PICO HOLDINGS INC /NEW
Form 10-K
March 12, 2007

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(MARK ONE)
x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2006

OR

o **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 0-18786

PICO HOLDINGS, INC.
(Exact Name of Registrant as Specified in its Charter)

California	**94-2723335**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

875 Prospect Street, Suite 301
La Jolla, California 92037
(Address of Principal Executive Offices)

Registrant's Telephone Number, Including Area Code (858) 456-6022

Securities Registered Pursuant to Section 12(b) of the Act:
Common Stock, Par Value $.001, Listed on The NASDAQ Stock Market LLC

Securities Registered Pursuant to Section 12(g) of the Act:
None

Indicate by check mark whether the registrant is a well known seasoned issuer, as defined by Rule 405 of the Securities Act.
Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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 x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III or this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12-b of the Act). Yes o No x

Approximate aggregate market value of the registrant's voting and non-voting common equity held by non-affiliates of the registrant (based on the closing sales price of such stock as reported in the NASDAQ Global Market) as of June 30, 2006 the last business day of the registrant's most recently completed second fiscal quarter, was $400,381,041.

On March 9, 2007, the registrant had 23,129,923 shares of common stock, $.001 par value, outstanding, excluding 3,219,243 shares of common stock which are held by the registrant's subsidiaries.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Definitive Proxy Statement to be filed with the Commission pursuant to Regulation 14A in connection with the registrant's 2007 Annual Meeting of Shareholders, to be filed subsequent to the date hereof, are incorporated by reference into Part III of this Report. Such Definitive Proxy Statement will be filed with the Securities and Exchange Commission not later than 120 days after the conclusion of the registrant's fiscal year ended December 31, 2006.

PICO HOLDINGS, INC.

ANNUAL REPORT ON FORM 10-K

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PART I

The following discussion and analysis of financial condition and results of operations should be read in conjunction with the Consolidated Financial Statements and Notes thereto included elsewhere in this Annual Report on Form 10-K.

This Annual Report on Form 10-K (including the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section) contains "forward-looking statements" regarding our business, financial condition, results of operations and prospects, including, without limitation, statements about our expectations, beliefs, intentions, anticipated developments, and other information concerning future matters. Words such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates" and similar expres variations of such words are intended to identify forward-looking statements, but are not the exclusive means of identifying forward-looking statements in this Annual Report on Form 10-K.

Although forward-looking statements in this Annual Report on Form 10-K reflect the good faith judgment of our management, such statements can only be based on facts and factors currently known by us. Consequently, forward-looking statements are inherently subject to risks and uncertainties, and the actual results and outcomes could differ from those discussed in or anticipated by the forward-looking statements. Factors that could cause or contribute to such differences in results and outcomes include, without limitation, those discussed under the heading "Risk Factors" below, as well as those discussed elsewhere in this Annual Report on Form 10-K. Readers are urged not to place undue reliance on these forward-looking statements, which speak only as of the date of this Annual Report on Form 10-K We undertake no obligation to revise or update any forward-looking statements in order to reflect any event or circumstance that may arise after the date of this Annual Report on Form 10-K. Readers are urged to carefully review and consider the various disclosures made in this Annual Report on Form 10-K, which attempt to advise interested parties of the risks and factors that may affect our business, financial condition, results of operations, and prospects.

ITEM 1. BUSINESS

Introduction

PICO Holdings, Inc. (PICO and its subsidiaries are collectively referred to as "PICO" and "the Company," and by words such as "we," and "our") is a diversified holding company. We seek to build and operate businesses where significant value can be created from the development of unique assets, and to acquire businesses which we identify as undervalued and where our participation can aid in the recognition of the business's fair value, as well as create additional value.

Our objective is to maximize long-term shareholder value. We manage our operations to achieve a superior return on net assets over the long term, as opposed to short-term earnings.

Our business is separated into four major operating segments:

- Water Resource and Water Storage Operations;
- Real Estate Operations;
- Business Acquisitions & Financing (which contains businesses, interests in businesses, and other parent company assets); and
- Insurance Operations in "Run Off".

Currently our major consolidated subsidiaries are:

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Vidler Water Company, Inc. ("Vidler"), a business we started more than 10 years ago, which develops and owns water resources and water storage operations in the southwestern United States, primarily in Nevada and Arizona;

- Nevada Land and Resource Company, LLC ("Nevada Land"), an operation that we have built since we acquired the company more than 10 years ago, which currently owns approximately 560,000 acres of land in Nevada, and certain mineral rights and water rights related to the property;
- Physicians Insurance Company of Ohio ("Physicians"), which is "running off" its medical professional liability insurance loss reserves, and was our original business historically;
- Citation Insurance Company ("Citation"), which is "running off" its historical property & casualty and workers' compensation loss reserves. Citation was acquired because it was complimentary to our other insurance operations at the time; and
- Global Equity AG, which holds our interest in Jungfraubahn Holding AG ("Jungfraubahn"). Jungfraubahn is a public company, whose shares trade on the SWX Swiss Exchange, that operates railway and related tourism and transport activities in the Swiss Alps. We believed that Jungfraubahn was significantly undervalued at the time we acquired our interest, which was primarily acquired between 1999 and 2003.

During 2006, HyperFeed Technologies, Inc. filed for Chapter 7 bankruptcy protection. HyperFeed is accounted for in our consolidated financial statements for 2006 and prior years as a discontinued operation. *See "Discontinued Operations."*

The address of our main office is 875 Prospect Street, Suite 301, La Jolla, California 92037, and our telephone number is (858) 456-6022.

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Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports are made available on our website (www.picoholdings.com) as soon as reasonably practicable after the reports are electronically filed with the SEC. Our website also contains other material about PICO, and links to other sites, including some of the companies with which we are associated.

History

PICO was incorporated in 1981 and began operations in 1982. The company was known as Citation Insurance Group until a reverse merger with Physicians Insurance Company of Ohio on November 20, 1996. After the reverse merger, the former shareholders of Physicians owned approximately 80% of Citation Insurance Group, the Board of Directors and management of Physicians replaced their Citation counterparts, and Citation Insurance Group changed its name to PICO Holdings, Inc. You should be aware that some data on Bloomberg and other information services pre-dating the reverse merger relates to the old Citation Insurance Group only, and does not reflect the performance of Physicians prior to the merger.

Operating Segments and Major Subsidiary Companies

The following is a description of our operating segments and major subsidiaries. Unless otherwise indicated, we own 100% of each subsidiary.

Water Resource and Water Storage Operations

Water Resource and Water Storage Operations are primarily conducted through Vidler Water Company.

Vidler is a leading private company in the water resource development business in the southwestern United States. PICO identified water resource development in the Southwest as an attractive business opportunity due to the continued growth in demand for water, primarily as a result of population growth and economic development. We develop new sources of water for municipal and industrial use, and storage infrastructure to facilitate the efficient allocation of available water supplies. Vidler is not a water utility, and does not intend to enter into regulated utility activities.

The inefficient allocation of available water between agricultural users and municipal or industrial users, or the lack of available known water supply in a particular location, provide opportunities for Vidler:

- the majority of water rights are currently owned or controlled by agricultural users, and in many locations there are insufficient water rights owned or controlled by municipal and industrial users to meet present and future demand;
- certain areas of the Southwest experiencing rapid growth have insufficient known supplies of water to support future growth. Vidler identifies and develops new water supplies for communities with no other known water resources to support future growth. In certain cases, to supply water from the water resources identified by Vidler, it may require regulatory approval to import the water from its source to where development is occurring, or substantial infrastructure to convey the water. Vidler is able to assess the likelihood of being able to get the necessary approval to import water, and to build the infrastructure in a timely and economic manner. In cases where we assess that water importation is possible, Vidler has demonstrated an ability to obtain all of the required approval and entitlements, and to manage the building of the infrastructure necessary to import and convey the identified water from its source to development; and
- currently there are not effective procedures in place for the transfer of water from private parties with excess supply in one state to end-users in other states. However, regulations and procedures are steadily being developed to facilitate the interstate transfer of water. Infrastructure to store water will be required to accommodate and allow

interstate transfer, and transfers from wet years to dry years. Currently there is limited storage capacity in place.

We entered the water resource development business with the acquisition of Vidler in 1995. At the time, Vidler owned a limited quantity of water rights and related assets in Colorado. Since then, Vidler has acquired or developed:

- additional water rights and related assets, predominantly in Nevada and Arizona, the two leading states in population growth and new home construction. A water right is the legal right to divert water and put it to beneficial use. Water rights are assets which can be bought and sold. In some states, the use of the water can also be leased. The value of a water right depends on a number of factors, including location, the seniority of the right, and whether or not the right is transferable. Vidler seeks to acquire water rights at prices consistent with their current use, with the expectation of an increase in value if the water right can be converted to a higher use. Our objective is to monetize our water rights for municipal and industrial use. Typically, our water resources are the most competitive source of water (i.e., the most economical and practical source of water supply) to support new growth in municipalities and new industry; and
- a water storage facility in Arizona and an interest in Semitropic, a water storage facility in California. At December 31, 2006, Vidler had “net recharge credits” (i.e. an acre foot of water) representing more than 115,000 acre-feet of water in storage on its own account at the Vidler Arizona Recharge Facility. An acre-foot is a unit commonly used to measure the volume of water, being the volume of water required to cover one acre to a depth of one foot. As a rule of thumb, one acre-foot of water would sustain two families of four persons each for one year.

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Vidler is engaged in the following activities:

- supplying water to end-users in the Southwest, namely water utilities, municipalities, developers, or industrial users. The source of water could be from identifying and developing a new water supply, or a change in the use of water from agricultural to municipal and industrial; and
- development of storage and distribution infrastructure to generate cash flow from the purchase and storage of water for resale, and charging customers fees for "recharge," or placing water into storage.

Vidler's priority is to either monetize or develop recurring cash flow from its most important assets by:

- securing supply contracts utilizing its water rights in Nevada; and
- storing additional water at the Vidler Arizona Recharge Facility, and providing water supplies from net recharge credits (a recharge credit is an acre-foot of water) already in storage.

Vidler has also entered into "teaming" arrangements with parties who have water assets but lack the capital or expertise to commercially develop these assets. The first such arrangement is a water delivery teaming agreement with Lincoln County ("Lincoln/Vidler"), which is developing water resources in Lincoln County, Nevada. Vidler continues to explore additional teaming opportunities throughout the Southwest.

The following table details the water rights and water storage assets owned by Vidler at December 31, 2006. Please note that this is intended as a summary, and that some numbers are rounded. Item 7 of this Form 10-K contains more detail about these assets, recent developments affecting them, and the current outlook.

Name of asset & approximate location	**Brief Description**	**Present commercial use**
WATER RESOURCES		
Arizona:		
Harquahala Valley ground water basin	2,703 acres of land	Leased to farmers
La Paz County 75 miles northwest of metropolitan Phoenix	2,880 acre-feet of transferable ground water	
Nevada:		
Fish Springs Ranch, LLC (51% interest) & V&B, LLC (100% interest) Washoe County, 40 miles north of Reno	8,600 acres of deeded ranch land 13,000 acre-feet of permitted water rights, 8,000 of which are transferable to the Reno/Sparks area	Vidler is currently farming the property. Cattle graze on part of the property on a revenue- sharing basis Vidler is constructing a 35 mile long pipeline to convey 8,000 acre-feet of water annually from Fish Springs Ranch to the North Valleys of Reno, Nevada

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Lincoln County water delivery teaming agreement	Applications* for more than 100,000 acre-feet of water rights through an agreement with Lincoln County. It is currently anticipated that up to 40,000 acre-feet of the applications will be permitted, and the water put to use in Lincoln County / northern Clark County **The numbers indicated for water rights applications are the maximum amount which we have filed for. In some cases, we anticipate that the actual permits received will be for smaller quantities*	Agreement to sell 7,240 acre-feet of water as, and when, supplies are permitted from existing applications Agreement to sell water to a developer as, and when, supplies are permitted from applications in Kane Springs Basin in Lincoln County, Nevada
Clark County		
Sandy Valley Near the Nevada / California state line in the Interstate 15 corridor	415 acre-feet of permitted water rights Application for 1,000 acre-feet of water rights	Agreement to sell at least 415 acre-feet of water pending resolution of a protest of the permitting of the water rights
Muddy River water rights In the Moapa Valley, approximately 35 miles east of Las Vegas in the Interstate 15 corridor	221 acre-feet of water rights, plus approximately 46 acre-feet under option	
Colorado:		
Colorado water rights	180 acre-feet of water rights	66 acre-feet leased. 114 acre-feet are available for sale or lease
WATER STORAGE		
Arizona:		
Vidler Arizona Recharge Facility Harquahala Valley, Arizona	An underground water storage facility with estimated capacity exceeding 1 million acre-feet and annual recharge capability of up to 35,000 acre-feet	Vidler is currently buying water and storing it on its own account. At December 31, 2006, Vidler had net recharge credits equivalent to approximately 115,000 acre-feet of water in storage at the Arizona Recharge Facility. In addition, Vidler has purchased or ordered approximately 30,000 acre-feet of water for recharge in 2007.
California:		
Semitropic water storage facility	The right to store 30,000 acre-feet of water underground until 2035. This	

includes the right to minimum guaranteed recovery of approximately 2,700 acre-feet of water every year, and the right to recover up to approximately 6,800 acre-feet in one year in certain circumstances

Real Estate Operations

Real Estate Operations are conducted through Nevada Land And Resource Company, LLC.

In April 1997, PICO paid $48.6 million to acquire Nevada Land, which at the time owned approximately 1,352,723 acres of deeded land in northern Nevada, and the water, mineral, and geothermal rights related to the property. Much of Nevada Land's property is checker-boarded in square mile sections with publicly owned land. The lands generally parallel the Interstate 80 corridor and the Humboldt River, from Fernley, in western Nevada, to Elko County, in northeast Nevada.

Nevada Land is one of the largest private landowners in the state of Nevada. According to U.S. Census Bureau data, Nevada has experienced the most rapid population growth of any state in the United States for 19 of the past 20 years, being narrowly edged out by Arizona in 2006. The population of Nevada increased 66% in the 10 years ended April 1, 2000, and increased another 25%, to approximately 2.5 million people, from 2000 to 2006. Most of the growth is centered in southern Nevada, which includes the city of Las Vegas and surrounding municipalities. Land available for private development in Nevada is relatively scarce, as governmental agencies own approximately 87% of the land in Nevada.

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Before we acquired Nevada Land, the property had been under the ownership of a succession of railway companies, to whom it was a non-core asset. Accordingly, when we acquired Nevada Land, we believed that the commercial potential of the property had not been maximized.

After acquiring Nevada Land, we completed a "highest and best use" study which divided the land into categories. We developed strategies to maximize the value of each category, with the objective of monetizing assets once they had reached their highest and best use. These strategies include:

- the sale of land and water rights. There is demand for land and water for a variety of purposes including residential development, residential estate living, farming, ranching, and from industrial users;
- the development of water rights. Nevada Land has applied for additional water rights on land it owns and intends to improve. Where water rights are permitted, we anticipate that the value, productivity, and marketability of the related land will increase;
- the development of land in and around growing municipalities; and
- the management of mineral rights.

During the period from April 23, 1997 to December 31, 2006, Nevada Land received consideration of approximately $70.1 million from the sale and exchange of land, and the sale of water rights. This is comprised of $69 million from the sale and exchange of land, and $1.1 million from the sale of water rights related to land that was sold. Over this period, we divested approximately 814,000 acres of land at an average price of $85 per acre, which compares to our average basis of $35 in the acres disposed of. The average gross margin percentage on the disposal of land and water rights over this period is 59.6%. The average cost for the total land, water, and mineral assets acquired with Nevada Land was $35 per acre.

At December 31, 2006, Nevada Land owned approximately 541,000 acres of former railroad land. In addition to the former railroad property, Nevada Land acquired:

- 17,558 acres of land in a land exchange with a private landowner. This land is contiguous with Native American tribal lands and is culturally sensitive; and
- Spring Valley Ranches, which originally consisted of 8,717 acres of deeded land, located approximately 40 miles east of Ely in White Pine County, Nevada. During 2006, we sold approximately 7,675 acres of land and related water assets at Spring Valley.

In recent years, Nevada Land has filed additional applications for approximately 50,600 acre-feet of water rights on the Company's former railroad lands. Of these applications, approximately 12,400 acre-feet of water rights have been certificated and permitted, and applications are pending for approximately 38,200 acre-feet of water use for agricultural, municipal, and industrial use. Potentially, some of these water rights could be utilized to support the growth of municipalities in northern Nevada.

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Business Acquisitions and Financing

This segment contains businesses, interests in businesses, and other parent company assets.

We do not sell holdings on a regular basis. A holding may be sold if the price of a security has significantly exceeded our target, or if there have been changes which we believe limit further appreciation potential on a risk-adjusted basis. Consequently, the amount of net realized gains or losses recognized during any accounting period has no predictive value. In addition, in this segment various income items relate to specific holdings owned during a particular accounting period. Since our holdings change over time, results in this segment are not necessarily comparable from year to year.

The largest asset in this segment is our 22.5% interest in Jungfraubahn Holding AG ("Jungfraubahn"), which had a market value and carrying value (before taxes) of $49.1 million at the end of 2006. The holding in Jungraubahn, and our residual holding in Raetia Energie AG, are the only interests in publicly-traded companies in this segment.

PICO seeks to acquire businesses and interests in businesses which we identify as undervalued based on fundamental analysis -- that is, our assessment of what the business is worth, based on the private market value of its assets, earnings, and cash flow. Typically, the business will be generating free cash flow and have a low level of debt, or, alternatively, strong interest coverage ratios or the ability to realize surplus assets. As well as being undervalued, the business must have special qualities such as unique assets, a potential catalyst for change, or be in an industry with attractive economics. We are also interested in acquiring businesses and interests in businesses where there is significant unrecognized value in land and other tangible assets.

We have acquired businesses and interests in businesses through the acquisition of private companies, and the purchase of shares in public companies, both directly through participation in financing transactions and through open market purchases.

When we acquire an interest in a public company, we are prepared to play an active role, for example encouraging companies to use proper financial criteria when making capital expenditure decisions, or by providing financing or strategic input.

At the time we acquire an interest in a public company, we believe that the intrinsic value of the underlying business significantly exceeds the current market capitalization. The gap between market price and intrinsic value may persist for several years, and the stock price may decline while our estimate of intrinsic value is stable or increasing. Sometimes the gap is not eliminated until another party attempts to acquire the company.

When acquisitions become core operations, typically through majority ownership, we become involved in the management and strategic direction of the business. If we acquire majority ownership, the business may become a separate segment in our consolidated financial statements.

Insurance Operations in "Run Off"

This segment consists of Physicians Insurance Company of Ohio and Citation Insurance Company.

Physicians Insurance Company of Ohio

Until 1995, Physicians wrote medical professional liability insurance, mostly in the state of Ohio. In 1995 we concluded that maximum value would be obtained by placing Physicians in "run off." This means handling and resolving the claims arising from its historical business, but not writing new business.

After Physicians went into "run off," the company expanded its insurance operations by acquisition:

- In 1995, we purchased Sequoia Insurance Company, which primarily wrote commercial lines of insurance in California and Nevada. After the acquisition, we re-capitalized Sequoia, which provided the capital to support growth in the book of business; and

- In 1996, Physicians completed a reverse merger with the parent company of Citation Insurance Company. At that time, Citation wrote various lines of commercial property and casualty insurance and workers' compensation insurance, primarily in California and Arizona. The operations of Sequoia and Citation were combined, and eventually the business previously written by Citation was transferred to Sequoia. At the end of 2000, Citation ceased writing business and went into "run off". In 2003, we sold Sequoia Insurance Company. Despite significant growth in its book of business, and combined ratios and investment return better than the industry averages, Sequoia continued to generate a return on capital lower than our expectation, and we concluded that value would be maximized by the sale of Sequoia, particularly given the increasingly restrictive regulatory environment and the highly competitive marketplace.

Physicians and Citation obtain the funds to pay claims from the maturity of fixed-income securities, the sale of investments, and collections from reinsurance companies (that is, specialized insurance companies who share in our claims risk).

Typically, most of the revenues of an insurance company in "run off" come from investment income on funds held as part of the insurance business. During the "run off" process, as claims are paid, both the loss reserve liabilities and the corresponding fixed-income investment assets decrease. Since interest income in this segment will decline over time, we are attempting to minimize segment overhead expenses as much as possible.

Although we regularly evaluate the strategic alternatives, we currently believe that the most advantageous option is for Physicians' own claims personnel to manage the "run off." We believe that this will ensure a high standard of claims handling for our policyholders and, from the Company's perspective, ensure the most careful examination of claims made to minimize loss and loss adjustment expense payments. If we were to reinsure Physicians' entire book of business and outsource claims handling, this would involve giving up management of the corresponding investment assets.

Administering our own "run off" also provides us with the following opportunities:

- we retain management of the associated investment portfolios. After we resumed direct management of our insurance company portfolios in 2000, we believe that the return on our portfolio assets has been attractive in absolute terms, and very competitive in relative terms (see next paragraph). Since the claims reserves of the "run off" insurance companies effectively recognize the cost of paying and handling claims in future years, the investment return on the corresponding investment assets, less non-insurance expenses, accrues to PICO. We aim to maximize this source of income; and
- to participate in favorable development in our claims reserves if there is any, although this entails the corresponding risk that we could be exposed to unfavorable development.

As the "run off" progresses, at an indeterminate time in the future, Physicians' claims reserves may diminish to the point where it is more cost-effective to outsource claims handling to a third party administrator.

At December 31, 2006, Physicians had $9.4 million in medical professional liability loss reserves, net of reinsurance.

Citation Insurance Company

In 1996, Physicians completed a reverse merger with Citation's parent company. In the past, Citation wrote various lines of commercial property and casualty insurance and workers' compensation insurance, primarily in California and Arizona.

After we assumed management of Citation, we tightened underwriting standards significantly and did not renew much of the business which Citation had written previously. At the end of 2000 Citation ceased writing business and went into "run off."

Prior to the reverse merger, Citation had been a direct writer of workers' compensation insurance. Since PICO did not wish to be exposed to that line of business, shortly after the merger was completed Citation reinsured 100% of its workers compensation business with a subsidiary, Citation National Insurance Company ("CNIC"), and sold CNIC to Fremont Indemnity Company ("Fremont") in a third-party transaction in 1997. As part of the sale of CNIC, all assets and liabilities, including the assets which corresponded to the workers' compensation reserves reinsured with CNIC, and all records, computer systems, policy files, and reinsurance arrangements were transferred to Fremont. Fremont merged CNIC into Fremont, and administered and paid all of the workers' compensation claims which had been sold to it. From 1997 until the second quarter of 2003, Citation booked the losses reported by Fremont, and recorded an equal and offsetting reinsurance recoverable from Fremont, as an admitted reinsurer, for all losses and loss adjustment expenses. This resulted in no net impact on Citation's reserves and financial statements, and no net impact on PICO's consolidated financial statements.

In June 2003, the California Department of Insurance obtained a conservation order over Fremont, and applied for a court order to liquidate Fremont. In July 2003, the California Superior Court placed Fremont in liquidation. Since Fremont was no longer an admitted reinsurance company under the statutory basis of insurance accounting, Citation reversed the $7.5 million reinsurance recoverable from Fremont in both its statutory basis and GAAP basis financial statements in the 2003 financial year. Citation was unsuccessful in court action to recover deposits reported as held by Fremont for Citation's insureds.

In September 2004, Citation entered into a third-party administration agreement with Cambridge Integrated Services, Inc. to administer the claims handling and claims payment for Citation's workers' compensation insurance run-off book of business.

At December 31, 2006, Citation had $14.7 million in loss reserves, net of reinsurance. Citation's loss reserves consist of $5.1 million for property and casualty insurance, principally in the artisans/contractors line of business, and $9.6 million for workers' compensation insurance.

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Discontinued Operations

HyperFeed Technologies, Inc.
During the fourth quarter of 2006, our majority-owned subsidiary HyperFeed Technologies, Inc. ("HyperFeed") filed for bankruptcy protection under Chapter 7 of the U.S. Bankruptcy Code. Consequently, HyperFeed is now recorded as a discontinued operation for 2006 and prior years in the Consolidated Financial Statements in this Annual Report on Form 10-K.

HyperFeed was a provider of enterprise-wide ticker plant and transaction technology software and services enabling financial institutions to process and use high performance exchange data with Smart Order Routing and other applications. HyperFeed was a publicly traded company, which became a subsidiary of PICO Holdings in 2003, when we acquired direct ownership of a majority voting interest.

PICO first invested in HyperFeed in 1995, and we built our shareholding through the purchase of common stock and provision of convertible debt financing. During 2002 and 2003, HyperFeed restructured its operations, culminating in the sale of its consolidated market data feed customers to Interactive Data Corporation for $8.5 million in October 2003.

Despite possessing potentially valuable technology, HyperFeed was unable to generate sufficient cash flow to finance its own operations. During 2006, PICO and HyperFeed negotiated a business combination with Exegy Incorporated ("Exegy"). On August 25, 2006, PICO, HyperFeed, and Exegy entered into an agreement, pursuant to which the common stock of HyperFeed owned by PICO would have been contributed to Exegy in exchange for Exegy's issuance to PICO of certain Exegy stock. However, in a letter dated November 7, 2006, Exegy informed PICO and HyperFeed that it was terminating the agreement. At this time, PICO and HyperFeed dispute Exegy's right to terminate the agreement and plan to vigorously defend their rights thereunder through all available legal means.

Given the uncertainty of additional funding available to HyperFeed due to the termination of the agreement and therefore for HyperFeed to continue as a going concern, HyperFeed filed for bankruptcy protection under Chapter 7 of the U.S. Bankruptcy Code on November 29, 2006. See Note 2 of Notes to Consolidated Financial Statements, "Discontinued Operations".

Employees

At December 31, 2006, PICO had 42 employees. A total of 7 employees were engaged in land and related mineral rights and water rights operations; 9 in water resource and storage operations; 3 in property and casualty insurance operations; 2 in medical professional liability operations; and 21 in business acquisitions & financing and holding company activities.

Executive Officers

The executive officers of PICO are as follows:

Name	Age	Position
Ronald Langley	62	Chairman of the Board, Director
John R. Hart	47	President, Chief Executive Officer and Director
Richard H. Sharpe	51	Chief Operating Officer
James F. Mosier	59	General Counsel and Secretary
Maxim C. W. Webb	45	

		Chief Financial Officer and Treasurer
W. Raymond Webb	45	Vice President, Investments
John T. Perri	37	Vice President, Controller

Mr. Langley has been Chairman of the Board of PICO since November 1996 and of Physicians since July 1995. Mr. Langley has been a Director of PICO since November 1996 and a Director of Physicians since 1993. Mr. Langley has been a Director of Jungfraubahn Holding AG since 2000.

Mr. Hart has been President and Chief Executive Officer of PICO since November 1996 and of Physicians since July 1995. Mr. Hart has been a Director of PICO since November 1996 and a Director of Physicians since 1993.

Mr. Sharpe has served as Chief Operating Officer of PICO since November 1996 and in various executive capacities since joining Physicians in 1977.

Mr. Mosier has served as General Counsel and Secretary of PICO since November 1996 and of Physicians since October 1984 and in various other executive capacities since joining Physicians in 1981.

Mr. Maxim Webb has been Chief Financial Officer and Treasurer of PICO since May 14, 2001. Mr. Webb served in various capacities with the Global Equity Corporation group of companies since 1993, including Vice President, Investments of Forbes Ceylon Limited from 1994 through 1996. Mr. Webb became an officer of Global Equity Corporation in November 1997 and Vice President, Investments of PICO on November 20, 1998.

Mr. Raymond Webb has been with the Company since August 1999 as Chief Investment Analyst and became Vice President, Investments in April 2003.

Mr. Perri has been Vice President, Controller of PICO since April 2003 and served in various capacities since joining the Company in 1998, including Financial Reporting Manager and Corporate Controller.

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ITEM 1A. RISK FACTORS

The following information sets forth factors that could cause our actual results to differ materially from those contained in forward-looking statements we have made in this Annual Report on Form 10-K and those we may make from time to time. You should carefully consider the following risks, together with other matters described in this Form 10-K or incorporated herein by reference in evaluating our business and prospects. If any of the following risks occurs, our business, financial condition or operating results could be harmed. In such case, the trading price of our securities could decline, in some cases significantly. The risks described below are not the only ones we face. Additional risks not presently known to us, or that we currently deem immaterial, may also impair our business operations.

Our future water revenues are uncertain and depend on a number of factors that may make our revenue streams and profitability volatile.

We engage in various water resource acquisition, management, development, and sale and lease activities. Accordingly, our future profitability will primarily be dependent on our ability to develop and sell or lease water and water rights. Our long-term profitability will be affected by various factors, including the timing of water resource acquisitions, regulatory approvals and permits associated with such acquisitions, transportation arrangements, and changing technology. We may also encounter unforeseen technical difficulties which could result in construction delays and cost increases with respect to our water resource and water storage development projects. Moreover, our profitability is significantly affected by changes in the market price of water. Future prices of water may fluctuate widely as demand is affected by climatic, demographic and technological factors. Additionally, to the extent that we possess junior or conditional water rights, during extreme climatic conditions, such as periods of low flow or drought, our water rights could be subordinated to superior water rights holders. Many of the factors described above are not within our control. One or more of these factors could impact the profitability of our water resources and cause our results of operations to be volatile.

Our water activities may become concentrated in a limited number of assets, making our growth and profitability vulnerable to fluctuations in local economies and governmental regulations.

In the future, we anticipate that a significant amount of Vidler’s revenues and asset value will come from a limited number of assets, including our water resources in Nevada and Arizona and the Vidler Arizona Recharge Facility. Water resources in this region are scarce and we may not be successful in continuing to acquire and develop additional water assets. If we are unable to develop additional water assets, our revenues will be derived from a limited number of assets, primarily located in Arizona and Nevada. As a result of this concentration, our invested capital and results of operation will be vulnerable to fluctuations in local economies and governmental regulations.

Vidler’s Arizona Recharge facility is one of the few private sector water storage sites in Arizona. To date, we have stored more than 100,000 acre feet at the facility for our own account. We have not stored any water on behalf of any customers, and have not as yet generated any revenue from the recharge facility. We believe that the best economic return on the asset will come from storing water in surplus years for sale in dry years; however we cannot assure you that we will ultimately be able sell the stored water at a price sufficient to provide an adequate return on the capital we have invested in the facility.

A subsidiary of Vidler’s is constructing a pipeline approximately 35 miles long, to deliver water from Fish Springs Ranch to the northern valleys of Reno, Nevada. Vidler estimates that the total cost of the pipeline will be in the $78 million to $83 million range, and completion is estimated to be late 2007 or early 2008. To date, Vidler has only entered into sale agreements for a very small proportion of the total amount of water that will be conveyed through the pipeline to the northern valleys of Reno. By the time construction of the pipeline has been completed, we anticipate that negotiations will have begun with the principal buyers of this water, who will largely be real estate developers. Although the current market value of water in the area greatly exceeds the total estimated cost of the pipeline and the water to be supplied, we cannot assure you that the sales prices we obtain will provide an adequate return on capital employed in the project. Furthermore, if our negotiations do not result in prices that are acceptable to us, we may choose to monetize the water at a later time, which would have an adverse effect on our near-term revenues and cash flows.

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Our water sales may meet with political opposition in certain locations, thereby limiting our growth in these areas.

The water rights we hold and the transferability of these rights to other uses and places of use are governed by the laws concerning the laws concerning water rights in the states of Arizona, California, and Nevada. Our sale of water resources is subject to the risks of delay associated with receiving all necessary regulatory approvals and permits. Additionally, the transfer of water rights from one use to another may affect the economic base of a community and will, in some instances, be met with local opposition. Moreover, certain of the end users of our water rights, namely municipalities, regulate the use of water in order to manage growth, thereby creating additional requirements that we must satisfy to sell and convey water resources. If we are unable to effectively sell and convey water rights, our liquidity will suffer and our revenues would decline.

The fair values of our real estate and water assets are linked to external growth factors.

The real estate and water assets we hold have fair values that are significantly affected by the growth in population and the general state of the local economies where our real estate and water assets are located, primarily in the states of Arizona and Nevada.

The current decline in the U.S. housing market, including the housing markets in Arizona and Nevada, may lead to a near-term slowdown in demand for our real estate and water assets, which could cause a decline in our revenues and income. While we do not expect long-term demand for our assets to decline, a slowdown in the housing market may impact the timing of our monetization of our real estate and water assets. Any prolonged delay in the monetization of our assets may have an adverse effect on our business, financial condition, results of operations, and cash flows.

Variances in physical availability of water, along with environmental and legal restrictions and legal impediments, could impact profitability from our water rights.

We value our water assets, in part, based upon the amounts of acre-feet of water we anticipate from water rights applications and permitted rights. The water rights held by us and the transferability of these rights to other uses and places of use are governed by the laws concerning water rights in the states of Arizona, Colorado and Nevada. The volumes of water actually derived from the water rights applications or permitted rights may vary considerably based upon physical availability and may be further limited by applicable legal restrictions. As a result, the amounts of acre-feet anticipated from the water rights applications or permitted rights do not in every case represent a reliable, firm annual yield of water, but in some cases describe the face amount of the water right claims or management’s best estimate of such entitlement. Additionally, we may face legal restrictions on the sale or transfer of some of our water rights, which may affect their commercial value. If we were unable to transfer or sell our water rights, we may lose some or all of our value in our water rights acquisitions.

We may not receive all of the permitted water rights we expect from the water rights applications we have filed in Nevada.

We have filed certain water rights applications in Nevada, primarily as part of the water teaming agreement with Lincoln County. Vidler expends the capital required to enable the filed applications to be converted into permitted water rights. We only expend capital in those areas where our initial investigations lead us to believe that we can obtain a sufficient quantity of water to provide an adequate return on the capital employed in the project. These capital expenditures largely consist of drilling and engineering costs for water production, costs of monitoring wells, and legal and consulting costs for hearings with the State Engineer, and National Environmental Protection Act, or “NEPA”, compliance costs. Until the State Engineer permits the water rights, there can be no assurance that we will be awarded all of the water which we expect based on the results of our drilling and our legal position. Any significant reduction in the quantity of water awarded to us from our expectations could adversely affect our revenues, profitability, and cash flows.

Our sale of water may be subject to environmental regulations which would impact the profitability of such sales.

The quality of the water we lease or sell may be subject to regulation by the United States Environmental Protection Agency acting pursuant to the federal Safe Drinking Water Act. While environmental regulations do not directly affect us, the regulations regarding the quality of water distributed affects our intended customers and may, therefore, depending on the quality of our water, impact the price and terms upon which we may in the future sell our water rights. If we need to reduce the price of our water rights in order to make a sale to our intended customers, our results of operations could suffer.

Purchasers of our real estate and water assets may default on their obligations to us and adversely affect our results of operations and cash flow.

In certain circumstances, we finance sales of real estate and water assets, and we secure such financing through deeds of trust on the property, which are only released once the financing has been fully paid off. Purchasers of our real estate and water assets may default on their financing obligations. Such defaults may have an adverse effect on our business, financial condition, and the results of operations and cash flows.

If we do not successfully locate, select and manage acquisitions and investments, or if our acquisitions or investments otherwise fail or decline in value, our financial condition could suffer.

We invest in businesses that we believe are undervalued or that will benefit from additional capital, restructuring of operations or improved competitiveness through operational efficiencies. If a business in which we invest fails or its fair value declines, we could experience a material adverse effect on our business, financial condition, the results of operations and cash flows. Additionally, we may not be able to find sufficient opportunities to make our business strategy successful. Our failure to successfully locate, select and manage acquisition and investment opportunities could have a material adverse effect on our business, financial condition, the results of operations and cash flows. Such business failures, declines in fair values, and/or failure to successfully locate, select and manage acquisitions or investments could result in an inferior return on shareholders' equity. We could also lose part or all of our capital in these businesses and experience reductions in our net income, cash flows, assets and shareholders' equity.

Failure to successfully manage newly acquired companies could adversely affect our business.

Our management of the operations of acquired businesses requires significant efforts, including the coordination of information technologies, research and development, sales and marketing, operations, and finance. These efforts result in additional expenses and involve significant amounts of our management's time and could distract our management from the day-to-day operations of our business. The diversion of our management's attention from the day-to-day operations, or difficulties encountered in the integration process, could have a material adverse effect on our business, financial condition, and the results of operations and cash flows. If we fail to integrate acquired businesses into our operations successfully, we may be unable to achieve our strategic goals and the value of your investment could suffer.

Our acquisitions may result in dilution to our shareholders and increase liabilities.

We make selective acquisitions of companies that we believe could benefit from our resources of additional capital, business expertise or existing operations. We endeavor to enhance and realize additional value to these acquired companies through our influence and control. Any acquisition could result in the use of a significant portion of our available cash, significant dilution to you, and significant acquisition-related charges. Acquisitions may also result in the assumption of liabilities, including liabilities that are unknown or not fully known to us at the time of the acquisition, which could have a material adverse effect on us.

Our acquisitions and investments may yield low or negative returns for an extended period of time, which could temporarily or permanently depress our return on shareholders' equity, and we may not realize the value of the funds we invest.

We generally make acquisitions and investments that tend to be long term in nature, and for the purpose of realizing additional value by means of appropriate levels of shareholder influence and control. We acquire businesses that we believe to be undervalued or may benefit from additional capital, restructuring of operations or management or improved competitiveness through operational efficiencies with our existing operations. We may not be able to develop acceptable revenue streams and investment returns through the businesses we acquire, and as a result we may lose part or all of our investment in these assets. Additionally, when any of our acquisitions do not achieve acceptable rates of return or we do not realize the value of the funds invested, we may write down the value of such acquisitions or sell the acquired businesses at a loss. Some of our prior acquisitions have lost either part or all of the capital we invested. Unsuccessful acquisitions could have negative impacts on our cash flows, income, assets and shareholders' equity, which may be temporary or permanent. Moreover, the process we employ to enhance value in our acquisitions and investments can consume considerable amounts of time and resources. Consequently, costs incurred as a result of these acquisitions and investments may exceed their revenues and/or increases in their values for an extended period of time. Ultimately, however, we may not be able to develop the potential of these assets that we originally anticipated.

Our ability to achieve an acceptable rate of return on any particular investment is subject to a number of factors which may be beyond our control, including increased competition and loss of market share, quality of management, cyclical or uneven financial results, technological obsolescence, foreign currency risks and regulatory delays.

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We may not be able to sell our investments when it is advantageous to do so and we may have to sell these investments at a discount to fair value.

No active market exists for some of the companies in which we invest. We acquire stakes in private companies that are not as liquid as investments in public companies. Additionally, some of our acquisitions may be in restricted or unregistered stock of U.S. public companies. Moreover, even our investments for which there is an established market are subject to dramatic fluctuations in their market price. These illiquidity factors may affect our ability to divest some of our acquisitions and could affect the value that we receive for the sale of such investments and have a negative impact on our results of operations.

Our acquisitions of and investments in foreign companies subject us to additional market and liquidity risks which could affect the value of our stock.

We have acquired, and may continue to acquire, shares of stock in foreign public companies. Typically, these foreign companies are not registered with the SEC and regulation of these companies is under the jurisdiction of the relevant foreign country. The respective foreign regulatory regime may limit our ability to obtain timely and comprehensive financial information for the foreign companies in which we have invested. In addition, if a foreign company in which we invest were to take actions which could be deleterious to its shareholders, foreign legal systems may make it difficult or time-consuming for us to challenge such actions. These factors may affect our ability to acquire controlling stakes, or to dispose of our foreign investments, or to realize the full fair value of our foreign investments. In addition, investments in foreign countries may give rise to complex cross-border tax issues. We aim to manage our tax affairs efficiently, but given the complexity of dealing with domestic and foreign tax jurisdictions, we may have to pay tax in both the U.S. and in foreign countries, and we may be unable to offset any U.S. tax liabilities with foreign tax credits. If we are unable to manage our foreign tax issues efficiently, our financial condition and the results of operations and cash flows could be adversely affected. In addition, we are subject to foreign exchange risk through our acquisitions of stocks in foreign public companies. We attempt to mitigate this foreign exchange risk by borrowing funds in the same currency to purchase the stocks. Significant fluctuations in the foreign currencies in which we hold investments or consummate transactions, could negatively impact our financial condition and the results of operations and cash flows.

Volatile fluctuations in our insurance reserves could cause our financial condition to be materially misstated.

Although we provide reserves that management believes are adequate, the actual losses could be greater. Our insurance subsidiaries may not have established reserves that are adequate to meet the ultimate cost of losses arising from claims. It has been, and will continue to be, necessary for our insurance subsidiaries to review and make appropriate adjustments to reserves for claims and expenses for settling claims. Inadequate reserves could cause our financial condition to fluctuate from period to period and cause our financial condition to appear to be better than it actually is for periods in which insurance claims reserves are understated. In subsequent periods when we discover the underestimation and pay the additional claims, our cash needs will be greater than expected and our financial results of operations for that period will be worse than they would have been had our reserves been accurately estimated originally.

The inherent uncertainties in estimating loss reserves are greater for some insurance products than for others, and are dependent on various factors including:

- the length of time in reporting claims;
- the diversity of historical losses among claims;
- the amount of historical information available during the estimation process;
- the degree of impact that changing regulations and legal precedents may have on open claims; and
- the consistency of reinsurance programs over time.

Because medical malpractice liability, commercial property and casualty, and workers' compensation claims may not be completely paid off for several years, estimating reserves for these types of claims can be more uncertain than estimating reserves for other types of insurance. As a result, precise reserve estimates cannot be made for several years following the year for which reserves were initially established. During the past several years, the levels of the reserves for our insurance subsidiaries have been very volatile. We have had to significantly increase and decrease these reserves in the past several years. Significant increases in the reserves may be necessary in the future, and the level of reserves for our insurance subsidiaries may be volatile in the future. These increases or volatility may have an adverse effect on our business, financial condition, and the results of operations and cash flows.

If we underestimate the amount of reinsurance we need or if the companies with which we have reinsurance agreements default on their obligations, we may be unable to cover claims made and that would have a material adverse effect on our results of operations.

We have reinsurance agreements on all of our insurance books of business with reinsurance companies. We purchase reinsurance based upon our assessment of the overall direct underwriting risk. It is possible that we may underestimate the amount of reinsurance required to achieve the desired level of net claims risk, and a claim may exceed the combined value of our reserve and the amount of reinsurance available. Additionally, our reinsurers could default on amounts owed to us for their portion of the direct insurance claim. Our insurance subsidiaries, as direct writers of lines of insurance, have ultimate responsibility for the payment of claims, and any defaults by reinsurers may result in our established reserves not being adequate to meet the ultimate cost of losses arising from claims. If claims made exceed the amount of our direct reserves and the available reinsurance, we may be subject to regulatory action or litigation and our results of operation would suffer as a result.

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State regulators could require changes to our capitalization and/or to the operations of our insurance subsidiaries, and/or place them into rehabilitation or liquidation.

Beginning in 1994, Physicians and Citation became subject to the provisions of the Risk-Based Capital for Insurers Model Act which has been adopted by the National Association of Insurance Commissioners for the purpose of helping regulators identify insurers that may be in financial difficulty. The Model Act contains a formula which takes into account asset risk, credit risk, underwriting risk and all other relevant risks. Under this formula, each insurer is required to report to regulators using formulas which measure the quality of its capital and the relationship of its modified capital base to the level of risk assumed in specific aspects of its operations. The formula does not address all of the risks associated with the operations of an insurer. The formula is intended to provide a minimum threshold measure of capital adequacy by an individual insurance company and does not purport to compute a target level of capital. Companies which fall below the threshold will be placed into one of four categories: Company Action Level, where the insurer must submit a plan of corrective action; Regulatory Action Level, where the insurer must submit such a plan of corrective action, the regulator is required to perform such examination or analysis the Superintendent of Insurance considers necessary and the regulator must issue a corrective order; Authorized Control Level, which includes the above actions and may include rehabilitation or liquidation; and Mandatory Control Level, where the regulator must rehabilitate or liquidate the insurer. As of December 31, 2006, all of our insurance subsidiaries' risk-based capital results exceeded the Company Action Level. However, we cannot assure you that insurance subsidiaries' risk-based capital results will exceed the Company Action Level in the future. If the risk-based capital of any of our insurance subsidiaries fails to exceed the Company Action Level, we will be subject to the regulatory action described above and our results of operations could suffer.

If we are required to register as an investment company, we will be subject to a significant regulatory burden and our results of operations will suffer.

At all times we intend to conduct our business so as to avoid being regulated as an investment company under the Investment Company Act of 1940. However, if we were required to register as an investment company, our ability to use debt would be substantially reduced, and we would be subject to significant additional disclosure obligations and restrictions on our operational activities. Because of the additional requirements imposed on an investment company with regard to the distribution of earnings, operational activities and the use of debt, in addition to increased expenditures due to additional reporting responsibilities, our cash available for investments would be reduced. The additional expenses would reduce income. These factors would adversely affect our business, financial condition, and the results of operations and cash flows.

We are directly impacted by international affairs, which directly exposes us to the adverse effects of any foreign economic or governmental instability.

As a result of global investment diversification, our business, financial condition, the results of operations and cash flows may be adversely affected by:

- exposure to fluctuations in exchange rates;
- the imposition of governmental controls;
- the need to comply with a wide variety of foreign and U.S. export laws;
- political and economic instability;
- trade restrictions;
- changes in tariffs and taxes;
- volatile interest rates;
- changes in certain commodity prices;
- exchange controls which may limit our ability to withdraw money;