 2006   | 59,180    | 18.11                           | 7.3 years                                   | 1,742                     |

The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based upon the Company's closing stock price of \$47.55 on June 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date. The range of exercise prices on stock options outstanding under the Incentive Plan was \$12.00 to \$42.85 at June 30, 2006 and \$12.00 to \$35.23 at June 30, 2005. The weighted average grant-date fair value of options granted during the six months ended June 30, 2006 and 2005 was estimated at \$16.05 and \$12.62, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2006 and 2005 was \$4,625 and \$3,519, respectively.

A summary of the status of non-vested options as of June 30, 2006 is presented below:

|                               | Number of Shares | Weighted Average Grant Date Exercise Price |
|-------------------------------|------------------|--|
| Non-vested at January 1, 2006 | 446,446          | \$ 17.39                                   |
| Granted during the period     | 126,225          | 42.85                                      |
| Vested during the period      | (148,454)        | 15.88                                      |
| Forfeited during the period   | (2,600)          | 27.07                                      |
| Non-vested at June 30, 2006   | 421,617          | \$ 25.48                                   |

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As of June 30, 2006, there was \$2,695 unrecognized compensation expense related to non-vested option awards that is expected to be recognized over a weighted average period of 3.8 years.

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Cash received from options exercised was \$1,980 and \$2,164 for the six months ended June 30, 2006 and 2005, respectively.

### Restricted Stock

Restricted stock awarded to employees in the form of unvested shares are recorded at the market value of the Company's common stock on the grant date and amortized ratably as expense over the requisite service period.

A summary of restricted stock activity under the Incentive Plan during the six months ended June 30, 2006 is presented below:

|   | Shares<br>Under<br>Restriction | Weighted<br>Average<br>Fair Value |
|---|--------------------------------|-----------------------------------|
| Outstanding at January 1, 2006            | 98,417                         | \$ 27.77                          |
| Granted during the period                 | 62,342                         | 42.85                             |
| Vested and unrestricted during the period | (33,969 )                      | 25.97                             |
| Outstanding at June 30, 2006              | 126,790                        | 35.67                             |

As of June 30, 2006, there was \$3,713 of unrecognized compensation expense related to non-vested restricted stock awards that is expected to be recognized over a weighted average period of 1.6 years. The total fair value of the shares that were vested and unrestricted during the six months ended June 30, 2006 was \$882. For the six months ended June 30, 2006 and 2005, the Company recorded compensation expense related to restricted stock of \$572 and \$332, net of income tax benefits of \$308 and \$178, respectively.

### 5. Investments

The gross unrealized appreciation (depreciation) of investments in fixed maturities securities, including redeemable preferred stocks that have characteristics of fixed maturities, and equity securities, including interests in mutual funds, was as follows:

|  | June 30, 2006 |                              |                               |                            |
|--|---------------|------------------------------|-------------------------------|----------------------------|
|  | Cost          | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
| U.S. Treasury securities and obligations of U.S. Government agencies (1) | \$ 149,308    | \$ 38                        | \$ (5,535 )                   | \$ 143,811                 |
| Obligations of states and political subdivisions                         | 410,042       | 1,257                        | (6,727 )                      | 404,572                    |
| Asset-backed securities (1)  | 179,202       | 41                           | (5,390 )                      | 173,853                    |
| Corporate and other securities   | 137,582       | 703                          | (4,045 )                      | 134,240                    |
| Subtotal, fixed maturity securities                                      | 876,134       | 2,039                        | (21,697 )                     | 856,476                    |
| Equity securities  | 3,887         | 105                          | (9 )                          | 3,983                      |
| Totals   | \$ 880,021    | \$ 2,144                     | \$ (21,706 )                  | \$ 860,459                 |

(1) Obligations of U.S. Government agencies include collateralized mortgage obligations issued, guaranteed and/or insured by the following issuers: Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA). The total of these fixed maturity securities was \$139,311 at amortized cost and \$134,016 at estimated fair value as of June 30, 2006. As such, the asset-backed securities presented exclude such issuers already presented under U.S. Treasury securities and obligations of U.S. Government Agencies.



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The amortized cost and the estimated fair value of fixed maturity securities, by maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | June 30, 2006     |                         |
|--|-------------------|-------------------------|
|  | Amortized<br>Cost | Estimated<br>Fair Value |
| Due in one year or less                  | \$ 13,304         | \$ 13,247               |
| Due after one year through five years    | 165,812           | 162,212                 |
| Due after five years through ten years   | 154,089           | 151,341                 |
| Due after ten years through twenty years | 206,133           | 203,220                 |
| Due after twenty years                   | 18,283            | 18,587                  |
| Asset-backed securities                  | 318,513           | 307,869                 |
| Totals                                   | \$ 876,134        | \$ 856,476              |

Gross gains of \$340 and \$0 and gross losses of \$531 and \$11 were realized on sales of fixed maturities for the three months ended June 30, 2006 and 2005, respectively. Gross gains of \$13 and \$0 and gross losses of \$9 and \$0 were realized on sales of equity securities for the three months ended June 30, 2006 and 2005, respectively. Proceeds from fixed maturities maturing were \$3,200 and \$4,975 for the three months ended June 30, 2006 and 2005, respectively. Gross gains of \$377 and \$412 and gross losses of \$660 and \$17 were realized on sales of fixed maturities for the six months ended June 30, 2006 and 2005, respectively. Gross gains of \$31 and \$1 and gross losses of \$9 and \$0 were realized on sales of equity securities for the six months ended June 30, 2006 and 2005, respectively. Proceeds from fixed maturities maturing were \$12,200 and \$4,975 for the six months ended June 30, 2006 and 2005, respectively.

The following tables illustrate the gross unrealized losses included in the Company's investment portfolio and the fair value of those securities aggregated by investment category. The table also illustrates the length of time that they have been in a continuous unrealized loss position.

|  | As of June 30, 2006 |                      |                   |                      |            |                      |
|--|---------------------|----------------------|-------------------|----------------------|------------|----------------------|
|  | Less than 12 Months |                      | 12 Months or More |                      | Total      |                      |
|  | Fair Value          | Unrealized<br>Losses | Fair Value        | Unrealized<br>Losses | Fair Value | Unrealized<br>Losses |
| U.S. Treasury securities and obligations of U.S. Government agencies | \$ 52,458           | \$ 1,088             | \$ 89,380         | \$ 4,447             | \$ 141,838 | \$ 5,535             |
| Obligations of states and political subdivisions                     | 200,998             | 2,818                | 109,790           | 3,909                | 310,788    | 6,727                |
| Asset-backed securities  | 114,975             | 3,311                | 46,229            | 2,079                | 161,204    | 5,390                |
| Corporate and other securities                                       | 62,676              | 2,104                | 49,203            | 1,941                | 111,879    | 4,045                |
| Subtotal, fixed maturity securities                                  | 431,107             | 9,321                | 294,602           | 12,376               | 725,709    | 21,697               |
| Equity securities  | 349                 | 9                    |                   |                      | 349        | 9                    |
| Total temporarily impaired securities                                | \$ 431,456          | \$ 9,330             | \$ 294,602        | \$ 12,376            | \$ 726,058 | \$ 21,706            |

The Company's investment portfolio included 288 securities in an unrealized loss position at June 30, 2006. The Company's methodology of assessing other-than-temporary impairment is based upon analysis of each security as of the balance sheet date and considers various factors including the length of time and the extent to which fair value has been less than the cost, the financial condition and the near term prospects of the issuer, whether the debtor is current on its contractually obligated interest and principal payments, and the Company's intent and ability to hold the investment for a period of time sufficient to allow for recovery of its costs.

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During the three and six months ended June 30, 2006 and 2005, there was no significant deterioration in the credit quality of any of the Company's holdings and no other-than-temporary impairment charges were recorded related to the Company's portfolio of investment securities.

As of June 30, 2006, the Company's fixed income securities portfolio was comprised entirely of investment grade securities as defined by Moody's Investor Services, Inc., Standard and Poor's, and the Securities Valuation Office of the National Association of Insurance Commissioners.

### Net Investment Income

The components of net investment income were as follows:

|  | Three Months Ended |          | Six Months Ended |           |
|--|--------------------|----------|------------------|-----------|
|  | June 30,<br>2006   | 2005     | June 30,<br>2006 | 2005      |
| Interest and dividends on fixed maturities | \$ 9,584           | \$ 6,949 | \$ 17,924        | \$ 13,922 |
| Dividends on equity securities             | 31                 | 9        | 38               | 11        |
| Interest on cash and cash equivalents      | 511                | 960      | 1,831            | 1,705     |
| Total investment income                    | 10,126             | 7,918    | 19,793           | 15,638    |
| Investment expenses                        | 292                | 265      | 581              | 526       |
| Net investment income                      | \$ 9,834           | \$ 7,653 | \$ 19,212        | \$ 15,112 |

### 6. Loss and Loss Adjustment Expense ( LAE ) Reserves

The following table sets forth a reconciliation of beginning and ending reserves for losses and LAE, as shown in the Company's consolidated financial statements for the periods indicated:

|   | Six Months Ended |            |
|---|------------------|------------|
|   | June 30,<br>2006 | 2005       |
| Reserves for losses and LAE, beginning of year          | \$ 450,716       | \$ 450,897 |
| Less reinsurance recoverable on unpaid losses and LAE   | (80,550 )        | (84,167 )  |
| Net reserves for losses and LAE, beginning of year      | 370,166          | 366,730    |
| Incurring losses and LAE, related to:                   |                  |            |
| Current year  | 195,734          | 221,205    |
| Prior years   | (25,379 )        | (17,233 )  |
| Total incurred losses and LAE                           | 170,355          | 203,972    |
| Paid losses and LAE related to:                         |                  |            |
| Current year  | 100,113          | 116,181    |
| Prior years   | 86,855           | 75,749     |
| Total paid losses and LAE                               | 186,968          | 191,930    |
| Net reserves for losses and LAE, end of current quarter | 353,553          | 378,772    |
| Plus reinsurance recoverables on unpaid losses and LAE  | 76,068           | 83,957     |
| Reserves for losses and LAE, end of current quarter     | \$ 429,621       | \$ 462,729 |

At the end of each period, the reserves were re-estimated for all prior accident years. The Company's prior year reserves decreased by \$25,379 and \$17,233 for the six months ended June 30, 2006 and 2005, respectively. The decrease in prior year reserves during the 2006 period resulted from re-estimations of prior year ultimate loss and LAE liabilities and is primarily composed of reductions of \$10,261 in Commonwealth Automobile Reinsurers ( CAR ) assumed reserves, \$11,721 in the Company's automobile reserves and \$2,605 in the Company's homeowners reserves. The decrease in prior year reserves



during the 2005 period resulted from re-estimations of prior year ultimate loss and LAE liabilities and is composed of reductions of \$12,583 in CAR assumed reserves and \$4,650 in the Company's own automobile reserves. It is not appropriate to extrapolate future favorable or unfavorable development of reserves from this past experience.

Due to the nature of the risks that the Company underwrites and has historically underwritten, management does not believe that it has an exposure to asbestos or environmental pollution liabilities.

## **7. Commitments and Contingencies**

Various claims, generally incidental to the conduct of normal business, are pending or alleged against the Company from time to time. In the opinion of management, based in part on the advice of legal counsel, the ultimate resolution of such claims will not have a material adverse effect on the Company's consolidated financial statements. However, liabilities related to those proceedings could be established in the near term if estimates of the ultimate resolutions of those proceedings are revised.

Massachusetts law requires that insurers licensed to do business in Massachusetts participate in the Massachusetts Insurers Insolvency Fund ( "Insolvency Fund" ). Members of the Insolvency Fund are assessed a proportionate share of the obligations and expenses of the Insolvency Fund in connection with an insolvent insurer. It is anticipated that there will be additional assessments from time to time relating to various insolvencies. Although the timing and amounts of any future assessments are not known, based upon existing knowledge, management's opinion is that such future assessments will not have a material effect upon the financial position of the Company.

## **8. Debt**

The Company has a \$30,000 revolving credit facility with Citizens Bank of Massachusetts which expires on June 17, 2008. Loans under the credit facility bear interest at our option at either (i) the LIBOR rate plus 1.5% per annum or (ii) the higher of Citizens Bank of Massachusetts prime rate or 0.5% above the federal funds rate plus 1.5% per annum. Interest only is payable prior to maturity. The obligations of the Company under the credit facility are secured by pledges of the Company's assets and the capital stock of its operating subsidiaries. The credit facility is guaranteed by the non-insurance company subsidiaries of the Company. The credit facility contains covenants including requirements to maintain minimum risk based capital ratios and statutory surplus of Safety Insurance Company as well as limitations or restrictions on indebtedness, liens, dividends, and other matters. As of June 30, 2006, the Company was in compliance with all such covenants.

The Company paid down the balance of \$19,956 on December 8, 2005 and had no amounts outstanding on its credit facility at June 30, 2006 and at December 31, 2005. The interest rate on the \$30,000 commitment was .25% at June 30, 2006 and December 31, 2005.

## **9. Income Taxes**

Federal income tax expense for the three and six months ended June 30, 2006 and 2005 has been computed using estimated effective tax rates. These rates are revised, if necessary, at the end of each successive interim period to reflect the current estimates of the annual effective tax rates.

**Item 2.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS**

**OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following discussion should be read in conjunction with our accompanying consolidated financial statements and notes thereto, which appear elsewhere in this document. In this discussion, all dollar amounts are presented in thousands, except share and per share data.*

*The following discussion contains forward-looking statements. We intend statements which are not historical in nature to be, and are hereby identified as forward-looking statements to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. In addition, the Company's senior management may make forward-looking statements orally to analysts, investors, the media and others. This safe harbor requires that we specify important factors that could cause actual results to differ materially from those contained in forward-looking statements made by or on behalf of us. We cannot promise that our expectations in such forward-looking statements will turn out to be correct. Our actual results could be materially different from and worse than our expectations. See Section G. Forward-Looking Statements for specific important factors that could cause actual results to differ materially from those contained in forward-looking statements.*

**A. Executive Summary and Overview**

In this discussion, Safety refers to Safety Insurance Group, Inc. and our Company, we, us and our refer to Safety Insurance Group, Inc. and its consolidated subsidiaries. Our subsidiaries consist of Safety Insurance Company ( Safety Insurance ), Safety Indemnity Insurance Company, Whiteshirts Asset Management Corporation ( WAMC ), and Whiteshirts Management Corporation, which is WAMC's holding company.

We are a leading provider of private passenger automobile insurance in Massachusetts. In addition to private passenger automobile insurance (which represented 80.3% of our direct written premiums in 2005), we offer a portfolio of other insurance products, including commercial automobile (10.8% of 2005 direct written premiums), homeowners (7.2% of 2005 direct written premiums), dwelling fire, umbrella and business owner policies (totaling 1.7% of 2005 direct written premiums). Operating exclusively in Massachusetts through our insurance company subsidiaries, Safety Insurance and Safety Indemnity Insurance Company (together referred to as the Insurance Subsidiaries ), we have established strong relationships with 637 independent insurance agents in 743 locations throughout Massachusetts. We have used these relationships and our extensive knowledge of the Massachusetts market to become the second largest private passenger automobile insurance carrier in Massachusetts, capturing an approximate 11.3% share of the Massachusetts private passenger automobile market in 2005, according to the Commonwealth Automobile Reinsures ( CAR ) Cession Volume Analysis Report of February 27, 2006, based on automobile exposures. These statistics total, for each vehicle insured, the number of months during the year insurance for that vehicle is in effect, to arrive at an aggregate number of car-months for each insurer; this aggregate number, divided by 12, equals the insurer's number of car-years, a measure we refer to in this discussion as automobile exposures.

*Massachusetts Automobile Insurance Market*

We are subject to the extensive regulation of the private passenger automobile insurance industry in Massachusetts, which represented 80.3% of our direct written premiums in 2005. Owners of registered automobiles in Massachusetts are required to maintain minimum automobile insurance coverages. We are required to participate in a state-mandated reinsurance program run by CAR to which we cede certain unprofitable risks and from which we are allocated a portion of the overall losses. As a servicing carrier of CAR, we are required to issue a policy to all qualified applicants. This program operates at an underwriting deficit. This deficit is allocated among every Massachusetts automobile insurance company, including us, based on a complex formula that takes into consideration a company's voluntary market share, the rate at which it cedes business to CAR, and the company's utilization of a credit system CAR has designed to encourage carriers to reduce their use of CAR. In addition, based on our market share, we are assigned certain licensed producers by CAR that have been unable to obtain a voluntary contract with another insurer. We call these agents Exclusive Representative Producers, or ERPs.

On December 31, 2004, the Commissioner approved new rules for CAR, which became effective on January 1, 2005 (the Approved Rules ). On January 14, 2005, we filed, on Form 8-K, an estimate of the financial impact the Approved Rules may have on us and we stated that a lawsuit had been filed in Suffolk Superior Court by Commerce Insurance Company against the Commissioner that seeks an order permanently enjoining implementation and/or enforcement of the Approved Rules. Certain ERPs, Arbella Mutual Insurance Company and the Center for Insurance Research intervened as plaintiffs and CAR intervened as a defendant in this lawsuit. On June 20, 2005, the Massachusetts Superior Court ruled that the Commissioner lacked the statutory authority to implement the Approved Rules and ordered them vacated. As a result, the Approved

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Rules did not go into effect. The Commissioner appealed the decision of the Massachusetts Superior Court. On October 26, 2005, the Massachusetts Supreme

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Judicial Court agreed to take direct appellate review of the Commissioner's appeal. The Court held arguments in this matter on May 4, 2006. At the present time, we are unable to predict whether the Commissioner's appeal will be successful.

On June 15, 2005, CAR approved rules to modify the ERP subscription relief process, making the reassignment of ERP exposures from an oversubscribed servicing carrier more timely and responsive, while enhancing equity in the ERP distribution for all servicing carriers (the ERP Subscription Rules). Also, the current practice of two and three-party agreements between ERPs and servicing carriers would be prohibited. On September 30, 2005, the Commissioner approved the ERP Subscription Rules, and instructed CAR to complete a redistribution of all ERPs that will establish for all servicing carriers overall parity in the quantity and quality of their ERP exposures. The redistribution plan for ERPs as adopted by the CAR Governing Committee on November 16 and December 14, 2005, was approved by the Commissioner on January 27, 2006. On January 31, 2006, CAR notified each reassigned ERP and all servicing carriers of the redistribution. According to the January 31, 2006 CAR Private Passenger ERP Redistribution Summary, 18 Safety ERPs with 25,590 exposures were assigned to other servicing carriers beginning with new business effective March 1, 2006 and renewal business May 1, 2006. In addition, CAR assigned 29 ERPs with 24,670 exposures from other servicing carriers to Safety, however 25 of these ERPs with 23,116 exposures were given voluntary contracts by their former servicing carrier or other carriers and are no longer eligible for assignment to Safety as ERPs. We expect that the redistribution of ERPs will eliminate our disproportionate share of high loss ratio ERP business, and would therefore result in a reduction of the expense we incur because of our disproportionate share of high loss ratio ERPs.

On June 1, 2005, the Governor filed legislation that would introduce more competition into the Massachusetts automobile insurance marketplace, reduce rates for good drivers, target fraud and excessive personal injury costs, and allow insurers rate flexibility. A committee of the Legislature has substituted a different bill in place of the Governor's bill that contains many provisions that are similar to the Governor's bill. At this time we are unable to predict whether this substitute bill will be enacted by the legislature.

Beginning January 1, 2006, CAR has implemented a Limited Servicing Carrier Program (LSC) for ceded commercial automobile policies. CAR approved Safety and five other servicing carriers through a Request for Proposal to process approximately \$200,000 of ceded commercial automobile business based on CAR data as of December 31, 2005, which will be spread equitably among the six servicing carriers.

Each year, the Commissioner sets maximum premium rates that may be charged and minimum commissions that must be paid to agents for private passenger automobile insurance. The Commissioner announced on December 15, 2005, an 8.7% statewide average private passenger automobile insurance rate decrease for 2006, compared to a 1.7% decrease for 2005. Coinciding with the 2006 rate decision, the Commissioner also approved an 11.8% commission rate agents receive for selling private passenger automobile insurance, as a percentage of premiums, compared to a commission rate of 10.9% in 2005.

While state-mandated average maximum private passenger automobile insurance rates decreased 8.7% for 2006, our average premium per automobile exposure in the six months ended June 30, 2006 decreased from the six months ended June 30, 2005 by approximately 6.8%. The difference in our average premiums from the state-mandated rate reduction was primarily the result of purchases of new automobiles by our insureds. We believe that the continued benefits of our rate pursuit initiative, which validates insured rating classifications and discount eligibility, also contributed to the difference in our average premiums received per automobile exposure. The table below shows average Massachusetts-mandated private passenger automobile premium rate changes and changes in our average premium per automobile exposure from 1997-2006.

### Massachusetts Private Passenger Rate Decisions

| Year        | State Mandated<br>Average Rate<br>Change (1) | Safety Change in<br>Average Premium per<br>Automobile Exposure (2) |
|-------------|--|--|
| <b>2006</b> | <b>(8.7)%</b>                                | <b>(6.8)%</b>  |
| 2005        | (1.7)%                                       | 0.1%   |
| 2004        | 2.5%   | 6.1%   |
| 2003        | 2.7%   | 6.9%   |
| 2002        | 0.0%   | 5.2%   |
| 2001        | (8.3)%                                       | 0.0%   |
| 2000        | 0.7%   | 7.4%   |
| 1999        | 0.7%   | 10.9%  |
| 1998        | (4.0)%                                       | 2.8%   |
| 1997        | (6.2)%                                       | (5.1)%   |

- (1) Source: Commissioner rate decisions for 1997 - 2006.
- (2) Source: Safety Insurance.

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*Statutory Accounting Principles*

Our results are reported in accordance with United States generally accepted accounting principles ( GAAP ), which differ from amounts reported in accordance with statutory accounting principles ( SAP ) as prescribed by insurance regulatory authorities. Specifically, under GAAP:

- Policy acquisition costs such as commissions, premium taxes and other variable costs incurred in connection with writing new and renewal business are capitalized and amortized on a pro rata basis over the period in which the related premiums are earned, rather than expensed as incurred, as required by SAP.
- Certain assets are included in the consolidated balance sheets whereas, under SAP, such assets are designated as nonadmitted assets and charged directly against statutory surplus. These assets consist primarily of premium receivables that are outstanding over 90 days, federal deferred tax assets in excess of statutory limitations, furniture, equipment, leasehold improvements and prepaid expenses.
- Amounts related to ceded reinsurance are shown gross as prepaid reinsurance premiums and reinsurance recoverables, rather than netted against unearned premium reserves and loss and loss adjustment expense reserves, respectively, as required by SAP.
- Fixed maturities securities, which are classified as available-for-sale, are reported at current market values, rather than at amortized cost, or the lower of amortized cost or market, depending on the specific type of security, as required by SAP.
- Equity securities are reported at quoted market values, which may differ from the National Association of Insurance Commissioners market values as required by SAP.
- The differing treatment of income and expense items results in a corresponding difference in federal income tax expense. Changes in deferred income taxes are reflected as an item of income tax benefit or expense, rather than recorded directly to surplus as regards policyholders, as required by SAP. Admittance testing may result in a charge to unassigned surplus for non-admitted portions of deferred tax assets. Under GAAP reporting, a valuation allowance may be recorded against the deferred tax asset and reflected as an expense.

*Insurance Ratios*

The property and casualty insurance industry uses the combined ratio as a measure of underwriting profitability. The combined ratio is the sum of the loss ratio (losses and loss adjustment expenses incurred as a percent of net earned premiums) plus the expense ratio (underwriting expenses as a percent of net written premiums, if calculated on a SAP basis, or net earned premiums, if calculated on a GAAP basis). The combined ratio reflects only underwriting results, and does not include income from investments or finance and other service income. Underwriting profitability is subject to significant fluctuations due to competition, catastrophic events, weather, economic and social conditions and other factors.

Our SAP insurance ratios are outlined in the following table.

|                          | Three Months Ended June 30, |        | Six Months Ended June 30, |        |   |   |
|--------------------------|-----------------------------|--------|---------------------------|--------|---|---|
|                          | 2006                        | 2005   | 2006                      | 2005   |   |   |
| <b>Statutory Ratios:</b> |                             |        |                           |        |   |   |
| Loss Ratio               | <b>54.1</b>                 | % 59.9 | % <b>54.2</b>             | % 65.2 | % | % |
| Expense Ratio            | <b>26.7</b>                 | % 24.7 | % <b>25.8</b>             | % 23.3 | % | % |
| Combined Ratio           | <b>80.8</b>                 | % 84.6 | % <b>80.0</b>             | % 88.5 | % | % |

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Under GAAP, the loss ratio is computed in the same manner as under SAP, but the expense ratio is determined by matching underwriting expenses to the period over which net premiums were earned, rather than to the period that net premiums were written.

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Our GAAP insurance ratios are outlined in the following table.

|                     | Three Months Ended June 30,<br>2006 |   | Six Months Ended June 30,<br>2005 |   | Six Months Ended June 30,<br>2006 |   |      |   |
|---------------------|-------------------------------------|---|-----------------------------------|---|-----------------------------------|---|------|---|
| <b>GAAP Ratios:</b> |                                     |   |                                   |   |                                   |   |      |   |
| Loss Ratio          | <b>54.1</b>                         | % | 59.9                              | % | <b>54.2</b>                       | % | 65.2 | % |
| Expense Ratio       | <b>26.7</b>                         | % | 25.5                              | % | <b>26.2</b>                       | % | 24.5 | % |
| Combined Ratio      | <b>80.8</b>                         | % | 85.4                              | % | <b>80.4</b>                       | % | 89.7 | % |

#### Stock-Based Compensation

Long-term incentive compensation is provided under the Company's 2002 Management Omnibus Incentive Plan (the Incentive Plan) which provides for a variety of stock-based compensation awards, including nonqualified stock options (NQSOs), incentive stock options, stock appreciation rights and restricted stock (RS) awards.

On March 10, 2006, the Board of Directors (Board) of the Company approved amendments to the Incentive Plan, subject to shareholder approval, to (i) increase the number of shares of common stock available for issuance by 1,250,000 shares, (ii) remove obsolete provisions, and (iii) make other non-material changes. A total of 1,250,000 shares of common stock had previously been authorized for issuance under the Incentive Plan. The Incentive Plan, as amended, was approved by the shareholders at the 2006 Annual Meeting of Shareholders which was held on May 19, 2006. The new maximum number of shares of common stock with respect to which awards may be granted under the Incentive Plan is 2,500,000. At June 30, 2006, there were 1,289,991 shares available for future grant. The Board and the Compensation Committee intend to issue more awards under the Incentive Plan in the future.

There were no grants made under the Incentive Plan during the quarter ended June 30, 2006. A summary of stock-based awards granted under the Incentive Plan during the six months ended June 30, 2006 is as follows:

| Type of Equity Awarded | Effective Date | Number of Awards Granted | Exercise Price (1) or Fair Value (2) per Share | Vesting Terms         | Expiration Date |
|------------------------|----------------|--------------------------|--|-----------------------|-----------------|
| NQSOs                  | March 10, 2006 | 126,225                  | \$42.85(1)                                     | 5 years, 20% annually | March 10, 2016  |
| RS                     | March 10, 2006 | 58,342                   | 42.85(2)                                       | 3 years, 30%-30%-40%  | N/A             |
| RS                     | March 10, 2006 | 4,000                    | 42.85(2)                                       | No vesting period (3) | N/A             |

(1) The exercise price of the stock option grant is equal to the closing price of the Company's common stock on the grant effective date.

(2) The fair value of the restricted stock grant is equal to the closing price of the Company's common stock on the grant effective date.

(3) The shares cannot be sold, assigned, pledged, or otherwise transferred, encumbered or disposed of until the recipient is no longer a member of our Board of Directors.

#### Reinsurance

We reinsure with other insurance companies a portion of our potential liability under the policies we have underwritten, thereby protecting us against an unexpectedly large loss or a catastrophic occurrence that could produce large losses, primarily in our homeowners line of business. As of January 1, 2006, our catastrophe reinsurance provides gross per occurrence reinsurance coverage up to \$250,000. Our catastrophe reinsurance protects us in the event of a 415-year storm (that is, a storm of a severity expected to occur once in a 415-year period). Swiss Re, our primary reinsurer, maintains an A.M. Best rating of A+ (Superior). All of our other reinsurers have an A.M. Best rating of A (Excellent) or better except for Montpelier Re, Endurance Re and Amlin Bermuda which are rated A- (Excellent). We are a participant in CAR, a state-established body that runs the residual market reinsurance programs for both private passenger and commercial automobile insurance in Massachusetts under which premiums, expenses, losses and loss adjustment expenses on ceded business are shared by all insurers writing automobile insurance in

Massachusetts. We also participate in the Massachusetts Property Insurance Underwriting Association ( FAIR

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Plan ) in which premiums, expenses, losses and loss adjustment expenses on homeowners business that cannot be placed in the voluntary market are shared by all insurers writing homeowners insurance in Massachusetts. At June 30, 2006, we had no material amounts recoverable from any reinsurer, excluding the residual markets described above.

On March 10, 2005, our Board of Directors adopted a resolution that prohibits Safety from purchasing finite reinsurance (reinsurance that transfers only a finite or limited amount of risk to the reinsurer) without approval by the Board. To date, the Company has never purchased a finite reinsurance contract.

#### *Effects of Inflation*

We do not believe that inflation has had a material effect on our consolidated results of operations, except insofar as inflation may affect interest rates.

### **B. Critical Accounting Policies and Estimates**

#### *Loss and Loss Adjustment Expense Reserves.*

Significant periods of time can elapse between the occurrence of an insured loss, the reporting to us of that loss and our final payment of that loss. To recognize liabilities for unpaid losses, we establish reserves as balance sheet liabilities. Our reserves represent estimates of amounts needed to pay reported and unreported losses and the expenses of investigating and paying those losses, or loss adjustment expenses. Every quarter, we review our previously established reserves and adjust them, if necessary.

When a claim is reported, claims personnel establish a case reserve for the estimated amount of the ultimate payment. The amount of the reserve is primarily based upon an evaluation of the type of claim involved, the circumstances surrounding each claim and the policy provisions relating to the loss. The estimate reflects the informed judgment of such personnel based on general insurance reserving practices and on the experience and knowledge of the claims person. During the loss adjustment period, these estimates are revised as deemed necessary by our claims department based on subsequent developments and periodic reviews of the cases.

In accordance with industry practice, we also maintain reserves for estimated losses incurred but not yet reported ( IBNR ). IBNR reserves are determined in accordance with commonly accepted actuarial reserving techniques on the basis of our historical information and experience. We review and make adjustments to incurred but not yet reported reserves quarterly.

When reviewing reserves, we analyze historical data and estimate the impact of various loss development factors, such as our historical loss experience and that of the industry, trends in claims frequency and severity, our mix of business, our claims processing procedures, legislative enactments, judicial decisions, legal developments in imposition of damages, and changes and trends in general economic conditions, including the effects of inflation. A change in any of these factors from the assumption implicit in our estimate can cause our actual loss experience to be better or worse than our reserves, and the difference can be material. There is no precise method, however, for evaluating the impact of any specific factor on the adequacy of reserves, because the eventual development of reserves is affected by many factors.

Management determines the Company's loss and loss adjustment expense ( LAE ) reserves estimate based upon the work of the Company's actuaries and management's own assessment of reasonable reserves. A reasonable estimate is derived primarily by considering a range of indications calculated by the Company's actuaries using generally accepted actuarial techniques. Our key assumptions are the ultimate frequency and severity of claims, based upon the most recent ten years of claims reported to the Company and the data CAR reports to us to calculate our share of the residual market, as of the date of the applicable balance sheet. For each accident year and each coverage within a line of business our actuaries calculate reserve ranges using actuarial techniques such as:

- **Paid Loss Indications:** This method projects ultimate loss estimates based upon extrapolations of historic paid loss trends. This method tends to be used on short tail lines such as automobile physical damage.
- **Incurred Loss Indications:** This method projects ultimate loss estimates based upon extrapolations of historic incurred loss trends. This method tends to be used on long tail lines of business such as automobile liability and homeowner's liability.



- **Bornhuetter-Ferguson Indications:** This method projects ultimate loss estimates based upon extrapolations of an expected amount of IBNR, which is added to current incurred losses or paid losses. This method tends to be used on small, immature, or volatile lines of business, such as our BOP and umbrella lines of business.
- **Bodily Injury Code Indications:** This method projects ultimate loss estimates for our private passenger and commercial automobile bodily injury coverage based upon extrapolations of the historic number of accidents and the historic number of bodily injury claims per accident. Projected ultimate bodily injury claims are then segregated into expected claims by type of injury (e.g. soft tissue injury vs. hard tissue injury) based on past experience. An ultimate severity, or average paid loss amounts, is estimated based upon extrapolating historic trends. Projected ultimate loss estimates using this method are the aggregate of estimated losses by injury type.

Such techniques assume that past experience, adjusted for the effects of current developments and anticipated trends, are an appropriate basis for predicting future events. It is possible that the final outcome may fall above or below these amounts as a result of a number of factors, including immature data, sparse data, or significant growth in a line of business. Using these methodologies our actuaries established a range of reasonable possible estimations for net reserves of approximately \$317,897 to \$359,781 as of June 30, 2006. In general, the low and high values of the ranges represent reasonable minimum and maximum values of the indications based on the techniques described above.

The following table presents the recorded reserves and the range of estimations by line of business for net loss and LAE reserves as of June 30, 2006.

#### Range of Net Reserves for Losses and LAE

| Line of Business             | Low       | Recorded  | High      |
|------------------------------|-----------|-----------|-----------|
| Private passenger automobile | \$236,613 | \$264,547 | \$267,211 |
| Commercial automobile        | 44,894    | 48,649    | 50,456    |
| Homeowners                   | 27,832    | 29,723    | 30,645    |
| All other                    | 8,558     | 10,634    | 11,469    |
| Total                        | \$317,897 | \$353,553 | \$359,781 |

The Company's net loss and LAE reserves, based on management's best estimate, were set at \$353,553 as of June 30, 2006. For our private passenger and commercial auto lines of business as of June 30, 2006, due to the relatively long time we have been writing these lines of insurance, and our stable long-term trends in frequency and severity, the range of reserves are relatively narrow. We recorded reserves closer to the high in the respective ranges, in recognition that current ultimate estimations are lower than historical results for these lines of business.

For our homeowners and all other lines of business as of June 30, 2006, due to the relatively short time we have been writing these lines of business, and the resulting immature data available for our analysis, the range of reserves are relatively wide compared to the mid-point estimation and we recorded reserves close to the high of the range of projections.

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The following table presents information by line of business for our net reserves for losses and LAE as of June 30, 2006.

### Net Reserves for Losses and LAE

| Line of Business                         | Direct less Ceded | Assumed   | Net        |
|--|-------------------|-----------|------------|
| Private passenger automobile             | \$ 207,052        |           |            |
| CAR assumed private passenger automobile |                   | \$ 57,495 |            |
| Net private passenger automobile         |                   |           | \$ 264,547 |
| Commercial automobile                    | 32,614            |           |            |
| CAR assumed commercial automobile        |                   | 16,035    |            |
| Net commercial automobile                |                   |           | 48,649     |
| Homeowners                               | 21,068            |           |            |
| FAIR Plan assumed homeowners             |                   | 8,655     |            |
| Net homeowners                           |                   |           | 29,723     |
| All other                                | 10,634            |           | 10,634     |
| Total net reserves for losses and LAE    | \$ 271,368        | \$ 82,185 | \$ 353,553 |

#### *CAR Loss and Loss Adjustment Expense Reserves*

We are a participant in CAR and assume a significant portion of losses and LAE on business ceded by the industry participants to CAR. We estimate reserves for assumed losses and LAE that have not yet been reported to us by CAR. Our estimations are based upon the same factors we use for our own reserves, plus additional factors due to the nature of and the information we receive from CAR.

The CAR deficit, which consists of premium ceded to CAR less CAR losses and LAE, is allocated among every automobile insurance company writing business in Massachusetts based on a complex formula (the Participation Ratio) that takes into consideration a company's voluntary market share, the amount of business it cedes to CAR and credits the company earns under a system CAR has designed to encourage carriers to voluntarily write business in selected under-priced classes and territories.

We receive a Settlement of Balances report from CAR that reports our share of CAR premium, losses and LAE, on a lagged basis, seventy-five days after the end of every quarter. CAR-published financial data is always at least one quarter behind the financial data we report. For example, when we reported our financial results for the year ended December 31, 2005, we had nine months of reported 2005 CAR financial data, and we had to estimate what CAR would report to us for the last three months of the year.

We receive our final calendar year Participation Ratio report from CAR eight months after the end of that year, and thus we have to estimate for six quarters our share of the CAR deficit. For example, for the year ended December 31, 2004 we had to estimate our 2004 policy year CAR Participation Ratio beginning with the first quarter of 2004 through the second quarter of 2005.

Because of the lag in CAR estimates, and in order to try to validate to the extent possible the information CAR does provide, we must try to estimate the effects of the actions of our competitors in order to establish our Participation Ratio. Before final Participation Ratios are available, we estimate the size of CAR and the resulting deficit based on historical analysis of CAR results, and estimations of our competitors' current cession strategies. Even after our final Participation Ratio is available from CAR, we must continue to estimate the size of CAR, and the resulting deficit based upon data published by CAR and our own continuing analysis. As a result, changes in our reserves for CAR may continue to occur until all claims are finally settled. The Loss Reserving Committee at CAR meets 70 days after the end of each quarter to estimate the CAR deficit for all active policy years and publishes estimations, which we use to estimate our share of the deficit. The estimation that CAR calculates is based on data it collects from 19 servicing carriers which settle, reserve and report claims using a variety of methods. Any delays or errors in the collection of this data could have a significant impact on the accuracy of CAR's estimations.

Although we rely to a significant extent in setting our reserves on the information CAR provides, we are cautious in our use of that information, both because of the delays described above and because the CAR estimates incorporate data CAR receives from all other CAR servicing carriers in Massachusetts. We do not have direct access to that data or firsthand knowledge of how those carriers are currently conducting their operations. As a result, we are cautious in recording CAR reserves for the





calendar years that we have to estimate our Participation Ratio and these reserves are subject to significant judgments and estimates.

*Sensitivity Analysis*

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Establishment of appropriate reserves is an inherently uncertain process. There can be no certainty that currently established reserves based on our key assumptions regarding frequency and severity in our lines of business, or our assumptions regarding our share of the CAR loss will prove adequate in light of subsequent actual experience. To the extent that reserves are inadequate and are strengthened, the amount of such increase is treated as a charge to earnings in the period that the deficiency is recognized. To the extent that reserves are redundant and are released, the amount of the release is a credit to earnings in the period the redundancy is recognized. For the six months ended June 30, 2006 a 1 percentage-point change in the loss and LAE ratio would result in a change in reserves of \$3,140. Each 1 percentage-point change in the loss and loss expense ratio would have a \$2,041 effect on net income, or \$0.13 per diluted share.

Our assumptions consider that past experience, adjusted for the effects of current developments and anticipated trends, are an appropriate basis for establishing our reserves. Our key assumptions could have a reasonable possible range of plus or minus 5 percentage-points for each estimation. However, as 2005 and the first six months of 2006 have demonstrated, there is no guarantee that our assumptions will not have more than a 5 percentage-point variation. The following sensitivity tables present information for each of our primary lines of business on the effect each 1 percentage-point change in each of our key assumptions on unpaid frequency and severity could have on our direct minus ceded loss and LAE reserves and net income for the six months ended June 30, 2006. In evaluating the information in the table, it should be noted that a 1 percentage-point change in a single assumption would change estimated reserves by 1 percentage-point. A 1 percentage-point change in both our key assumptions would change estimated reserves within a range of plus or minus 2 percentage-points.

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|  | -1 Percent<br>Change in<br>Frequency | No<br>Change in<br>Frequency | +1 Percent<br>Change in<br>Frequency |
|--|--------------------------------------|------------------------------|--------------------------------------|
| <b>Private Passenger Auto Direct minus Ceded Loss and LAE Reserves</b> |                                      |                              |                                      |
| -1 Percent Change in Severity  |                                      |                              |                                      |
| Estimated decrease in reserves   | \$ (4,144 )                          | \$ (2,072 )                  | \$                                   |
| Estimated increase in net income                                       | 2,694                                | 1,347                        |                                      |
| No Change in Severity  |                                      |                              |                                      |
| Estimated (decrease) increase in reserves                              | (2,072 )                             |                              | 2,072                                |
| Estimated increase (decrease) in net income                            | 1,347                                |                              | (1,347 )                             |
| +1 Percent Change in Severity  |                                      |                              |                                      |
| Estimated increase in reserves   |                                      | 2,072                        | 4,144                                |
| Estimated decrease in net income                                       |                                      | (1,347 )                     | (2,694 )                             |
| <b>Commercial Auto Direct minus Ceded Loss and LAE Reserves</b>        |                                      |                              |                                      |
| -1 Percent Change in Severity  |                                      |                              |                                      |
| Estimated decrease in reserves   | (632 )                               | (316 )                       |                                      |
| Estimated increase in net income                                       | 411                                  | 206                          |                                      |
| No Change in Severity  |                                      |                              |                                      |
| Estimated (decrease) increase in reserves                              | (316 )                               |                              | 316                                  |
| Estimated increase (decrease) in net income                            | 206                                  |                              | (206 )                               |
| +1 Percent Change in Severity  |                                      |                              |                                      |
| Estimated increase in reserves   |                                      | 316                          | 632                                  |
| Estimated decrease in net income                                       |                                      | (206 )                       | (411 )                               |
| <b>Homeowners Direct minus Ceded Loss and LAE Reserves</b>             |                                      |                              |                                      |
| -1 Percent Change in Severity  |                                      |                              |                                      |
| Estimated decrease in reserves   | (405 )                               | (203 )                       |                                      |
| Estimated increase in net income                                       | 263                                  | 132                          |                                      |
| No Change in Severity  |                                      |                              |                                      |
| Estimated (decrease) increase in reserves                              | (203 )                               |                              | 203                                  |
| Estimated increase (decrease) in net income                            | 132                                  |                              | (132 )                               |
| +1 Percent Change in Severity  |                                      |                              |                                      |
| Estimated increase in reserves   |                                      | 203                          | 405                                  |
| Estimated decrease in net income                                       |                                      | (132 )                       | (263 )                               |
| <b>All Other Direct minus Ceded Loss and LAE Reserves</b>              |                                      |                              |                                      |
| -1 Percent Change in Severity  |                                      |                              |                                      |
| Estimated decrease in reserves   | (246 )                               | (123 )                       |                                      |
| Estimated increase in net income                                       | 160                                  | 80                           |                                      |
| No Change in Severity  |                                      |                              |                                      |
| Estimated (decrease) increase in reserves                              | (123 )                               |                              | 123                                  |
| Estimated increase (decrease) in net income                            | 80                                   |                              | (80 )                                |
| +1 Percent Change in Severity  |                                      |                              |                                      |
| Estimated increase in reserves   |                                      | 123                          | 246                                  |
| Estimated decrease in net income                                       |                                      | (80 )                        | (160 )                               |

Our estimated share of CAR loss and LAE reserves is based on assumptions about our Participation Ratio, the size of CAR, and the resulting deficit (similar assumptions apply with respect to the FAIR Plan). Our assumptions consider that past experience, adjusted for the effects of current developments and anticipated trends, are an appropriate basis for establishing our

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CAR reserves. Our assumptions could have a reasonable possible range of plus or minus 5 percentage-points for each estimation. However, as 2005 and 2006 have demonstrated, there is no guarantee that our assumptions will not have more than a 5 percentage-point variation. The following sensitivity table presents information of the effect each 1 percentage-point change in our assumptions on our share of reserves for CAR and other residual markets could have on our assumed loss and LAE reserves and net income for the six months ended June 30, 2006. In evaluating the information in the table, it should be noted that a 1 percentage-point change in our assumptions would change estimated reserves by 1 percentage-point.

|   | -1 Percent<br>Change in<br>Estimation | No<br>Change in<br>Estimation | +1 Percent<br>Change in<br>Estimation |
|---|---------------------------------------|-------------------------------|---------------------------------------|
| <b>CAR assumed private passenger automobile</b> |                                       |                               |                                       |
| Estimated (decrease) increase in reserves       | \$ (575 )                             | \$                            | \$ 575                                |
| Estimated increase (decrease) in net income     | 374                                   |                               | (374 )                                |
| <b>CAR assumed commercial automobile</b>        |                                       |                               |                                       |
| Estimated (decrease) increase in reserves       | (160 )                                |                               | 160                                   |
| Estimated increase (decrease) in net income     | 104                                   |                               | (104 )                                |
| <b>FAIR Plan assumed homeowners</b>             |                                       |                               |                                       |
| Estimated (decrease) increase in reserves       | (87 )                                 |                               | 87                                    |
| Estimated increase (decrease) in net income     | 57                                    |                               | (57 )                                 |

*Reserve Development Summary*

The changes we have recorded in our reserves in the past illustrate the uncertainty of estimating reserves. The following table presents a comparison of prior year development of our net reserves for losses and LAE for the six months ended June 30, 2006 and 2005.

**Prior Year Net Loss and LAE Reserve Development Summary**

| Accident<br>Year | Six Months Ended June 30, |              |
|------------------|---------------------------|--------------|
|                  | 2006                      | 2005         |
| 1996 & prior     | \$ (42 )                  | \$           |
| 1997             |                           |              |
| 1998             | 1                         |              |
| 1999             | (32 )                     |              |
| 2000             | (26 )                     | (66 )        |
| 2001             | (1,359 )                  | (11 )        |
| 2002             | (1,338 )                  | (2,708 )     |
| 2003             | (2,592 )                  | (3,062 )     |
| 2004             | (7,198 )                  | (11,386 )    |
| 2005             | (12,793 )                 |              |
| All prior years  | \$ (25,379 )              | \$ (17,233 ) |

The decrease in prior year reserves during the 2006 period resulted from re-estimations of prior year ultimate loss and LAE liabilities and is primarily composed of reductions of \$10,261 in CAR assumed reserves, \$11,721 in the Company's automobile reserves and \$2,605 in the Company's homeowners reserves. The decrease in prior year reserves during the 2005 period resulted from re-estimations of prior year ultimate loss and LAE liabilities and is primarily composed of reductions of \$12,583 in CAR assumed reserves and \$4,650 in the Company's own automobile reserves.

The following table presents information by line of business for prior year development of our net reserves for losses and LAE for the six months ended June 30, 2006. Each accident year represents all claims for an annual calendar accounting period in which loss events occurred, regardless of when the losses are actually reported, booked or paid. Our financial statements reflect the aggregate results of the current and all prior accident years.



**Prior Year Net Loss and LAE Reserve Development Summary**

| Accident Year   | Private Passenger Automobile | Commercial Automobile | Homeowners  | All Other | Total        |
|-----------------|------------------------------|-----------------------|-------------|-----------|--------------|
| 1996 & prior    | \$ (42 )                     | \$                    | \$          | \$        | \$ (42 )     |
| 1997            |                              |                       |             |           |              |
| 1998            | 1                            |                       |             |           | 1            |
| 1999            | (12 )                        | (20 )                 |             |           | (32 )        |
| 2000            | (131 )                       | 82                    | 15          | 8         | (26 )        |
| 2001            | (1,300 )                     | 4                     | (27 )       | (36 )     | (1,359 )     |
| 2002            | (541 )                       | (598 )                | (150 )      | (49 )     | (1,338 )     |
| 2003            | (1,487 )                     | (708 )                | (327 )      | (70 )     | (2,592 )     |
| 2004            | (5,079 )                     | (1,160 )              | (866 )      | (93 )     | (7,198 )     |
| 2005            | (10,089 )                    | (902 )                | (1,693 )    | (109 )    | (12,793 )    |
| All prior years | \$ (18,680 )                 | \$ (3,302 )           | \$ (3,048 ) | \$ (349 ) | \$ (25,379 ) |

To further clarify the effects of changes in our reserve estimates for CAR and other residual markets, the next two tables break out the information in the table above by source of the business (i.e., non-residual market vs. residual market).

The following table presents information by line of business for prior year development of direct minus ceded reserves for losses and LAE for the six months ended June 30, 2006; that is, all our reserves except for business ceded or assumed from CAR and other residual markets.

**Prior Year Net Direct minus Ceded Loss and LAE Reserve Development Summary**

| Accident Year   | Retained Private Passenger Automobile | Retained Commercial Automobile | Retained Homeowners | Retained All Other | Total        |
|-----------------|---------------------------------------|--------------------------------|---------------------|--------------------|--------------|
| 1996 & prior    | \$ (42 )                              | \$                             | \$                  | \$                 | \$ (42 )     |
| 1997            |                                       |                                |                     |                    |              |
| 1998            | 1                                     |                                |                     |                    | 1            |
| 1999            | (12 )                                 | (2 )                           |                     |                    | (14 )        |
| 2000            | (131 )                                | 98                             | 20                  | 8                  | (5 )         |
| 2001            | (1,093 )                              | (17 )                          | (10 )               | (36 )              | (1,156 )     |
| 2002            | (72 )                                 | (617 )                         | (119 )              | (49 )              | (857 )       |
| 2003            | (636 )                                | (644 )                         | (265 )              | (70 )              | (1,615 )     |
| 2004            | (2,485 )                              | (1,069 )                       | (725 )              | (93 )              | (4,372 )     |
| 2005            | (4,590 )                              | (410 )                         | (1,506 )            | (109 )             | (6,615 )     |
| All prior years | \$ (9,060 )                           | \$ (2,661 )                    | \$ (2,605 )         | \$ (349 )          | \$ (14,675 ) |

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The following table presents information by line of business for prior year development of reserves assumed from CAR and other residual markets for losses and LAE for the six months ended June 30, 2006.

**Prior Year assumed Loss and LAE Reserve Development Summary**

| Accident Year   | CAR Assumed Private Passenger Automobile | CAR Assumed Commercial Automobile | FAIR Plan Homeowners | All Other | Total        |
|-----------------|--|-----------------------------------|----------------------|-----------|--------------|
| 1996 & prior    | \$                                       | \$                                | \$                   | \$        | \$           |
| 1997            |  |                                   |                      |           |              |
| 1998            |  |                                   |                      |           |              |
| 1999            |  | (18 )                             |                      |           | (18 )        |
| 2000            |  | (16 )                             | (5 )                 |           | (21 )        |
| 2001            | (207 )                                   | 21                                | (17 )                |           | (203 )       |
| 2002            | (469 )                                   | 19                                | (31 )                |           | (481 )       |
| 2003            | (851 )                                   | (64 )                             | (62 )                |           | (977 )       |
| 2004            | (2,594 )                                 | (91 )                             | (141 )               |           | (2,826 )     |
| 2005            | (5,499 )                                 | (492 )                            | (187 )               |           | (6,178 )     |
| All prior years | \$ (9,620 )                              | \$ (641 )                         | \$ (443 )            | \$        | \$ (10,704 ) |

Our private passenger automobile line of business prior year reserves decreased by \$18,680 for the six months ended June 30, 2006. The decrease was due primarily to improved assumed CAR results of \$5,499 and \$2,594 for the 2005 and 2004 accident years and improved retained private passenger results of \$4,590 and \$2,485 for the 2005 and 2004 accident years. The improved CAR results were due primarily to improved CAR private passenger loss ratios for 2005 and 2004 as published and reported by the CAR Loss Reserving Committee at the June 7, 2006 meeting, as compared to the published results at the March 1, 2006 meeting. The improved retained private passenger automobile reserves were primarily due to better than previously estimated severity on our established bodily injury and property damage case reserves and fewer IBNR claims than previously estimated.

Our commercial automobile line of business prior year reserves decreased by \$3,302 for the six months ended June 30, 2006. The decrease was primarily due to more favorable commercial automobile bodily injury severity than previously estimated on our established case reserves.

Our homeowners line of business prior year reserves decreased by \$3,048 for the six months ended June 30, 2006 primarily as a result of improved severity on our established case reserves for 2004 and 2005 related to our retained homeowners business.

In estimating all our loss reserves, including CAR, we follow the guidance prescribed by Statement of Financial Accounting Standards ( FAS ) No. 60, Accounting and Reporting by Insurance Enterprises and FAS No. 113, Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.

For further information, see Section C. Results of Operations: *Losses and Loss Adjustment Expenses*.

*Other-Than-Temporary Impairments.*

We use a systematic methodology to evaluate declines in market values below cost or amortized cost of our investments. This methodology ensures that we evaluate available evidence concerning any declines in a disciplined manner.

In our determination of whether a decline in market value below amortized cost is an other-than-temporary impairment, we consider and evaluate several factors and circumstances including the issuer's overall financial condition, the issuer's credit and financial strength ratings, a weakening of the general market conditions in the industry or geographic region in which the issuer operates, a prolonged period (typically six months or longer) in which the fair value of an issuer's securities remains below our



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amortized cost, our ability and intent to hold these investments for a period of time sufficient to allow for recovery of our costs, and any other factors that may raise doubt about the issuer's ability to continue as a going concern.

We record other-than-temporary impairments as realized losses, which serve to reduce net income and earnings per share. We record temporary losses as unrealized losses, which do not impact net income and earnings per share but reduce other comprehensive net income. The risks inherent in our assessment of other-than-temporary impairments include the risk that market factors may differ from our expectations, or that the credit assessment could change in the near term, resulting in a charge to earnings.

For further information, see Section C. Results of Operations: *Net Realized Investment Losses*.

### C. Results of Operations

The following table shows certain of our selected financial results.

|  | Three Months Ended |            | Six Months Ended |            |
|--|--------------------|------------|------------------|------------|
|  | June 30,<br>2006   | 2005       | June 30,<br>2006 | 2005       |
| Direct written premiums                      | \$ 162,492         | \$ 167,455 | \$ 340,528       | \$ 353,230 |
| Net written premiums                         | 162,323            | 170,180    | 335,642          | 354,378    |
| Net earned premiums                          | 156,261            | 156,514    | 314,039          | 312,930    |
| Net investment income                        | 9,834              | 7,653      | 19,212           | 15,112     |
| Net realized (losses) gains on investments   | (187)              | (11)       | (261)            | 396        |
| Finance and other service income             | 3,720              | 3,977      | 7,579            | 7,946      |
| Total revenue                                | 169,628            | 168,133    | 340,569          | 336,384    |
| Loss and loss adjustment expenses            | 84,604             | 93,802     | 170,355          | 203,972    |
| Underwriting, operating and related expenses | 41,757             | 39,975     | 82,152           | 76,566     |
| Interest expenses                            | 20                 | 225        | 44               | 448        |
| Total expenses                               | 126,381            | 134,002    | 252,551          | 280,986    |
| Income before income taxes                   | 43,247             | 34,131     | 88,018           | 55,398     |
| Income tax expense                           | 14,109             | 10,885     | 28,078           | 17,650     |
| Net income                                   | \$ 29,138          | \$ 23,246  | \$ 59,940        | \$ 37,748  |

#### Three and Six Months Ended June 30, 2006 Compared to Three and Six Months Ended June 30, 2005

*Direct Written Premiums.* Direct written premiums for the quarter ended June 30, 2006 decreased by \$4,963, or 3.0%, to \$162,492 from \$167,455 for the comparable 2005 period. Direct written premiums for the six months ended June 30, 2006 decreased by \$12,702, or 3.6%, to \$340,528 from \$353,230 for the comparable 2005 period. The 2006 decrease occurred primarily in our personal automobile line, which experienced a 6.8% decrease in average written premium and a 1.4% decrease in written exposures. Partially offsetting the personal auto line decrease, were increases in our commercial automobile line's average written premium of 12.8% and written exposures of 13.3%. Our homeowners line's average written premium increased by 7.3%, which was partly offset by a 3.9% decrease in written exposures.

*Net Written Premiums.* Net written premiums for the quarter ended June 30, 2006 decreased by \$7,857, or 4.6%, to \$162,323 from \$170,180 for the comparable 2005 period. Net written premiums for the six months ended June 30, 2006

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decreased by \$18,736, or 5.3%, to \$335,642 from \$354,378 for the comparable 2005 period. These decreases were primarily due to the factors that decreased direct written premiums combined with a decrease in premiums assumed from CAR.

*Net Earned Premiums.* Net earned premiums for the quarter ended June 30, 2006 decreased by \$253, or 0.2%, to \$156,261 from \$156,514 for the comparable 2005 period. Net earned premiums for the six months ended June 30, 2006 increased by \$1,109, or 0.4%, to \$314,039 from \$312,930 for the comparable 2005 period.

*Net Investment Income.* Net investment income for the quarter ended June 30, 2006 was \$9,834 compared to \$7,653 for the comparable 2005 period. Net investment income for the six months ended June 30, 2006 was \$19,212 compared to \$15,112 for the comparable 2005 period. Average cash and investment securities (at cost) increased by \$81,849, or 10.1%, to \$895,039 for the six months ended June 30, 2006 from \$813,189 for the six months ended June 30, 2005. Net effective annualized yield on the investment portfolio increased to 4.3% during the six months ended June 30, 2006 from 3.7% during the comparable 2005 period. Our duration increased to 4.8 years at June 30, 2006 from 3.2 years at December 31, 2005.

*Net Realized (Losses) Gains on Investments.* Net realized losses on investments was \$187 for the quarter ended June 30, 2006 compared to net realized losses of \$11 for the comparable 2005 period. Net realized losses on investments was \$261 for the six months ended June 30, 2006 compared to net realized gains of \$396 for the comparable 2005 period.

The gross unrealized appreciation (depreciation) of investments in fixed maturity securities, including redeemable preferred stocks that have characteristics of fixed maturities, and equity securities, including interests in mutual funds, was as follows:

|  | June 30, 2006 |                              |                               |                            |
|--|---------------|------------------------------|-------------------------------|----------------------------|
|  | Cost          | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
| U.S. Treasury securities and obligations of U.S. Government agencies (1) | \$ 149,308    | \$ 38                        | \$ (5,535 )                   | \$ 143,811                 |
| Obligations of states and political subdivisions                         | 410,042       | 1,257                        | (6,727 )                      | 404,572                    |
| Asset-backed securities (1)  | 179,202       | 41                           | (5,390 )                      | 173,853                    |
| Corporate and other securities   | 137,582       | 703                          | (4,045 )                      | 134,240                    |
| Subtotal, fixed maturity securities                                      | 876,134       | 2,039                        | (21,697 )                     | 856,476                    |
| Equity securities  | 3,887         | 105                          | (9 )                          | 3,983                      |
| Totals   | \$ 880,021    | \$ 2,144                     | \$ (21,706 )                  | \$ 860,459                 |

(1) Obligations of U.S. Government agencies include collateralized mortgage obligations issued, guaranteed and/or insured by the following issuers: Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA). The total of these fixed maturity securities was \$139,311 at amortized cost and \$134,016 at estimated fair value as of June 30, 2006. As such, the asset-backed securities presented exclude such issuers already presented under U.S. Treasury securities and obligations of U.S. Government Agencies.

As of June 30, 2006, our portfolio of fixed maturity investments was comprised entirely of investment grade corporate fixed maturity securities, U.S. government and agency securities and asset-backed securities (i.e., all our securities received a rating assigned by Moody's Investors Service, Inc. of Baa or higher, except the few securities not rated by Moody's which received S&P ratings of AA/A or higher, as well as a rating assigned by the Securities Valuation Office of the National Association of Insurance Commissioners of 1 or 2).

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The composition of our fixed income security portfolio by Moody's rating was as follows:

|  | June 30, 2006 |         |
|--|---------------|---------|
|  | Estimated     | Percent |
|  | Fair Value    |         |
| U.S. Treasury securities and obligations of U.S. Government agencies | \$ 143,811    | 16.8 %  |
| Aaa/Aa   | 566,192       | 66.0 %  |
| A  | 83,103        | 9.7 %   |
| Baa  | 39,824        | 4.7 %   |
| Not rated (Standard & Poor's rating of A- or higher)                 | 23,546        | 2.8 %   |
| Total  | \$ 856,476    | 100.0 % |

Ratings are assigned by Moody's, or the equivalent, as discussed above. Such ratings are generally assigned upon the issuance of the securities and are subject to revision on the basis of ongoing evaluations. Ratings in the table are as of the date indicated.

In our determination of other-than-temporary impairments, we consider several factors and circumstances including the issuer's overall financial condition, the issuer's credit and financial strength ratings, a weakening of the general market conditions in the industry or geographic region in which the issuer operates, a prolonged period (typically six months or longer) in which the fair value of an issuer's securities remains below our amortized cost, our ability and intent to hold these investments for a period of time sufficient to allow for recovery of our costs, and any other factors that may raise doubt about the issuer's ability to continue as a going concern.

Other-than-temporary impairments are recorded as realized losses, which serve to reduce net income and earnings per share. Temporary losses are recorded as unrealized losses, which do not impact net income and earnings per share but reduce other comprehensive net income. The risks inherent in the assessment of other-than-temporary impairments include the risk that market factors may differ from our expectations; we may decide to subsequently sell a security for unforeseen business needs; or the credit assessment could change in the near term, resulting in a charge to earnings.

The following table illustrates the gross unrealized losses included in the Company's investment portfolio and the fair value of those securities, aggregated by investment category. The table also illustrates the length of time that they have been in a continuous unrealized loss position as of June 30, 2006.

|  | As of June 30, 2006 |                   |                   |                   |            |                   |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|  | Less than 12 Months |                   | 12 Months or More |                   | Total      |                   |
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities and obligations of U.S. Government agencies | \$ 52,458           | \$ 1,088          | \$ 89,380         | \$ 4,447          | \$ 141,838 | \$ 5,535          |
| Obligations of states and political subdivisions                     | 200,998             | 2,818             | 109,790           | 3,909             | 310,788    | 6,727             |
| Asset-backed securities  | 114,975             | 3,311             | 46,229            | 2,079             | 161,204    | 5,390             |
| Corporate and other securities                                       | 62,676              | 2,104             | 49,203            | 1,941             | 111,879    | 4,045             |
| Subtotal, fixed maturity securities                                  | 431,107             | 9,321             | 294,602           | 12,376            | 725,709    | 21,697            |
| Equity securities  | 349                 | 9                 |                   |                   | 349        | 9                 |
| Total temporarily impaired securities                                | \$ 431,456          | \$ 9,330          | \$ 294,602        | \$ 12,376         | \$ 726,058 | \$ 21,706         |

The unrealized losses recorded on the fixed maturity investment portfolio at June 30, 2006 resulted from fluctuations in market interest rates as opposed to fundamental changes in the credit quality of the issuers of such securities. Therefore, these decreases in values are viewed as being temporary as we have the intent and ability to retain such investments for a period of time sufficient to allow for recovery in market value.

Of the \$21,706 gross unrealized losses as of June 30, 2006, \$12,262 relates to fixed maturity obligations of states and political subdivisions and U.S. government agencies. The remaining \$9,444 of gross unrealized losses relates primarily to holdings of investment grade asset-backed, corporate and other fixed maturity and equity securities.



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During the six months ended June 30, 2006 and 2005, there was no significant deterioration in the credit quality of any of the Company's holdings and no other-than-temporary impairment charges were recorded related to the Company's portfolio of investment securities.

*Finance and Other Service Income.* Finance and other service income includes revenues from premium installment charges, which we recognize when earned. Finance and other service income decreased by \$257, or 6.5%, to \$3,720 for the quarter ended June 30, 2006 from \$3,977 for the comparable 2005 period. Finance and other service income decreased by \$367, or 4.6%, to \$7,579 for the six months ended June 30, 2006 from \$7,946 for the comparable 2005 period. These decreases were primarily due to the decreases in direct premiums written.

*Losses and Loss Adjustment Expenses.* Losses and loss adjustment expenses incurred during the quarter ended June 30, 2006 decreased by \$9,198, or 9.8%, to \$84,604 from \$93,802 for the comparable 2005 period. Losses and loss adjustment expenses incurred during the six months ended June 30, 2006 decreased by \$33,617, or 16.5%, to \$170,355 from \$203,972 for the comparable 2005 period. Our GAAP loss ratio for the quarter ended June 30, 2006 decreased to 54.1% from 59.9% for the comparable 2005 period. Our GAAP loss ratio for the six months ended June 30, 2006 decreased to 54.2% from 65.2% for the comparable 2005 period. Our GAAP loss ratio excluding loss adjustment expenses for the quarter ended June 30, 2006 decreased to 46.7% from 53.5% for the comparable 2005 period. Our GAAP loss ratio excluding loss adjustment expenses for the six months ended June 30, 2006 decreased to 47.0% from 58.3% for the comparable 2005 period. The loss ratio improved as a result of a decrease in personal and commercial automobile bodily injury and physical damage claim frequency and favorable loss development in our personal and commercial automobile and homeowners lines prior year results. Total prior year favorable development included in the pre-tax results for the quarter and six months ended June 30, 2006 was \$12,086 and \$25,379, respectively, compared to prior year favorable development of \$8,905 and \$17,233, respectively, for the comparable 2005 periods.

*Underwriting, Operating and Related Expenses.* Underwriting, operating and related expense for the quarter ended June 30, 2006 increased by \$1,782, or 4.5%, to \$41,757 from \$39,975 for the comparable 2005 period. Underwriting, operating and related expense for the six months ended June 30, 2006 increased by \$5,586, or 7.3%, to \$82,152 from \$76,566 for the comparable 2005 period. Our GAAP expense ratios for the second quarter of 2006 increased to 26.7% from 25.5% for the comparable 2005 period. Our GAAP expense ratios for the six months ended June 30, 2006 increased to 26.2% from 24.5% for the comparable 2005 period. The increases were primarily due to higher accrued agents contingent commissions and higher 2006 policy year mandated personal automobile commissions. The increase in accrued agents' contingent commissions is due to the improved underwriting results for the six months ended June 30, 2006 compared to the six months ended June 30, 2005.

*Interest Expenses.* Interest expense for the quarter ended June 30, 2006 was \$20 compared to \$225 for the comparable 2005 period. Interest expense for the six months ended June 30, 2006 was \$44 compared to \$448 for the comparable 2005 period. The decrease in interest expense was due to the pay down of the balance outstanding under our credit facility on December 8, 2005. We had no debt outstanding related to our credit facility during the six months ended June 30, 2006 compared to \$19,956 of debt outstanding during the comparable 2005 period. The credit facility commitment fee included in interest expense was \$19 and \$37 for the three and six months ended June 30, 2006 compared to \$7 and \$13 for the comparable 2005 periods.

*Income Tax Expense.* Our effective tax rate was 32.6% and 31.9% for the quarters ended June 30, 2006 and 2005, respectively. Our effective tax rate was 31.9% for both the six months ended June 30, 2006 and 2005. These effective rates were lower than the statutory rate of 35% primarily due to adjustments for tax-exempt investment income.

### **D. Liquidity and Capital Resources**

As a holding company, Safety's assets consist primarily of the stock of our direct and indirect subsidiaries. Our principal source of funds to meet our obligations and pay dividends to shareholders, therefore, is dividends and other permitted payments from our subsidiaries, principally Safety Insurance. Safety is the borrower under our credit facilities.

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Safety Insurance's sources of funds primarily include premiums received, investment income and proceeds from sales and redemptions of investments. Safety Insurance's principal uses of cash are the payment of claims, operating expenses and taxes, the purchase of investments and payment of dividends to Safety.

Net cash provided by operating activities was \$38,391 and \$44,236 during the six months ended June 30, 2006 and 2005, respectively. Our operations typically generate substantial positive cash flows from operations as most premiums are received in

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advance of the time when claim and benefit payments are required. These positive operating cash flows are expected to continue to meet our liquidity requirements.

Net cash used for investing activities was \$167,559 during the six months ended June 30, 2006 compared to \$28,329 during the six months ended June 30, 2005. This was primarily the result of reinvesting cash and cash equivalents in long term fixed maturities in 2006.

Net cash used for financing activities was \$2,316 and \$1,578 during the six months ended June 30, 2006 and 2005, respectively, due primarily from dividends paid to shareholders.

#### *Credit Facility*

Concurrent with the closing of our November 27, 2002 initial public offering ( IPO ) and repayment of our old credit facility, Safety obtained a new \$30,000 revolving credit facility. Safety borrowed the entire \$30,000 under this credit facility at the closing of the IPO and paid down the balance to \$19,956 on December 5, 2002 with the approximately \$10,000 net proceeds from the exercise of the underwriter's over-allotment option for 900,000 shares of our common stock. Loans under the credit facility bear interest at our option at either (i) the LIBOR rate plus 1.5% per annum or (ii) the higher of Citizens Bank of Massachusetts' prime rate or 0.5% above the federal funds rate plus 1.5% per annum. Interest only is payable prior to maturity. The obligations of Safety under the credit facility are secured by pledges of the assets of Safety and the capital stock of Safety's operating subsidiaries. The credit facility is guaranteed by the non-insurance company subsidiaries of Safety. The credit facility contains covenants including requirements to maintain minimum risk based capital ratios and statutory surplus of Safety Insurance as well as limitations or restrictions on indebtedness, liens, dividends, and other matters. As of June 30, 2006, we were in compliance with all such covenants.

Bank of America was the lender under this credit facility. Under an agreement effective on June 17, 2005, Bank of America assigned the \$30,000 credit facility to Citizens Bank of Massachusetts. The credit facility was due and payable at maturity on November 27, 2005, which was three years from the closing of the IPO. Under a June 17, 2005 amendment to the credit facility, the maturity date was extended to June 17, 2008. Other terms of the revolving credit facility remain unchanged.

We paid down the balance of \$19,956 on December 8, 2005 and had no amounts outstanding on our credit facility at June 30, 2006 and at December 31, 2005. The interest rate on the \$30,000 commitment was .25% at June 30, 2006 and December 31, 2005.

#### *Regulatory Matters*

Our insurance subsidiaries are subject to various regulatory restrictions that limit the maximum amount of dividends available to be paid to their parent without prior approval of the Commissioner. The Massachusetts statute limits the dividends an insurer may pay in any twelve-month period, without the prior permission of the Commissioner, to the greater of (i) 10% of the insurer's surplus as of the preceding December 31 or (ii) the insurer's net income for the twelve-month period ending the preceding December 31, in each case determined in accordance with statutory accounting practices. Our insurance company subsidiaries may not declare an extraordinary dividend (defined as any dividend or distribution that, together with other distributions made within the preceding twelve months, exceeds the limits established by Massachusetts statute) until thirty days after the Commissioner has received notice of the intended dividend and has not objected. As historically administered by the Commissioner, this provision requires the Commissioner's prior approval of an extraordinary dividend. Under Massachusetts law, an insurer may pay cash dividends only from its unassigned funds, also known as earned surplus, and the insurer's remaining surplus must be both reasonable in relation to its outstanding liabilities and adequate to its financial needs. At year-end 2005, the statutory surplus of Safety Insurance was \$350,833, and its net income for 2005 was \$92,432. As a result, a maximum of \$92,432 is available in 2006 for such dividends without prior approval of the Division. During the six months ended June 30, 2006, Safety Insurance paid dividends to Safety of \$3,917.

The maximum dividend permitted by law is not indicative of an insurer's actual ability to pay dividends, which may be constrained by business and regulatory considerations, such as the impact of dividends on surplus, which could affect an insurer's ratings or competitive position, the amount of premiums that can be written and the ability to pay future dividends.

On February 16, 2006, our Board approved a quarterly cash dividend on our common stock of \$0.18 per share which was paid on March 15, 2006 to shareholders of record on March 1, 2006. On May 5, 2006, our Board approved a quarterly cash dividend on our common stock of \$0.18 per share which was paid on June 15, 2006 to shareholders of record on June 1, 2006.





We plan to continue to declare and pay quarterly cash dividends in 2006, depending on our financial position and the regularity of our cash flows.

Management believes that the current level of cash flow from operations provides us with sufficient liquidity to meet our operating needs over the next 12 months. We expect to be able to continue to meet our operating needs after the next 12 months from internally generated funds. Since our ability to meet our obligations in the long term (beyond such twelve-month period) is dependent upon such factors as market changes, insurance regulatory changes and economic conditions, no assurance can be given that the available net cash flow will be sufficient to meet our operating needs. We expect that we would need to borrow or issue capital stock if we needed additional funds, for example, to pay for an acquisition or a significant expansion of our operations. There can be no assurance that sufficient funds for any of the foregoing purposes would be available to us at such time.

#### E. Off-Balance Sheet Arrangements

We have no material obligations under a guarantee contract meeting the characteristics identified in paragraph 3 of Financial Accounting Standards Board ( FASB ) Interpretation No. ( FIN ) 45, Guarantor s Accounting and Disclosure Requirements, Including Indirect Guarantees of Indebtedness of Others . We have no material retained or contingent interests in assets transferred to an unconsolidated entity. We have no material obligations, including contingent obligations, under contracts that would be accounted for as derivative instruments. We have no obligations, including contingent obligations, arising out of a variable interest in an unconsolidated entity held by, and material to, us, where such entity provides financing, liquidity, market risk or credit risk support to, or engages in leasing, hedging or research and development services with us. We have no direct investments in real estate and no holdings of mortgages secured by commercial real estate. Accordingly, we have no material off-balance sheet arrangements.

#### F. Contractual Obligations

We have obligations to make future payments under contracts and credit-related financial instruments and commitments. At June 30, 2006, certain long-term aggregate contractual obligations and credit-related commitments are as follows:

|                               | Payments Due by Period |                       |                        |                         | Total      |
|-------------------------------|------------------------|-----------------------|------------------------|-------------------------|------------|
|                               | Less Than<br>One Year  | One to Three<br>Years | Three to Five<br>Years | More Than<br>Five Years |            |
| Loss and LAE reserves         | \$ 210,514             | \$ 189,033            | \$ 25,777              | \$ 4,297                | \$ 429,621 |
| Capital lease obligations     | 153                    |                       |                        |                         | 153        |
| Operating leases              | 2,969                  | 4,675                 |                        |                         | 7,644      |
| Total contractual obligations | \$ 213,636             | \$ 193,708            | \$ 25,777              | \$ 4,297                | \$ 437,418 |

As of June 30, 2006, the Company had gross loss and LAE reserves of \$429,621, reinsurance recoverables of \$76,068 and net loss and LAE reserves of \$353,553. Our loss and LAE reserves are estimates as described in more detail under Critical Accounting Policies and Estimates . The specific amounts and timing of obligations related to case reserves, IBNR reserves and related LAE reserves are not set contractually, and the amounts and timing of these obligations are unknown. Nonetheless, based upon our cumulative claims paid over the last ten years, the Company estimates that its loss and LAE reserves will be paid in the period shown above. While management believes that historical performance of loss payment patterns is a reasonable source for projecting future claims payments, there is inherent uncertainty in this estimated projected settlement of loss and LAE reserves, and as a result these estimates will differ, perhaps significantly, from actual future payments. Our operations typically generate substantial positive cash flows from operations as most premiums are received in advance of the time when claim and benefit payments are required. These positive operating cash flows are expected to continue to meet our liquidity requirements, including any unexpected variations in the timing of claim settlements.

#### G. Forward-Looking Statements

Forward-looking statements might include one or more of the following, among others:

- Projections of revenues, income, earnings per share, capital expenditures, dividends, capital structure or other financial items;
- Descriptions of plans or objectives of management for future operations, products or services;

- Forecasts of future economic performance, liquidity, need for funding and income; and

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- Descriptions of assumptions underlying or relating to any of the foregoing.

Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. They often include words such as believe, expect, anticipate, intend, plan, estimate, aim, projects, or words of similar meaning and expressions that indicate future conditions and trends, or future or conditional verbs such as will, would, should, could, or may. All statements that address expectations or projections about the future, including statements about the Company's strategy for growth, product development, market position, expenditures and financial results, are forward-looking statements.

Forward-looking statements are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and uncertainties. There are a number of factors, many of which are beyond our control, that could cause actual future conditions, events, results or trends to differ significantly and/or materially from historical results or those projected in the forward-looking statements. These factors include but are not limited to the competitive nature of our industry and the possible adverse effects of such competition. Although a number of national insurers that are much larger than we are do not currently compete in a material way in the Massachusetts private passenger automobile market, if one or more of these companies decided to aggressively enter the market it could have a material adverse effect on us. Other significant factors include conditions for business operations and restrictive regulations in Massachusetts, the possibility of losses due to claims resulting from severe weather, the possibility that the Commissioner may approve future Rule changes that change the operation of the residual market, our possible need for and availability of additional financing, and our dependence on strategic relationships, among others, and other risks and factors identified from time to time in our reports filed with the SEC, such as those set forth under the caption "Risk Factors" in our Form 10-K for the year ended December 31, 2005 filed with the SEC on March 16, 2006.

Some other factors, such as market, operational, liquidity, interest rate, equity and other risks, are described elsewhere in this Quarterly Report on Form 10-Q. Factors relating to the regulation and supervision of our Company are also described or incorporated in this report. There are other factors besides those described or incorporated in this report that could cause actual conditions, events or results to differ from those in the forward-looking statements.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date on which they are made. We do not undertake any obligation to update publicly or revise any forward-looking statements to reflect circumstances or events that occur after the date the forward-looking statements are made.

### **Item 3. Quantitative and Qualitative Information about Market Risk (Dollars in thousands)**

*Market Risk.* Market risk is the risk that we will incur losses due to adverse changes in market rates and prices. We have exposure to market risk through our investment activities and our financing activities. Our primary market risk exposure is to changes in interest rates. We use both fixed and variable rate debt as sources of financing. We have not entered, and do not plan to enter, into any derivative financial instruments for trading or speculative purposes.

*Interest Rate Risk.* Interest rate risk is the risk that we will incur economic losses due to adverse changes in interest rates. Our exposure to interest rate changes primarily results from our significant holdings of fixed rate investments and from our financing activities. Our fixed maturity investments include U.S. and foreign government bonds, securities issued by government agencies, obligations of state and local governments and governmental authorities, corporate bonds and asset-backed securities, most of which are exposed to changes in prevailing interest rates.

We manage our exposure to risks associated with interest rate fluctuations through active review of our investment portfolio by our management and Board and consultation with third-party financial advisors. As a general matter, we do not attempt to match the durations of our assets with the durations of our liabilities, and the majority of our liabilities are short term. Our goal is to maximize the total after-tax return on all of our investments. An important strategy that we employ to achieve this goal is to try to hold enough in cash and short-term investments in order to avoid liquidating longer-term investments to pay claims.

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Based upon the results of interest rate sensitivity analysis, the following tables show the interest rate risk of our investments in fixed maturities, including preferred stocks with characteristics of fixed maturities, measured in terms of fair value (which is equal to the carrying value for all our fixed maturity securities).

| <b>As of June 30, 2006</b>                  | <b>-100 Basis<br/>Point Change</b> | <b>No Change</b> | <b>+100 Basis<br/>Point Change</b> |
|---|------------------------------------|------------------|------------------------------------|
| Estimated fair value                        | \$ 899,904                         | \$ 856,476       | \$ 812,685                         |
| Estimated increase (decrease) in fair value | \$ 43,428                          | \$               | \$ (43,791 )                       |

An important market risk for all of our long-term debt is interest rate risk. We continue to monitor the interest rate environment and to evaluate refinancing opportunities as maturity dates approach. With respect to floating rate debt, we are also exposed to the effects of changes in prevailing interest rates. We had no debt outstanding under our credit facility during the six months ended June 30, 2006. Assuming maximum utilization of our credit facility for the entire year, a 2.0% change in the prevailing interest rate on our variable rate debt would result in interest expense fluctuating approximately \$600.

*Equity Risk.* Equity risk is the risk that we will incur economic losses due to adverse changes in equity prices. In the past, our exposure to changes in equity prices primarily resulted from our holdings of common stocks, mutual funds and other equities. While we have in the past held common equity securities in our investment portfolio, presently we hold none, except for interests in mutual funds to fund the executive deferred compensation plan. We continuously evaluate market conditions and we expect in the future to purchase equity securities. We principally managed equity price risk through industry and issuer diversification and asset allocation techniques.

#### **Item 4. Controls and Procedures**

##### **Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act )) as of the end of the period covered by this report. Based on that evaluation, our CEO and CFO have concluded that our disclosure controls and procedures are adequate and effective and ensure that all information required to be disclosed is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and that information required to be disclosed in such reports is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosures.

##### **Changes in Internal Control over Financial Reporting**

There have been no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Part II. OTHER INFORMATION**

**Item 1. Legal Proceedings - Please see Item 1 Financial Statements - Note 7, Commitments and Contingencies.**

**Item 1A. Risk Factors**

There have been no material changes from the risk factors previously disclosed in the Company's Annual Report on Form 10-K.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds - None.**

**Item 3. Defaults upon Senior Securities - None.**

**Item 4. Submission of Matters to a Vote of Security Holders**

The annual Meeting of Shareholders was held on May 19, 2006.

The following proposals were adopted by the margins indicated:

1. Election of two Class I Directors to serve a three year term expiring in 2009.

|                  | Number of Shares |          |
|------------------|------------------|----------|
|                  | For              | Withheld |
| Peter J. Manning | 14,375,449       | 674,657  |
| David K. McKown  | 14,470,000       | 580,106  |

2. Approval of the 2002 Management Omnibus Incentive Plan, as amended.

|         |            |
|---------|------------|
| For     | 11,105,023 |
| Against | 1,187,195  |
| Abstain | 189,453    |
| No Vote | 2,568,435  |

3. Approval of the Annual Performance Incentive Plan.

|         |            |
|---------|------------|
| For     | 12,173,662 |
| Against | 118,279    |
| Abstain | 189,730    |
| No Vote | 2,568,435  |

**Item 5. Other Information - None.**

**Item 6. Exhibits - The exhibits are contained herein as listed in the Exhibit Index.**

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**SAFETY INSURANCE GROUP, INC. (Registrant)**

Date: August 9, 2006

By:

/s/ WILLIAM J. BEGLEY, JR.

William J. Begley, Jr.

*Vice President, Chief Financial Officer and Secretary*

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**SAFETY INSURANCE GROUP, INC.**

**EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Description</b>  |
|---------------------------|---|
| 11                        | Statement re: Computation of Per Share Earnings. (1)  |
| 31.1                      | CEO Certification Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (2) |
| 31.2                      | CFO Certification Pursuant to Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. (2) |
| 32.1                      | CEO Certification Pursuant to U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (2)      |
| 32.2                      | CFO Certification Pursuant to U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (2)      |

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(1) Not included herein as the information can be calculated from the face of the Consolidated Statements of Operations (see page 4).

(2) Included herein.