THE WORKERS' COMPENSATION
RATING AND INSPECTION BUREAU

August 31, 2012

CIRCULAR LETTER NO. 2202

To All Members and Subscribers of the Bureau:

RATE FILING

In follow up to Circular Letter No. 2191, the Commissioner of Insurance has disapproved the WCRIBMA's rate filing to change rates effective September 1, 2012. Therefore, there will be no change in rates and rating values. The Division of Insurance's August 30, 2012 Decision and Order on the WCRIBMA's Rate Filing is attached for your information.

Experience ratings and ARAP factors that have been issued effective on September 1, 2012 and subsequent will be revised to remove the preliminary status.

As is customary, the WCRIBMA will issue a circular letter when its next rate filing is submitted.

Paul F. Meagher, Esq.
President

Attachment

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Rate Filing of the Worker's Compensation Rating and Inspection Bureau
Docket No. R2012-01

Decision and Order

I. Introduction and Procedural History

On March 2, 2012, the Worker's Compensation Rating and Inspection Bureau of Massachusetts ("WCRIB"), on behalf of its members, submitted a filing for worker's compensation rates to be effective September 1, 2012 (the "Filing"). The Commissioner of Insurance ("Commissioner") designated Jean F. Farrington, Esq. and Stephen M. Sumner, Esq. to serve as presiding officers on this matter. A notice of hearing, issued on March 7, 2012, scheduled a public comment hearing and a prehearing conference for March 30, 2012. On March 20, 2012, the Attorney General ("AG") filed a notice of intent to participate. Counsel representing the parties throughout this proceeding are: for the WCRIB, Scott Lewis, Esq.; for the State Rating Bureau ("SRB"), Thomas McCall, Esq.; Matthew Mancini, Esq. and Mary Lou Moran, Esq.; and for the AG, Peter Leight, Esq., Alex Klibaner, Esq., Monica Brookman, Esq. and Glenn Kaplan, Esq.

Speakers at the public comment hearing included a representative of each party and individuals appearing on behalf of the Massachusetts Association of Insurance Agents, the Building Trades Employers' Association and its affiliated trade groups, the Associated General Contractors of Massachusetts, the Massachusetts Chamber of Commerce, the Greater Boston Chamber of Commerce, Risk Metrics Corporation, Liberty Mutual Insurance Company, Associated Industries of Massachusetts and the Charter Group of Insurance Companies. At the conclusion of the public comment hearing, the parties participated in a scheduling conference. Cross-examination of the WCRIB's witnesses took place on May 14 and 15, 2012. The SRB and the AG submitted advisory filings setting out their responses to the Filing on May 31, 2012, and their witnesses were cross-examined on June 25 and 28, 2012. The WCRIB made a rebuttal filing on July 9, 2012; cross-examination of its witnesses on their rebuttal testimony took place on July 18, 2012. The SRB and the AG submitted surrebuttal filings on July 23, 2012 and their witnesses were cross-examined on July 27, 2012. Briefs setting forth the parties' respective positions were submitted on August 8, 2012.

II. Statutory Framework

Massachusetts General Laws, Chapter 152, §53A ("§53A") sets out the statutory requirements for obtaining approval of rates for Massachusetts workers' compensation insurance. Under §53A, subsection (1), any insurance company writing workers' compensation insurance in the Commonwealth must file its risk classifications and premiums with the Commissioner, either directly or through a rating organization authorized to act for it. The Commissioner thereafter conducts a hearing to determine whether the classifications and rates are not excessive, inadequate or unfairly discriminatory for the risks to which they effectively apply, and fall within a range of reasonableness. If he finds that they do not satisfy these criteria, he may disapprove them. In addition to these general requirements, §53A (12) specifically states that the Commissioner shall not approve classifications or rates that provide for any of the following: 1) dividends, unabsorbed premium deposits, savings or other payments allowed or returned by the insurer to policyholders, members, subscribers or stockholders; 2) expenses that exceed the filing insurer's expense needs; or 3) commission allowances that are not demonstrated to be reasonable and to reflect the actual cost to agents or brokers of services they provide.

The Commissioner, pursuant to §53A (13), must also make a finding, on the basis of information in the rate filing, that insurers employ acceptable cost control programs and techniques which have had or are expected to have a substantial impact on fraudulent claim costs, unnecessary health care costs, any other unreasonable costs and expenses, and on the collection of appropriate premium charges owed to the insurer. If the Commissioner finds that the rates are excessive, and that the excess is the result of failure to employ adequate cost control programs, he may disapprove or limit any proposed increase in rates. Furthermore, if the Commissioner finds, after hearing, that any premiums currently in effect are excessive, he is to order a specific rate decrease, whether or not the insurer or rating organization has requested one.

Neither the statute nor the applicable procedural regulation, 211 CMR 110.00 *et seq.*, prescribes a particular methodology for developing rates or specifies the data that the insurer or rating bureau must include in its filing. However, §53A (3) requires that the filer provide the information that supports the filing, which may include information on the experience or judgment of the filer, the experience of other insurers, and any other factors which the insurer deems relevant. The burden is on the filer to satisfy the decisionmaker that its proposed rates meet the statutory standard. *Workers' Compensation Rating and Inspection Bureau v. Commissioner of Insurance*, 391 Mass. 238, 245 (1984), citing *Liberty Mutual Insurance Co. v. Commissioner of Insurance*, 366 Mass. 38, 42 (1974). *See also Blue Cross and Blue Shield of Massachusetts v. Commissioner of Insurance,* 420 Mass. 707, 709-710 (1995), in which the Court concluded that the Commissioner may disapprove rates if the filer fails to submit sufficient evidence on which he may reasonably conclude that the proposed rates will not be inadequate, excessive or unfairly discriminatory. As the proponent of a new mechanism or methodology, the WCRIB has the burden of proving its reasonableness. *See In re Application of the Workers' Compensation Rating and Inspection Bureau of Massachusetts for Approval of a General Rate Revision to be Effective on or after August 1, 1999*, Docket No. R99-34, at 39-40.

The Supreme Judicial Court has articulated the standard of review to be applied by the Commissioner when reviewing filings by the WCRIB. That standard was summarized in the *Decision on August 1, 1999 Workers' Compensation Insurance Rates,* Division of Insurance Docket No. R99-34, at 6, as follows:

> It is well-settled that the Commissioner or her designee, the Presiding Officer, has the authority to analyze each element of the rate filing and each method set forth in the rate filing *and may reject the proposed rates if any element or method fails to meet the statutory standard. See Workers' Compensation Rating & Inspection Bureau v. Commissioner of Insurance*, 391 Mass. at 264. Accordingly, the Commissioner or Presiding Officer may reject certain "elements of a filing" if they may lead to "rates falling within a range of excess, no matter how small." *Id.* (emphasis added).
>
> The statute does not require the commissioner to approve elements of filings which would lead to rates falling within a range of excess, no matter how small. The Commissioner's decision disapproving rates needs only to be reasonably supported by the evidence that the proposed filing will fail to produce rates which are not excessive, or will result in inadequate or unfairly discriminatory rates. *Id. See also Blue Cross of Massachusetts v. Commissioner of Insurance,* 397 Mass. 117, 119 (1986).

The Supreme Judicial Court in *Workers' Compensation Rating & Inspection Bureau* v. *Commissioner of Ins.*, 391 Mass. 238, 245 (1984), also considered the scope of the Commissioner's review of a filing for workers' compensation rates:

> We have noted, however, that the scope of the commissioner's authority under G. L. c. 152, Section 52, differs from that under some other statutes. *See, e.g.,* G. L. c. 175, Section 113B. The commissioner "may disapprove rates or withdraw his approval only if rates are inadequate, excessive or unfairly discriminatory. He does not have the power to fix rates; 'he may not require that they be at the figures he finds reasonable.'" *Liberty Mut. Ins. Co. v. Commissioner of Ins., supra* at [366 Mass. 35,] 42 [(1974)], quoting *Massachusetts Medical Serv. v. Commissioner of Ins.*, 344 Mass. 335, 339 (1962). He must determine whether the rates are inadequate, excessive or unfairly discriminatory, based upon their falling within a "range of reasonableness." Nevertheless, "[t]he burden of furnishing evidence to enable the Commissioner to establish a range of reasonableness is on the insurers." *Id.* If the insurers fail to submit evidence sufficient to allow the commissioner reasonably to conclude, based on the evidence, that proposed rates will not be "inadequate, excessive or unfairly discriminatory" he may disapprove them.

The *Opinion, Findings and Decision on Workers' Compensation Rates* rendered in October 1982 discussed, at page 2, the appropriate role of alternative proposals advanced by other parties in hearings on WCRIB rates (emphasis added):

> The statutory standards of review, contained in M. G. L. chapter 152, section 52, provide that Workers' Compensation Insurance rates may not be made effective until approved by the Commissioner as not excessive, inadequate or unfairly discriminatory for the risks to which they apply.
>
> A rating organization making a filing must provide sufficient information to enable the Commissioner to make such a decision. The Commissioner serves as a rate reviewer, not as a rate maker. The Commissioner reviews the filing submitted. *He (or she) does not accept or reject other proposals, but rather uses them as an aid in judging the filing.*

The Supreme Judicial Court in *Workers' Compensation Rating & Inspection Bureau v. Commissioner of Insurance*, 391 Mass. 238, 245, n. 5 (1984), endorsed this language as being consistent with the proper principles to be used in WCRIB rate hearings.

III. The Parties' Recommendations

The WCRIB, in its initial filing, sought an overall rate increase of 19.8 percent, a recommendation that was later, as a result of correcting an error in a tax value, reduced to a recommended increase of 18.8 percent. The AG recommended a decrease of 8.5 percent. The

SRB opposes the WCRIB's proposed rates, but makes no alternative overall recommendation. The WCRIB acknowledges that it is seeking a significant increase in average rates, arguing that an increase is necessary, in part, because rates have not increased since 2001. Approval of the Filing will, it asserts, ensure that rates are adequate and encourage a robust competitive market for workers' compensation insurance in Massachusetts. The WCRIB argues that if rates are adequate, insurers are likely to offer downward deviations in a competitive market. However, if rates are inadequate, it suggests that the adverse consequences could be significant, including a less competitive voluntary market and continued growth in the residual market.[1]

The SRB argues that the WCRIB incorrectly views the current state of the workers' compensation insurance market in Massachusetts. It points out that over the latest six policy years, 2005-2010, the average rate deviation in Massachusetts has steadily increased from -2.1 percent in 2001 to -5.8 percent in 2010. That level of deviations, the SRB argues, demonstrates that the current market is neither unrobust nor uncompetitive. The AG concurs with the SRB's conclusions about the relationship between the aggregate increase in deviations and the adequacy of current rate levels, agreeing that the history of voluntary rate reductions is inconsistent with the WCRIB's asserted need for higher rates. She argues, as well, that the WCRIB's proposed rates would greatly increase the cost of doing business in Massachusetts and have a deleterious effect on the overall employment level.

Our task in this proceeding is to determine whether the WCRIB has submitted sufficient evidence from which we may reasonably conclude that the proposed rates will not be inadequate, excessive or unfairly discriminatory. Unlike the last contested proceeding on workers' compensation insurance rates, in 2003, the parties have not stipulated this year to any aspects of the 2012 Filing. We conclude, after reviewing the evidence on specifically contested issues, that the evidence does not support approval of the rate increase requested in the Filing. We also conclude that the record is insufficient to support a rate decrease. Although our Decision does not address every aspect of the Filing, we remind the parties that the omission of any discussion

[1] The WCRIB, in Section I of the filing, asserts that the residual market covers one in every four Massachusetts employers. Robert McCarthy, FCAS, CFA, vice-president and actuary for the WCRIB and a witness in this proceeding, in the course of cross-examination clarified that this value measures policy count, and testified that the pool policy count may have been higher in the years between 2005 and 2011. He further commented that a disproportionate number of small businesses with one or two employees are written in the pool. Despite the inclusion of information on the pool in the Filing Mr. McCarthy testified that it was not a factor in the WCRIB's rate recommendation.

on a particular element of the ratemaking process does not constitute approval of any party's position or permit an inference that the element is approved.

IV. Contested Issues

A. Loss Development

Loss development refers to the process for estimating the ultimate value of workers' compensation claims, once they are paid or settled. Because losses are not always reported immediately and loss values change over time as insurers make payments and adjust reserves, the ultimate value of losses cannot be determined from reported losses alone. Some workers' compensation claims are paid out over long time periods, so that losses may not reach their ultimate value for many years. The assumption underlying loss development is that historical payment and settlement patterns can, if properly adjusted, be used to predict future patterns. . Loss development calculations proceed from a review of loss reports that insurers submit at sequential reporting intervals to determine the changes from one report to the next. In the Filing, the WCRIB calculates two sets of loss development factors ("LDFs"), one for use in Section II, Loss Development and one for use in Section V, Trend. The dispute over loss development arises from the WCRIB's use of two different data sets to derive the Section II and Section V LDFs.

In Section XIII of the Filing, the WCRIB reports its procedures for reviewing the two basic data sets submitted by its members that underlie development of workers' compensation rates: Aggregate Financial Data and Unit Statistical Reports. Insurers transmit both sets to the WCRIB electronically. The data are then subject to edits that are intended to discover errors and to identify apparent anomalies. The WCRIB reports, in Section XIII, that in preparing the Filing it excluded data from several companies for particular purposes; it explains the reasons for the exclusions and assesses their effect on the rate indication.[2] The SRB and the AG question the WCRIB's decision to exclude Aggregate Financial Data from the Liberty Mutual Insurance Company ("Liberty Mutual") and the Chartis Insurance Company ("Chartis") in calculating LDFs in Section II but to include Unit Statistical Report data from those insurers in calculating the LDFs that are used to estimate frequency and severity trends in Section V.

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[2] The WCRIB excluded Aggregate Financial data from the Liberty Mutual Group from the estimation of loss development factors, Aggregate Financial data from the Travelers Group from the estimation of premium development factors, Aggregate Financial data from the Chartis Insurance Group, the Redland Insurance Group, and Praetorian Insurance Company from the estimation of loss development factors and premium development factors, Aggregate Financial data from the Ace Group in the expense section, and all Aggregate Financial data from the Argonaut and Argonaut Great Central Insurance companies for any purpose.

Mr. McCarthy testified that the LDFs in Sections II and V were calculated from different data sets because they are used for two different purposes. Section II LDFs are based on Aggregate Financial Data and are projected out to 252 months (21 years) to estimate ultimate losses. Section V LDFs are based on Unit Statistical Report data that permit separate calculation of frequency and severity trends, are developed only to the fifth report (66 months), and are used to estimate a trend factor. The WCRIB elected to exclude the Liberty Mutual data from Section II because the company had changed its case reserving practices and, compared to the remainder of the industry, its development practices appeared to be an outlier. It eliminated the Chartis data in calculating Section II ultimate losses because the company showed both atypical development practices, compared to the remainder of the industry, and its market share varied significantly over 21 years. Section XIII reports, and the testimony of Claudia Cunniff, FCAS, MAAA, a vice-president of and actuary for the WCRIB, confirmed that all else equal, inclusion of the Liberty Mutual and Chartis data in calculating the Section II LDFs would have produced a higher rate indication.

The SRB does not object to the exclusion of Chartis and Liberty Mutual data from the calculation of Section II LDFs, but takes the position that their data should also be excluded in calculating the Section V LDFs, at least for purposes of calculating the severity trend. The AG argues that the Liberty Mutual and Chartis data should be excluded from the Section V loss development calculations with respect to both severity and frequency. The AG's witness, Allan I Schwartz, FCAS, MAAA, a consulting actuary, stated in the AG's Advisory Filing that any "issues or concerns" that cause distortions or problems with loss development based on Aggregate Financial Data cause the same distortions or problems for loss development based on Unit Statistical Plan policy year data.

The WCRIB argues that reasonable actuarial judgment informed and supports its decision to use the Liberty Mutual and Chartis data to calculate the Section V LDFs. It contends that the two companies are important carriers, that there is a presumption that data from all carriers should be used in ratesetting and that the reasons for excluding the two companies from Section V were "far less compelling" in the context of trend development than they were in Section II. The WCRIB contends that neither the SRB nor the AG asserts that the data are erroneous, and that it exercised its actuarial judgment reasonably. It points out that the Section V development factors look only at data for five policy years, 2004-2008, rather than data for 21 years, concluding that the long-term changes supporting exclusion of the data for Section II purposes do not create comparable distortions in the shorter five-year period. The WCRIB argues that its statistical analysis of the Chartis data showed that the variation in its market share for the period 1990 through 2008 was significantly higher than the variation in its market share from 2004 through 2008; it reaches the same conclusion when the calculation is expanded to include data on the Chartis 2009 market share.

The SRB argues that the WCRIB's inclusion of the Liberty Mutual and Chartis data in the Section V loss development calculation is internally inconsistent, result oriented, leads to inaccurate and distorted loss development factors and creates excessive rates. It contends that the problems with the Liberty Mutual and Chartis data that supported the WCRIB's decision to exclude them from the 252-month Section II loss development calculation apply equally to those insurers' data for the period through the fifth report that are used to calculate the Section V LDFs.

The AG points out that the development triangles in Section V of the Filing include data from Liberty Mutual for some of the same policy years that are included in the Section II calculation. She asserts that they distort development in Section V, as the WCRIB found they did in Section II, and therefore should be excluded. With respect to the Chartis data, she argues that the insurer's loss development factors for the years 2004-2009 are materially different from the remainder of the industry and that its market share, measured by premium, and losses fell during that same period.[3] For that reason, she asserts, the Chartis data should also be excluded from the Section V loss development calculations.

Two of the three principles that the WCRIB asserts support its decision to include Liberty Mutual and Chartis data in the Section V calculation, their status as "important carriers" and a presumption that data from all carriers should be used in ratesetting, are equally relevant to its decision to exclude the two insurers' data in Section II and have no special merit with respect to the Section V LDF calculation. Only the third issue, whether the record supports the WCRIB's argument that the issues that supported exclusion for purposes of Section II do not support the same decision for Section V requires our attention.

The WCRIB uses different data sources to derive overall LDFs in Section II and LDFs at fifth report in Section V. That it does so is an artifact of the reporting process; only Unit

[3] The AG is also troubled by the lack of information on the reasons for differences between the Chartis loss development and that of the industry as a whole.

Statistical Report data permit separate calculation of frequency and severity trends. Both in the Filing and on cross-examination Mr. McCarthy testified that the WCRIB has procedures in place to reconcile premium and loss amounts in the two reports and that he believes the two data sets reconcile. It is therefore reasonable to expect that both data sets might demonstrate similar problems or distortions for the same time periods.

For Liberty Mutual, the question is whether changes in claims handling practices that altered case reserves, the basis for excluding its data from Section II, also produced unusual development factors for the time period considered in Section V. In that case, the WCRIB has the burden to demonstrate that, despite the differences between Liberty Mutual and the rest of the industry, it was reasonable to include the Liberty Mutual experience in calculating the Section V LDFs. Mr. McCarthy testified that "some" of the issues with respect to Liberty Mutual's development factors occurred beyond sixty months of development, but that the insurer's changes spanned a number of policy years. He testified that those changes still have some impact on the Section V calculations, but that the WCRIB did not deem it "material enough" to exclude the Liberty Mutual data from the trend calculation. However, he did not perform a calculation to quantify the effect of the Liberty Mutual data on the Section V trend.

Ms. Cunniff testified that she had oral discussions with Liberty Mutual, late in 2008 or in 2009, in which it affirmed that claims reorganization had affected its loss development patterns, for at least 2005, 2006 and 2007, as well as earlier years. In November 2010 and November 2011 Ms. Cunniff contacted Liberty Mutual by e-mail, in both years stating that the WCRIB had some questions about its loss development patterns. The 2010 e-mail specifically inquired about, among other things, aspects of PYs 2004, 2005, 2006 and 2007, while the 2011 e-mail asked about PY 2007.[4] Ms. Cunniff further stated that she understood that the claims reorganization also could have affected 2008. Subsequent to the Filing, Ms. Cunniff calculated Section V development factors excluding Liberty Mutual data and did a trend analysis using that value. She did not specifically quantify the effect of excluding Liberty Mutual data on the resulting trends, but opined that it did have a material impact on those trends, *i.e.*, one that would affect the overall rate level need.

The WCRIB offers a different rationale for excluding the Chartis data in Section II and including it in Section V. It states that it decided to exclude the Chartis data from Section II

[4] PY refers to Policy Year. The e-mails were entered into evidence as Hearing Exhibits 17 and 18.

based on a combination of atypical loss development patterns and wide variations in its market share over the years 1990-2008. Mr. McCarthy testified that, absent material changes in the Chartis market share, it would have included the Chartis data for the purpose of Section II loss development. In contrast, the WCRIB included the Chartis data in the Section V calculations, arguing that the company's market share was more stable during the five-year time period underlying that calculation. The evidence shows that Chartis data for the years 2004-2008 demonstrated loss development patterns that differ from the remainder of the industry.

Ms. Cunniff testified that she had sought from Chartis an explanation for its development factors and was informed that for the years 2004 through 2008 they principally related to large losses.[5] She testified that the types of business that Chartis writes also contributed to its different development patterns. Ms. Cunniff confirmed that the Chartis data used in the Section V LDF calculation included data from a time when the company's market share was changing. As with Liberty Mutual, Ms. Cunniff testified that she had performed a trend analysis omitting the Chartis data and concluded that it had a material effect on the loss trends.

No party disputes that the Chartis loss development data demonstrate a development pattern that differs from the rest of the industry.[6] The WCRIB does not explain why it concluded that those differences in loss development, taken alone, were insufficient to support its decisions to exclude the Chartis data in Section II and to include it in Section V. Instead, it contends, the unusual loss development pattern is significant because it is linked to historical changes in the Chartis market share. The WCRIB asserts that because the Chartis market share was less volatile for policy years 2004 through 2008 than for the period 1990-2008, it is therefore appropriate to use Chartis data in the Section V calculations. Chartis's market share for the years 2004-2008 ranged from 20.8 percent to 26.2 percent.[7] The relative volatility of its market share compared to earlier time periods does not address the simpler question of whether the disparity between the Chartis development patterns for 2004-2008 and the remainder of the industry is such that inclusion of its data for the Section V calculation distorts the LDFs that are used to estimate

[5] Hearing Exhibit 19 documents the Chartis explanations.
[6] The WCRIB, in its rebuttal filing, characterizes the Chartis loss development patterns as "so different from the balance of the industry." Mr. Schwartz agrees that the Chartis development factors differ from the remainder of the industry, and Ms. Mays, the SRB's witness, , testified that the Chartis paid plus case losses demonstrate a different development pattern from the rest of the industry.
[7] Exhibit 26, p. 28.

trend in the Filing. During the relevant period, Chartis wrote at least 20 percent of the market. The WCRIB does not explain why, given the size of the Chartis market share, a significant difference between its loss development patterns and the remainder of the industry would not affect the calculation of industrywide LDFs during those years. Its focus on the Chartis market share rather than disparities between its loss development patterns and those of the rest of the industry during the years 2004 and 2008 is misplaced.[8]

On this record, we are not persuaded that it was reasonable to include the Liberty Mutual and Chartis data in the Section V loss development calculations. The evidence supports a conclusion that the issues relating to Liberty Mutual's claims and reserving practices affected its loss development during the 2004-2008 time period. The Chartis development factors, similarly, differed from the remainder of the industry throughout that period.[9] Although the WCRIB characterizes its choice as a matter of actuarial judgment, its failure to determine the effect of including the Liberty Mutual and Chartis data in the Section V calculations, an exercise it did perform in connection with the Section II calculations, suggests that it exercised that judgment without understanding its effect on the outcome. The WCRIB concedes that, when it did perform a parallel calculation for purposes of Section V, the inclusion of the Liberty Mutual and Chartis data had a material effect on its trend factors in Section V. The evidence does not support the reasonability of the WCRIB's decision to exclude the Liberty Mutual and Chartis data as outliers in Section II but to include it in Section V. We disapprove the Filing because the inclusion of the data in Section V improperly affected the trend estimate.

B. Premium development

Insurers audit workers' compensation policies after the end of the policy year to determine whether the data, including business classification and estimated payroll, underlying the initial premium charge were accurate. As a result of an audit, a policyholder's premium may be adjusted upward or downward. Typically, as the WCRIB observes in its Filing, "industry-wide policy year earned standard and ARAP premium historically develops upward until such

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[8] Market share may be relevant, to the extent that loss development data from a company with a very small market share may have no material effect on calculating industrywide factors. However, as Ms. Mays testified, the issue is more than whether the Chartis market share has changed materially. (TR VI, 14).

[9] The WCRIB states in its rebuttal filing that it had questioned Chartis about its "large loss activity" and commented on the difficulty of estimating case reserves for large claims. It claims that the frequency and size of such losses do not warrant exclusion of its data, but provides no further analysis to support inclusion of the Chartis data in Section V. A more precise inquiry is how, with respect to such losses, the Chartis development patterns differ from the rest of the industry.

time as all audits have been finalized and no further premium modifications can be made." Therefore insurers generally expect to receive additional premium income on policies after the policy term has expired. As with loss development, premium development is derived from information reported by insurers. In Filing Section III, the WCRIB calculates a premium development factor that reflects anticipated changes in insurers' premium income; it develops that factor by averaging the latest two years of age-to-age development factors for a five-year period from zero to 60 months. The result of this methodology is a premium development factor of less than 1.00.

The SRB argues that the WCRIB's two-year averaging methodology will produce excessive rates and proposes two changes to that methodology that its witness, DeeDee Mays, FCAS, MAAA, a consulting actuary, testified would more accurately calculate premium development. The SRB proposes to substitute a five-year average for the WCRIB's two-year average and to extend the period for reviewing premium development from five years to 21 years. These changes, Ms. Mays testified, would reduce the WCRIB's rate request by 0.6%.

1. Methodology for calculating the premium development factor

The rationale for the SRB's first recommendation is an unusual premium development pattern for PY 2008. For that year, the WCRIB calculates a premium development factor of 0.991, reflecting negative development between 24 and 36 months. Averaging that value with a 2009 premium development value of 1.003 reduces the cumulative premium development factor that the WCRIB incorporates into its rate proposal to 0.997, less than 1.000. Ms. Mays characterized the downward development of premium from 24 to 36 months reported for the policy year 2008 as "significant," noting that a negative development factor of nine-tenths of one percent (0.991) is less than historical development, which is usually a positive value above one percent. Because of that unusual pattern, the SRB contends that using a five-year average is more appropriate than the WCRIB's two-year methodology.

Mr. McCarthy described the 2008 difference as a "blip," commenting that as a consequence of a deep recession, some negative premium development may reflect return of premium. Ms. Cunniff similarly opined that the negative development resulted from audits in which the audited payrolls were less than the estimated payrolls. However, the WCRIB did not contend that the circumstances underlying that unusual value were likely to be repeated nor did it adjust its methodology to reflect the unusual value.

The WCRIB points out that the two-year averaging methodology has been in place since the *Decision on 2003 Workers' Compensation Rates,* DOI Docket No. R2003-08 (the *"2003 Decision"*) and has been used in each subsequent rate filing. It argues that the consistent use of a two-year average will produce unbiased and reliable estimates. The *2003 Decision*, however, addressed *loss* development, rather than *premium* development, and determined, on the record of that proceeding, that the two-year averaging methodology would produce reasonable rates. The issue under consideration in this proceeding is whether, for the purpose of estimating future premium development, use of the two-year averaging methodology will produce reasonable rates when one of the two most recent data points concededly represents a departure from a consistent historical pattern.[10] Understated anticipated premium development will increase proposed rates.

The goal of any ratemaking methodology is to produce a result that reasonably reflects what is expected to occur. To that end, the chosen approach to premium development should be responsive to any unusual circumstances in the historical record.[11] Nothing in the record suggests that conditions that produced the unusual premium development for PY 2008 have persisted and that further departures from the historical premium development pattern are likely to occur.

Absent support in the record for the likelihood of post-2008 negative premium development, we find that, for purposes of estimating premium development in this Filing, a two-year averaging methodology gives undue weight to an unusual negative data point. For that reason, the result is likely to understate ultimate premiums and to produce excessive rates. We voice no opinion on the merits of the SRB's proposed five-year averaging methodology as opposed to other alternative averaging methodologies or to options such as relying on the single most recent data point. However, the methodology for calculating an ultimate premium development factor should reflect what insurers realistically expect will occur during the period when proposed rate are in effect and avoid giving undue weight to uncharacteristic results. We find that the methodology employed in the Filing produces a result that is inconsistent with historical experience and will lead to excessive rates.

2. Estimate of Premium Development from 60 months to ultimate

[10] The SRB's Advisory Filing, Ex. 26, 18, presents historical data on industrywide premium development factors. For the 24-36 month period, since 1995, all but two factors (1999 and 2008) have been positive.

[11] *See, e.g.,* the discussion of loss development factors in the *Decision on 2001 Automobile Insurance Rates*, DOI Docket Nos. 2000-10, 11, 12, 16-19. In that case, different methodologies were approved for estimating LDFs for different coverages provided under the automobile policy.

The WCRIB assumed this year that premium will not develop beyond 60 months (5 years) from the beginning of a policy year. Its approach departs from that taken in the contested 2003 rate proceeding. In its filing that year, the WCRIB calculated its premium development factor from 192 months of premium data. This year the SRB's witness, Ms. Mays, examined the longer range of premium development data, concluded that premium development from 60 months to ultimate is not insignificant and therefore opined that it should be included in estimating ultimate premium development.

The WCRIB argues that its decision to calculate its premium development factor only on five years of data is supported by the rules in the WCRIB Workers' Compensation Insurance Manual relating to the limitation of policy audits and by the results of an investigation of premium development that the WCRIB undertook in 2004. It does not contend that insurers never report premium development after five years but that it has found such reports to be inaccurate. In 2004 the WCRIB investigated data from insurers reporting premium development beyond sixty months and determined that in each case the data reports "created the appearance of premium development," but gave no reason to believe that material development had actually occurred after 60 months.

The WCRIB therefore concluded that it no longer was necessary to develop premiums to 21 years. Based on the audit rules and its prior analysis, the WCRIB did not expect any material premium development beyond 60 months and therefore, for purposes of this Filing, did not review premium development factors beyond that point. In response to Ms. Mays's observations on premium development in the SRB advisory filing, the WCRIB initiated discussions with four insurers that had reported premium development beyond 60 months and again determined that data reporting anomalies created the appearance of development, but that no true premium development had occurred.

The parties do not disagree that premium development beyond 60 months is limited or that, on this record, the WCRIB's estimated premium development factor requires no adjustment to reflect development beyond 60 months. That record also indicates that companies do, nevertheless, report data from later years that, on its face, might have a material effect on premium development. The WCRIB's assumption that such data will never show any real development rests on a shaky foundation. It is unreasonable to conclude that, because the controversy over the use of 21 years of premium development data arose this year as a result of misreported data from four carriers, misreporting will always be the operative cause of data showing premium development after 60 months. Furthermore, misreported data raises a broader question about issues of reporting quality and the adequacy and effectiveness of the WCRIB's procedures for reviewing data.[12] It is incumbent on the WCRIB to take all reasonable measures to ensure that the data underlying its filings are complete and accurate.

C. Claim Frequency Trend

As part of its claim frequency trend calculation, the WCRIB derives historical claim frequencies that are the ratio of reported claim counts, adjusted to the current mix of Massachusetts payrolls, divided by estimated worker weeks. To estimate worker weeks, it divides total covered payroll for a particular time period by the state average weekly wage ("SAWW") corresponding to the same time period. Because the SAWW is calculated annually by the Massachusetts Division of Unemployment Assistance ("DUA") for a twelve month period that does not correspond to the policy year data underlying the Filing, the WCRIB develops the SAWW for each policy year by weighting the values in place during that period. To estimate worker weeks, it then "smooths" the SAWW by averaging the value for the applicable policy year with the values for the two preceding policy years.

Both the SRB and the AG object to the WCRIB's use of smoothing to adjust the SAWW. The AG argues that it is inconsistent with the WCRIB's statement that its methodology divides payroll for a particular period with the corresponding SAWW for that period. She further observes that because the SAWW rises from year to year, a smoothing process that averages current data with lower values from prior years produces a value that is less than the actual SAWW in place during the policy year. The AG comments that the rationale for utilizing a smoothing methodology is unclear, noting that the Filing does not support or justify the procedure.[13] The SRB concurs with the AG's position. The WCRIB argues that testimony from the AG's witness that the smoothing technique produced a mismatch of the policy year payroll data and the policy year SAWW did not support the AG's objections to use of the technique

[12] The Filing, Section I, at page 3, notes that over the past several years the WCRIB has intensified its efforts to ensure that the data it collects from its members are sufficiently reliable for use in ratemaking. It states that it continues to improve its editing techniques, and further comments that "[m]any WCRIB members have responded to the increased scrutiny of their reported data by improving their understanding or and compliance with the Massachusetts Workers' Compensation Statistical Plan." It appears that further improvement is still possible.

[13] She further comments that smoothing, as performed by the WCRIB, mathematically smooths only the second of the three averaged values, and that the use of that value still produces a mismatch between the policy year payroll data and the policy year SAWW. The WCRIB argues that the selection of values for smoothing is a matter of actuarial judgment.

because it did not take into consideration the DUA's method for calculating the SAWW. Its argument is not persuasive. As stated in Filing Section V, at 17, the WCRIB is aware that the SAWW is not compiled for workers' compensation purposes, "and is not defined in exactly the same way as payroll is used in workers' compensation calculations," but has determined that "the overall movement over time in this series is reasonably representative of the overall movement to be expected in the average wages used to calculate workers' compensation premiums."

At issue in this proceeding is the smoothing methodology, not the SAWW data itself. Dividing payroll for a particular policy year by a lower "smoothed" value rather than the actual value for that year will result in overstated worker weeks, produce inaccurate values for historical claim frequencies, and ultimately impact the frequency trend.[14] We therefore disapprove its use.

D. Underwriting Profits

1. The Use of an IRR Model

In the *2003 Decision*, the Commissioner approved the use of an Internal Rate of Return ("IRR") model to calculate the underwriting profit provision in the rates. She also found that rates proposed by the WCRIB that year, which incorporated an underwriting profit provision utilizing an IRR model developed by Milliman, Inc., would not fall within a range of reasonableness. In rate filings since 2003, the WCRIB has continued to use an IRR model that it has developed for its own use with the assistance of David Appel, Ph.D., Director of Economic Consulting for Milliman, Inc., and a witness for the WCRIB in this proceeding. Because the proceedings on those filings have been settled, this is the first occasion to review the particular provisions of the WCRIB's current IRR model.

The AG urges the Commissioner to require the WCRIB to use a Calendar Year Accounting Model ("CYAM") to develop the underwriting profit provision. The SRB does not oppose the use, in principle, of an IRR to estimate profits, but challenges aspects of the model and the model inputs proffered by the WCRIB. The goal of this proceeding is to review the WCRIB's Filing, including its underwriting profit model, and to determine whether the proposed rates satisfy the statutory standards. Whatever the merits of CYAMs, we are not persuaded that the Filing should be disapproved because the WCRIB, as it has since 2003, developed its profit

[14] The WCRIB did not perform an analogous smoothing technique to historical payroll values.

provision using an IRR model. Consistent with our *2003 Decision*, we will again approve the use of an IRR model to derive the underwriting profit provision. That approval, however, does not represent wholesale approval of the WCRIB's model as structured and implemented, of the WCRIB's inputs to it, or of the rates incorporating its results. As we observed in the *2003 Decision*, at 41, disputes in rate proceedings "often focus as much on the structure of the model and the values to be inserted into a particular model as on the model itself." To that end, our decision addresses disputed aspects of the WCRIB's IRR model.

2. *The Cost of Capital*

As stated in the *2003 Decision,* at 42, an underwriting profits provision developed through an IRR is based on the premise that insurers should receive a fair rate of return for investing in the insurance transaction. One expense associated with that transaction is the cost of capital committed to the insurance business; another aspect is investment income that insurers receive. Implementation of an IRR is a multistep process that first estimates a fair and reasonable rate of return, or cost of capital, to insurers and then establishes a profit provision that will produce that fair return. The SRB identifies a series of differences between the WCRIB's 2003 IRR methodology and that in the Filing.

That the IRR model presented by the WCRIB this year differs from that in its 2003 filing is not surprising. The *2003 Decision* did not approve that year's filing, specifically finding that rates incorporating an underwriting profits provision developed from that model would not fall within a range of reasonableness. Among the disputed aspects of the model were the cost of capital, including inputs chosen for analyses based on the Capital Asset Pricing Model ("CAPM") and the Discounted Cash Flow ("DCF") model and weighting the cost of capital to reflect debt structure. The Commissioner concluded that the IRR model was "appropriately viewed as a work in progress" and anticipated that proposals to refine its application would be included in future proceedings on workers' compensation rates.[15]

Disputes over inputs to the CAPM and DCF models and other matters relevant to calculating a cost of capital are not unique to proceedings on workers' compensation insurance. Although the Commissioner in her *Decision on 2004 Private Passenger Automobile Insurance Rates* approved the use of an IRR to model the underwriting profits component of private passenger automobile insurance rates, decisions in subsequent proceedings on automobile

[15] *2003 Decision,* at 70.

insurance rates that used an IRR model for the underwriting profits provision demonstrate that the parties to those proceedings achieved no consensus on standard inputs to models used to calculate the cost of capital.

Issues relating to calculation of the cost of capital that arise with each filing that utilizes an IRR model, at least in part, relate to current and projected conditions in the financial markets, which differ from year to year. For that reason, a detailed analysis of the cost of capital calculations in this proceeding is likely to be of limited value in future proceedings, and we have elected not to increase the length of this decision by performing that analysis. Our decision does not imply approval of the approach to calculating the cost of capital taken by any party to this proceeding. We do address two aspects of the IRR model, as implemented by the WCRIB, that relate to methodological choices that are not dependent on the current environment.

a. Data selection

The development of the cost of capital relies on an analysis of market data for publicly traded insurance companies. In 2003, the WCRIB examined data from a sample group of 26 companies as reported in the Value Line Investment Survey of Property and Casualty Insurance Groups. This year, the WCRIB uses a different Value Line data set, the Investment Survey, Small and MidCap Edition as well as data from Compustat, a Standard & Poors database. It asserts that Compustat includes data from smaller companies that are not included in the Value Line data and are more representative of the mix of carriers in the Massachusetts workers' compensation market. The WCRIB reports that its "sample" now includes data on all publicly traded property casualty insurers, a total of 98 companies, asserting that the broader range of data produces more reliable estimates of the cost of capital. The SRB continues to use a limited data set, consisting of 22 companies, to develop a recommended cost of capital.

The development of the cost of capital from what is reported to be the full panoply of publicly traded property and casualty insurance companies represents a departure from the methodology used in other rate proceedings that employ an IRR model.[16] While the sample size has varied, it has always been a representative group of companies, rather than the entire industry. The WCRIB's conclusory statement about its selection this year does not constitute a persuasive argument that this shift in methodology produces more accurate estimates of the cost

[16] In the proceeding on 2005 Private Passenger Insurance Rates, the SRB used a sample of 29 companies; the Automobile Insurers Bureau a smaller number. In the proceeding on 2006 Private Passenger Insurance Rates, the sample consisted of 30 companies reported by Value Line.

of capital in an IRR model used to develop workers' compensation rates. Absent evidence that it does so, we are unable to approve its use.

b. Weighting the cost of capital to reflect debt structure

The SRB points out that the WCRIB in this proceeding has used market value capital, rather than book value capital, as a measure of the equity and debt financing in the capital structure of insurance companies. It argues that this method is inappropriate because book value reflects the dollars of capital that are available for investment. The Commissioner has previously approved the use of book value to calculate the debt/equity ratio in an IRR model.[17] The WCRIB has not offered any persuasive argument to revise the conclusion that book value is the appropriate measure of that ratio, and we disapprove the methodology that it uses in the Filing.[18]

3. Asset Returns

As the underlying source for estimating insurer return on invested assets, the parties utilize the data on investment portfolios reported in the 2011 *Best's Aggregates and Averages* ("*Best's*") for the consolidated property and casualty industry. The WCRIB argues that the proper investment yield for use in the IRR model is solely what insurers can earn on new money that becomes available from the sale of policies during the period when the proposed rates are in effect. It considers that insurers' actual earnings on invested assets are irrelevant; Dr. Appel testified that the historical investment earnings also are irrelevant to the question of future earnings. The WCRIB further argues that returns on investments that insurers make with funds that, according to the WCRIB, are not "directly related" to the insurance transaction should be excluded from the calculation of asset returns for purposes of ratemaking.

The AG and the SRB argue that the WCRIB's position is inconsistent with the reality of the insurance industry and underestimates the asset returns that insurers may reasonably expect to earn in the rate period. Three issues are particularly contested: the yields that insurers reasonably may expect to receive on bonds, the asset category constituting approximately 75 percent of their investment portfolios, the return they may expect to receive on "other assets," and the exclusion from the asset return calculation of returns on investments that the WCRIB views as unrelated to the insurance transaction.

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17 *Decision on 2006 Private Passenger Automobile Insurance Rates*, at 33.

18 We note as well that the *2003 Decision* approved the application of the debt/equity ratio to both short- and long-term debt, a departure from decisions on private passenger automobile insurance rates that derived the ratio from long-term debt only. The *2003 Decision* commented that although there was agreement on the formula that year, it was subject to reassessment in the future. The parties may wish to address the issue in future proceedings.

a. Bond yields

The Filing looks at current bond yields and assumes that they are an appropriate measure of the rate of return that insurers expect to earn on that type of security during the years in which claims will be paid on policies sold during the rate period. David Parcell, M.A., MBA, a consulting economist and witness for the SRB, testified that the result of that approach is that the WCRIB's estimated overall investment return, less than two percent, is far less than the minimum historical return, four percent, that insurers have received in the past few years.[19]

Mr. McCarthy testified that the expected bond returns in the Filing assume that companies will receive premium and on that day go into the market to purchase a bond at the current rate. He agrees, however, that the assumption in the Filing is incorrect for a company that is a going concern.[20] The SRB notes that insurers receive interest on bonds at the rate in place on the date of purchase, not on what they would receive if the bond were purchased today. The methodology that the WCRIB advocates has been proposed previously in proceedings addressing the rates for private passenger automobile insurance, and has been soundly rejected each time.

In the *Decision on 2004 Private Passenger Automobile Insurance Rates*, DOI Docket Nos. R2003-13, 14, 15 and 17, at 51, the Commissioner stated that: "A provision for asset returns in an IRR model should estimate what insurers will realistically expect to earn on investments that they hold, not what they would receive if they purchased those investments now. A profits model that is based only on current asset yields, without regard for the returns that insurers receive on assets that have been held for some time, will understate profitability."[21] The WCRIB has offered no argument that persuades us to alter that long-standing position. That current bond yields are lower now than they have been in the past is uncontested. The WCRIB's methodology for calculating bond yields, however, underestimates the returns that insurers receive on bonds with longer maturities that they purchased in the past.[22] Understating asset

[19] The historical values are reported in Best's and by the Value Line Investment Survey.

[20] The AG points out that there is no evidence that any start-up companies will be writing workers' compensation insurance in Massachusetts during the policy year.

[21] She reached the same conclusion in the *Decision on 2005 Private Passenger Insurance Rates*, Docket Nos. R2004-11, 12 and 13, at pp. 105-111.

[22] The AG questions the logic of the WCRIB's position that investment returns should be calculated on the basis of investments of "new" money that will be received (for example, premiums) on the ground that insurers, who presumably seek to maximize investment returns, would use assets that currently receive a relatively high yield to pay older claims rather than use current receipts that would, if invested, produce little income. We agree that it is

returns in the rate period will produce excessive rates. The WCRIB's methodology therefore is rejected.[23]

b. *The return on "other assets"*

The second issue is the appropriate asset return on "other assets" that, as shown in the Filing, constitute 7.63 percent of property and casualty insurance company invested assets.[24] The WCRIB does not separately estimate the yield on those assets, but applies a weighted average of the rate of return on other types of assets, chiefly bonds, that insurers hold. The SRB points out that in its 2003 filing the WCRIB estimated that the return on "other assets" would equal that on common stocks. The WCRIB argues that the 2003 Decision did not specifically address the issue of an appropriate return on "other assets". As support for its choice, it notes that Mr. Parcell, in other states, has taken the approach that the WCRIB uses this year.[25] The WCRIB contends that it is reasonable to estimate the yield on "other assets" as the average of that on other investments, absent information that they produce higher returns.

Mr. Parcell testified that in Massachusetts rate proceedings, both in the 2003 workers' compensation proceeding and in proceedings on private passenger automobile insurance rates, asset returns have preserved "other assets" as a separate class of investments and assigned a rate of return to that class. The burden is on the WCRIB to demonstrate that its revised methodology eliminating "other assets" as a separate class is superior to past practice in Massachusetts. We are not persuaded that use by the SRB's witness of a different methodology in Virginia satisfies that burden. In the event, the significant issue is the selection of a rate of return on "other assets" for purposes of calculating the overall asset return rate that reasonably reflects expected values.[26]

In its 2003 filing, the WCRIB assigned the same return rate to common stock and to "other assets." Its choice this year effectively is a determination that the characteristics of "other assets" are more akin to fixed return investments than to common stocks. The SRB argues that the WCRIB's assumption does not accurately reflect the significant returns that insurance

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highly unlikely that insurers would manage funds in a manner that would fail to preserve the continuity of income on relatively high-yield assets.

[23] The WCRIB objects to the SRB's method of determining yields on bonds with long maturities. Because we are disapproving the Filing, we express no opinion on the merits of Mr. Parcell's approach. We note that disputes over estimating bond maturities in insurers' portfolios has been the subject of extended debate; *see , e.g., Decision on 2005 Private Passenger Automobile Insurance Rates*, at 105-107.

[24] The value, reported in the Filing, Section VII, p. 80 is that reported in the 2011 Best's Averages and Aggregates.

[25] In particular, the WCRIB refers to rate proceedings in Virginia.

[26] The WCRIB would have achieved the same result by retaining the "other asset" category and then assigning to that category its estimated rate of return.

companies, as sophisticated investors, expect when they invest in "other assets." The record supports a conclusion that for insurers writing workers' compensation insurance in Massachusetts the "other assets" category consists, in large measure, of investments in hedge funds and private equity funds.[27] The SRB questions the credibility of the WCRIB's position that insurers that invest in hedge funds and private equity funds do not expect to receive a return higher than that on their bond holdings.

Although the WCRIB contends that it is reasonable to attribute an average bond yield to "other assets," absent information that they produce higher returns, the record is not devoid of evidence that "other assets" do produce such higher returns. Insurers report their actual "other investments" on Schedule BA of their annual statements. While *Best's* does not aggregate and display information from Schedule BA in its consolidated financial statements relating to the insurance industry, the National Association of Insurance Commissioners, Center for Insurance Policy and Research, published a Capital Markets Special Report in 2011 that analyzed information on Schedules BA as of December 31, 2010.[28] Its analysis showed an average investment income from such assets, over the years 2005-2010, of 6.8 percent. Schedule BA also asks insurers to categorize private equity and hedge fund investments by their underlying characteristics, *i.e.,* whether they are more like equities, bonds, real estate, or "other." The responses demonstrate that 73 percent of those investments were characterized as "equity-like" and only 7 percent as "bond-like." It is therefore reasonable to treat them consonant with common stock, rather than fixed return investments.

The total return on invested assets reflects, in addition to income, realized and unrealized capital gain. The WCRIB's methodology effectively omits from its overall asset returns any analysis of changes in the capital value of "other assets."[29] On this record, we are persuaded that the WCRIB's treatment of the return on "other assets" in the Filing underestimates the return that insurance companies can be expected to receive on those assets and therefore overstates the proposed underwriting profit provision. We therefore disapprove the use of that methodology.

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[27] Exhibit 44 consists of Schedule BA as submitted by twelve such insurers.

[28] The report was included in Exhibit 46, at pages 12-20; because of legibility problems a readable copy was substituted and marked as Exhibit 50.

[29] Exhibit 43, the Instructions for preparing Schedule BA, indicates that insurers are to report year to year changes in value.

b. The Estimated Value of Invested Assets.

The AG points out that the WCRIB's IRR model, in estimating asset returns, excludes a substantial amount of the assets that insurers actually invest. She observes that the Insurance Expense Exhibit to the Statutory Annual Statement requires insurers to report income on all invested assets, but then prescribes formulas for allocating the investments gains between those "attributable to insurance transactions" and those "attributable to capital and surplus." The WCRIB contends that ratemaking should only reflect investment income that is "directly related" to the insurance transaction and is attributable to funds provided by policyholders in connection with the insurance transaction. It contends that policyholders, for purposes of ratemaking, should not be credited with income from other funds that insurers hold.

As examples, the WCRIB notes that insurers, in connection with the purchase of reinsurance, may hold balances that may ultimately be payable to the reinsurer, and may hold billions of dollars in accounts payable which they would realistically invest during the holding period. Dr Appel also stated that insurers hold nearly $10 billion in "amounts withheld or retained by company for the accounts of others" and another $10 billion of borrowed money, conceding that these amounts would add to insurers investible funds but arguing that, because they are not derived from policyholders, for ratemaking purposes the income from those funds should not be credited to policyholders.

The WCRIB does not explain the decisionmaking parameters underlying its characterization of invested funds as "directly related" or unrelated to the insurance transaction. The Filing, for example, includes a cost of reinsurance in the calculation of the expense ratio that is loaded into the rates; at the same time the WCRIB contends that reinsurance is not attributable to the insurance transaction in the context of attributing investment returns on funds insurers hold that may ultimately be transferred to reinsurers. Further, the WCRIB ignores the underlying link between insurance transactions with policyholders and the purchase of reinsurance; were it not for the former, the latter would be unnecessary.[30]

Similarly, the WCRIB offers no rationale for its contention that income it earns on funds held to pay its expenses does not relate to the insurance transaction. As with reinsurance, insurer expenses are included in the expense factor that is a part of the rates. Insurers receive income in the form of premiums from purchasers of workers' compensation policies and incur expenses in

[30] The Filing, Section VI-A, p. 6, observes that in workers' compensation, primary insurers utilize reinsurance to reduce their overall underwriting risk.

connection with administering and handling claims made on those policies. Such expenses are ineluctably incurred as part of the insurance transaction; income earned on funds that are held for paying those expenses is appropriately included in the IRR asset returns. With respect to the amounts withheld or retained by the company for the accounts of others and borrowed funds, the WCRIB offers no specific information relevant to its assertion that these amounts do not relate to the insurance transaction.[31]

The record is murky on the extent to which the WCRIB's definition of gains that are attributable to the insurance transaction and those that are attributable to capital and surplus is a straightforward reiteration of the treatment of expenses on the Insurance Expense Exhibit for NAIC reporting purposes. Even if that is the source, the WCRIB does not explain why the NAIC's allocation methodology justifies eliminating, for ratemaking purposes, gains that insurers allocate on that report to capital and surplus.[32]

In the *Decision on 2005 Private Passenger Automobile Insurance Rates*, at 70, the Commissioner stated that "[t]he underwriting profit component of private passenger automobile rates is intended to address two goals: 1) to compensate investors in the insurance business for risks associated with that investment, by provisions that are expected to ensure a fair rate of return to them; and 2) to ensure that the rates charged to policyholders reflect insurers total income. Giving equal attention in the ratemaking process to each goal is essential." That same Decision observed, at 103, that "[i]nsurers receive the cost of capital from returns on their investments as well as premiums from policyholders. If the investment yields are understated, the provision for underwriting profits in the rates will increase, and policyholders will pay more in premium. A realistic expectation of the asset returns is required if the rates are to be reasonable." We find no reason to set aside those principles in this proceeding. The WCRIB's exclusion from the asset return estimates of returns that it characterizes as unrelated to the insurance transaction, by understating insurers total income, will produce excessive rates. For that reason, its methodology is disapproved.

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[31] The WCRIB, in its Rebuttal Filing, comments on the Insurance Expense Exhibit treatment of approximately $9.6 billion in agent's balances. If that is what the WCRIB is referring to as an amount held by the company for the accounts of others, it is difficult to understand why the WCRIB views it as unrelated to the insurance transaction, regardless of how it is treated in Insurance Expense Exhibit reporting. Commission payments are included in ratemaking and therefore are made from funds contributed by policyholders. Similarly, borrowed funds might be used to pay expenses incurred as part of the insurance transaction.

[32] Mr. McCarthy testified that the WCRIB's IRR model's treatment of investible funds was taken from the Milliman IRR model that the WCRIB used in its 2003 filing.

4. *Investment Expenses*

In calculating the net return on assets, insurers subtract the expenses of managing the investment portfolio. The WCRIB proposes a value for investment expense of 0.40 percent, the average of ten years of expense ratios (2001 through 2010) as published in *Best's*. The total deductions, as shown in Filing Section VII at page 87, Column 5, are the sum of four separate items: total investment expense incurred; interest expense; real estate depreciation and aggregate write-ins. Mr. McCarthy testified that the WCRIB's calculation of investment expenses in this Filing differs from the method that the Commissioner has approved in the past.[33]

The SRB's advisory filing recommends an investment expense ratio of 0.23, the ratio of the value of the investment expense published in *Best's* to the total cash and invested assets. The SRB excludes from its calculation the values for interest expense, real estate depreciation, and aggregate write-ins that the WCRIB includes. The purpose of the investment expense ratio is to compensate insurers for the expenses of acquiring or managing the investment portfolio. The SRB's methodology is consistent with the Commissioner's prior decisions on the appropriate basis for calculating the expenses actually related to an insurer's portfolio management.[34] The WCRIB offers no support for calculating the investment expense ratio using, in addition to the investment expense reported in *Best's*, other expenses that insurers report on their annual statements. The WCRIB's methodology underestimates asset returns, will therefore produce excessive rates, and is disapproved.

E. Classification and Rating

1. *Class Ratemaking Methodology*

The Filing this year uses a class ratemaking methodology that, according to the WCRIB, it introduced in prior filings.[35] However, revisions in 2010 and 2011 to the WCRIB's class ratemaking methodology have never been addressed in a contested proceeding. The WCRIB

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[33] The SRB's witness, Mr. Parcell, confirmed that the WCRIB had used a different methodology in its 2003 filing, commenting on the difference between the 0.09 value for the investment expense ratio proposed in that filing and the 0.40 percent value in the 2012 Filing.

[34] See, *Decision on 2001 Private Passenger Automobile Insurance Rates*, DOI Docket Nos. R2000-10, 11, 12, at 69; *Decision on 2005 Private Passenger Automobile Insurance Rates*, DOI Docket Nos. R2004-11,12, 13, at 112, *Decision on 2007 Private Passenger Automobile Insurance Rates*, Docket No. R2006-04, 05, 06, at 43. The Commissioner concluded in 2001 that a calculation based on all reported expense deductions on the annual statements may overstate expenses actually related to portfolio management. In subsequent proceeding on automobile insurance rates, the investment expense ratio was calculated using the methodology that the SRB recommends this year, resulting in expense ratios of 0.28 and 0.26.

[35] In Filing Section IX, the WCRIB refers to implementation in the 2010 filing of a change in the method of calculating excess loss factors and to implementation in the 2011filing of the NCCI's method of categorizing injuries for purposes of estimating LDFs.

states that the methodology in the Filing "closely mirrors" a new methodology developed by the National Council on Compensation Insurance ("NCCI") that, since 2009, has been approved for use in loss cost and rate filings in 36 of the 37 states in which the NCCI makes such filings. The WCRIB requests explicit approval of this aspect of its methodology, noting that neither the AG nor the SRB has opposed such approval. The Commissioner's decision, however, does not depend on opposition from the intervenors, but on whether the methodology is a reasonable approach in producing rates that satisfy the statutory standards and fall within a range of reasonableness.

Thomas Daley, ACAA, MAAA, a director and actuary at the NCCI who was responsible for the research into class ratemaking and implementation of the new system in the states in which the NCCI makes loss cost or rate filings, testified on behalf of the WCRIB. His paper describing the system was attached to his testimony.[36] Mr. Daley identified differences between the NCCI class ratemaking methodology as used by the NCCI in states where it makes filings and as used by the WCRIB in the Filing, opining that the WCRIB's modifications were reasonable. He also identified a series of "minor technical differences" that did not change his professional opinion that the WCRIB's proposed rates met the statutory standards.

The goals of the new NCCI system, as set out in Mr. Daley's paper, are to improve the predictive ability and adequacy of loss costs by state code, to provide year to year stability of loss cost changes by class code and to explore the potential of new data elements that the NCCI began to collect in 1996. As part of its new methodology, the NCCI revised its approach to categorizing claims for purposes of estimating loss development from Serious/Non-serious to Likely to Develop/Not Likely to Develop. Claims are assigned to a category based on the type of injury, the affected body part, and whether the claim is open or closed. Implementation of the new methodology has apparently required changes to state reporting procedures.[37] From the WCRIB's statement that it developed its classification pricing from information in insurers' unit statistical reports, we infer that it has collected appropriate data that enable it to implement the new NCCI methodology.

Mr. Daley testified that the new NCCI methodology would result in substantial changes to the way class rates are calculated in Massachusetts. The approach is revenue neutral, *i.e.*, it

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[36] His paper was published in the Winter 2009 E-Forum, a publication of the Casualty Actuarial Society.
[37] Mr. Daley testified that Texas does not use the new NCCI methodology because the Texas statistical plan does not require the reporting of injured body part, a data element that is necessary to the new methodology.

does not change the overall amount of premium that will be generated in the state, but does alter the relative amount of that premium that is generated from different industry groups.[38] Mr. Daley's paper recognized as a potential problem with implementation acceptance by state regulators because "loss costs underlying the methodology, although very much improved, may generate unpalatable premium changes in the year of implementation for certain regulators and the employers within their jurisdiction."

The WCRIB used the NCCI's revised methodology in its 2010 filing to calculate excess loss factors and its methodology for classification of injury types to calculate LDFs in 2011. Its use this year is therefore not precisely "new."[39] Neither the AG nor the SRB suggests that the proposed rate increase in the Filing results from the WCRIB's integration of the new NCCI methodology into its procedures for developing class rates.[40] We therefore do not disapprove the WCRIB's Filing on the ground that it employed aspects of the new NCCI methodology for that purpose.

2. *The All Risk Adjustment Program*

The WCRIB proposes to increase the maximum surcharge applicable under the All Risk Adjustment Program ("ARAP") from 1.25 percent to 1.49 percent. The SRB and the AG oppose the increase, asserting that the WCRIB has provided no justification for its recommendation. The WCRIB initially proposed the ARAP in a filing dated October 11, 1989, which the Commissioner approved in the *Decision on 1990 Workers' Compensation Rates,* DOI Docket No. G89-45, at 4. ARAP, in essence, increases the premium paid by employers with higher than expected losses and was intended to create a financial incentive to reduce those losses.[41] The maximum surcharge under the 1989 filing was 1.49 percent.[42] In the *Decision on 2007 Workers'*

[38] The NCCI and the WCRIB assign class codes to one of five industry groups: Manufacturing, Contracting, Office and Clerical, Goods and Services, and Miscellaneous.

[39] The AG argues that the WCRIB's proposal to increase the maximum ARAP surcharge should be denied in part because of what she refers to as the "new" classification system that will increase rates for some classes of employers and decrease rates for others. Her argument apparently does not recognize that the classification system is not "new" in this Filing.

[40] The AG argues that the increase is principally attributable to the WCRIB's underwriting profits provision and net loss trends.

[41] Since implementation of the ARAP, WCRIB filings have included an offset to the overall rate request that reflects additional premium that insurers expect to receive from ARAP surcharges. The surcharge therefore does not increase insurers' total premium income, but affects the premiums for individual employers.

[42] The program was approved for continued use in 1991, with the caveat that it might be reconsidered with respect to policies effective on or after January 1, 1992. *Decision on 1991 Workers' Compensation Rate*, DOI Docket No. G90-44, at 6. The WCRIB subsequently filed revisions to the ARAP; on December 29, 1992 it sought approval of an increase in the maximum surcharge from 1.49 to 1.61 for policies incepting or renewing on or after January 1, 1993. The Commissioner approved the increase in her contemporaneous *Decision on 1993 Workers' Compensation*

Compensation Rates, DOI Docket No. R2007-01, the maximum ARAP surcharge was capped, as of September 1, 2007, at 1.25 percent.

The WCRIB's stated reason for its proposal to increase the maximum ARAP surcharge is to increase incentives for policyholders to work with insurers to improve workplace safety, reduce claim frequency, and manage claims severity. The Filing offered no actuarial support for its recommended increase, and Mr. McCarthy testified that he had made no study of the effect of ARAP surcharges on employer behavior.[43]

Implicit in the WCRIB's proposal is the notion that the current ARAP surcharge provides an inadequate incentive for employers to reduce insured losses. However, while the WCRIB projects downward movement in claim frequency in Section V-2 of the filing, it quantifies no connection between an increased ARAP surcharge and projected claim frequency. If a higher ARAP surcharge were expected to provide added motivation to reduce claims, it might be expected to be reflected in an adjustment to the claim frequency trend. In addition, the Filing offers no evidence that employers are not cooperating with insurers on workplace safety matters or management of claim severity.[44]

The WCRIB has not met its burden to demonstrate that the current ARAP surcharge is inadequate to achieve its goals and that its proposed surcharge increase would not unjustifiably increase premiums paid by certain employers. An unsupported request to increase the ARAP surcharge does not satisfy the WCRIB's obligation to prove that the Filing, if approved, will not produce premiums that unfairly discriminate against employers on whom the surcharge is imposed.

3. Payroll Caps

The WCRIB proposes to remove the minimum payroll and increase the maximum payroll for two business classifications, 9178 and 9179, and to remove the payroll cap for Class 9186. Classes 9178 and 9179 include Athletic Teams and Parks; those engaged in non-contact sports

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Rates, DOI Docket No. G92-25, but eliminated it a year later in her *Decision on 1994 Workers' Compensation Rates*, DOI Docket No. G93-45. The effect of that decision was to restore the ARAP as it existed before January 1, 1993.

[43] According to the AG, the ARAP is intended to produce actuarially sound premiums on an individual risk basis. The SRB, in its Advisory Filing, acknowledged that the current ARAP produces rates that are more actuarially appropriate then they would be without the ARAP. The AG and the SRB, in their briefs, both ask the Commissioner to consider eliminating ARAP, a recommendation that has been made, but not approved, in the past and we do not consider this year.

[44] The Cost Containment Section of the Filing does not ask insurers to report on such issues.

are assigned to 9178 and those engaged in contact sports to 9179.[45] Operators of amusement devices and employees of carnivals or travelling circuses are assigned to Class 9186. The WCRIB also seeks to revise the minimum and maximum payrolls for executive officers of corporations and associations, caps that are applied in all business classifications that include such employees.

For class codes 9178 and 9179, the weekly payroll basis for calculating workers' compensation insurance premiums is capped at an average of $300 per employee, a limit that has been in place, according to the WCRIB, since at least 1980. These codes also set a "per season" minimum payroll of $500 per employee, a value that has been in place since at least 1979. The WCRIB proposes to set the maximum weekly payroll per employee at four times the SAWW, rounded to the nearest $100, and to adjust it each October to reflect the annual recalculation of the SAWW. It also proposes to eliminate the "per season" minimum, stating that it is not necessary and is so low that it has little to no effect on premium calculation. It also expands the personnel included in the classification to include trainers, equipment managers and all sports officials, not just umpires.

The WCRIB proposed to implement this change as of October 1, 2012, when the SAWW is next revised. The magnitude of the change to the payroll cap, based on the current SAWW, $1,145.82, would change the minimum from an average of $300 per week per employee to $4,543.28 per week per employee. Mr. McCarthy testified that he had not determined the amount of expected increase in reported payroll for classes 9178 and 9179 if the WCRIB's proposal were adopted or adjusted the calculation of the proposed manual rates to reflect such a payroll increase. The WCRIB offered no evidence of an increased risk level for these classes.

With respect to class code 9186, the WCRIB states that in its 1999 rate filing it combined Class codes 9180 (fixed carnivals and circuses) and 9186 (travelling carnivals and circuses) for ratemaking purposes. Mr. McCarthy testified that Class code 9180 had no payroll cap and a lower premium rate, while 9186 had a higher rate but capped payroll at an average of $300 per week per employee. The combined class retained the lower Class 1980 rate and the Class 1986 payroll cap. The WCRIB characterizes retention of the payroll cap for the combined class as an oversight and asks that it now be corrected by eliminating the cap.[46] Mr. McCarthy testified that

[45] "Contact sports" are defined to include, but not be limited to, football, hockey and roller derby. "Non-contact sports" include, but are not limited to, baseball, basketball and soccer.

[46] The WCRIB does not explain why this recommendation apparently was not pursued in previous filings.

removal of the cap would generate much higher premium for businesses assigned to Class 9186, but that he had not calculated the effect of the increase in reported payroll on the class code. The WCRIB did not adjust the proposed manual rate for this class to consider the effect of the proposed payroll increase.

The Massachusetts Manual for Workers' Compensation, Section XI, sets minimum and maximum levels for determining payroll for executive officers of a corporation or association. The current minimum is $200 and the maximum is $1,000. The WCRIB proposes to adopt a new methodology that would increase the minimum payroll for an executive officer to the state average weekly wage ("SAWW") rounded to the nearest $100 and the maximum to four times the SAWW, also rounded to the nearest $100. The new methodology would be implemented for policies with an effective date of October 1, 2012, to coincide with the annual revision to the SAWW. The minimum and maximum limits would thereafter be revised each year to track changes in the SAWW. Because the 2012 value for the SAWW is not known at this time, the WCRIB's Filing does not include a value for the proposed increase although Mr. McCarthy opined that it would be close to the current SAWW. The WCRIB's rationale for increasing the payroll limitations for executive officers is that those limitations have not changed since 1990, while the SAWW has more than doubled since then.

In the *Decision on 1991 Workers' Compensation Rates*, DOI Docket No. G90-44, the Commissioner approved the WCRIB's November 2, 1990 filing for an increase in the minimum and maximum payrolls for executive officers. The approved increases doubled the minimum from $100 to $200 and the maximum from $500 to $1,000. The rationale for the filing was that the individual payroll limits had not changed in many years while the SAWW had continued to rise. Mr. McCarthy testified that the SAWW in 1990 was $490.57. The new 1991 minimum therefore represented about two-fifths of the SAWW and the new maximum twice the SAWW. The WCRIB further specified in 1991 that the manual rates would be lowered by offsets shown in the filing to compensate for the anticipated increase in payroll.

The WCRIB has offered no rationale for changing the longstanding practice of setting a minimum for executive compensation that is less than the SAWW and a maximum that approximately doubled that value. It provides no principled basis for a change matching the minimum executive compensation to the SAWW and quadrupling that value to set a maximum cap, nor does it explain why such a dramatic increase is necessary at this time. We find that its proposal is unsupported. A change to the executive compensation limits will affect employers of all sizes engaged in a wide range of businesses. It is therefore particularly important that changes be supported by evidence that the increases will more accurately reflect the risk. In addition, the Filing should include information estimating the effect of such changes. Although Mr. McCarthy testified that the indicated rates for class codes that include executive officers would be expected to go down if the payroll limits were increased, the WCRIB did not adjust the calculation of its proposed rates to reflect the effect of the proposed payroll increase.

The rates for each of the classes that would be affected by the WCRIB's proposed changes to payroll caps would require adjustment if the changes were approved. Because the Filing includes no such adjustments, its proposed rates, were the Filing approved, would be excessive. We therefore disapprove the Filing because the proposed class rates do not reflect application of the proposed changes to payroll caps.

4. Construction Credit Program

Section 53A instructs the Commissioner to provide for equitable distribution of premiums among employers paying higher than average wages and those paying lower than average wages. In 1991, the WCRIB initiated the Massachusetts Construction Classification Adjustment Program which permits experience rated employers, who pay wages in excess of $18 per hour for employees in certain construction classes, to apply for a premium credit. The WCRIB this year proposes to increase the qualifying wage for participation in the construction credit program from $18 per hour to $28 per hour. The intent of the program, the WCRIB contends, was to benefit employers who paid higher than average wages but now, because the statewide average hourly wage has risen from $12 in 1991 to about $28 per hour in 2012, the threshold no longer exceeds the average hourly wage. The WCRIB's goal is to move in the direction of restoring the 1991 relationship between the eligibility standard for the construction credit and the SAWW. The SRB does not oppose the WCRIB's proposal to increase the threshold for offering the construction credit, but recommends that it be implemented over time, suggesting incremental increases of $2 per hour over a five year period.

Exhibit 3 to the *Decision on 1991 Workers' Compensation Rates*, DOI Docket No. G90-44, confirms the WCRIB's position that the threshold was initially determined by comparing average weekly wages for construction workers to the average statewide weekly wage for all employees. Revision of the Construction Credit Program to retain an appropriate relative relationship between statewide average wages and average wages for certain construction classes may be a reasonable goal. Nevertheless, the magnitude of the reduction of the wage base for the construction credit resulting from immediate implementation of the proposed increase has the potential to increase substantially the premiums paid by employers in the building trades.[47] The WCRIB offers no explanation as to why it elected only this year to incorporate in its Filing a provision to reinstate the 1991 relative relationship between statewide average wages and average wages in the construction industry, and does not propose to make annual adjustments to maintain that relationship. Considerations of rate stability in the marketplace mandate against sudden changes that are not responsive to demonstrated expectations of increased losses.

5. F-Class Rates

The WCRIB this year recommends that the average rates for businesses in the 14 F-Class classifications increase by 20 percent beginning on September 12, 2012. It comments that this increase will move toward the rate levels indicated by the loss data, but temper year-to-year variations.[48] The WCRIB develops its recommendations from the analysis of five years of data from 2005 through 2009. Those data show that both losses and premium have declined substantially over the five year period from 2005-2009.

The AG opposes the WCRIB's approach, contending that the data requires adjustment because the limited number of claims renders the historical experience not fully credible. She observed, in her advisory filing, that the indicated rate level would be different if derived from fewer historical data points than the five years used by the WCRIB. The AG recommends a credibility-weighted approach that trends the existing rate forward by a weighted average of the annual net loss trends for indemnity and medical losses.

In its rebuttal filing, the WCRIB proposes a different credibility adjusted calculation, asserting that if F-class rates are derived from a credibility weighted formula, a complement of credibility also should be used that adjusts rates forward for net loss trend, changes in benefits, and Special Fund Assessments since the last rate revision, and that incorporates expense and profit provisions used in the general rate revision. It offered a hypothetical review of an

[47] Like the ARAP, the Construction Credit Program is revenue neutral.
[48] On Section VIII, p. 8, the WCRIB calculates the overall indicated rate change as 48.6 percent.

appropriate complement of credibility that produced an indicated average rate change of 9.2 percent.[49]

We find that the WCRIB improperly relied on sparse historical data over a five year period in which claims and losses in the F-Classes declined significantly to develop the F-Class rates in the Filing, and that its methodology will result in excessive rates. Although the WCRIB in its brief asks the Commissioner to reject the AG's proposal, it does not object to using a credibility-weighted methodology to derive the F-Class rates. If credibility weighting is to be used, it recommends adjustments in addition to those proposed by the AG. We recommend that in future filings the WCRIB utilize credibility weighting in circumstances when the historical record, such as that for the F-Classes, is not fully credible. However, we decline to order a specific formula for credibility weighting or to resolve matters relating to the appropriate selection of adjustments to credibility weighted results.

6. Swing Limits

In Filing Section IX, the WCRIB proposes to continue the adjustment that caps average proposed rates by class through an iterative process that sets maximum and minimum rate changes for a class within an industry group equal to the benefit level change and one-half the experience change, plus or minus 20 percent. Capping, the WCRIB notes, provides some rate stability over time. The WCRIB's witness, Mr. Daley, testified that swing limits are not actuarially necessary but are more a matter of public policy to help prevent unpalatable premium changes. The formula in the Filing for calculating so-called "swing limits" is unchanged from current practice.

The SRB proposes to modify swing limits so as to cap minimum and maximum rate changes at 15, rather than 20 percent. Caleb Huntington, ACAS, MAAA, a mathematician for the SRB, testified that its proposal was intended to respond to the proposed rate increases in the

[49] The example in the WCRIB's rebuttal filing, Hearing Exhibit 39, identified the source of certain values as an exhibit to the Stipulation filed in the proceeding on the WCRIB's 2010 rate filing. The AG objected, noting that language in that stipulation provided that the values therein did not constitute precedent and could not be relied upon in future proceedings. In her brief, the AG asks that we strike the calculation at page 61 of Hearing Exhibit 39. The WCRIB, in footnote 32 to its brief, contends that the reference to the stipulation was a mistake, and that the example intended to refer to factors in the current F-Class rates that were calculated in accordance with the *Decision on 2010 Rates* that approved the Stipulation. We note that in Section VIII of the Filing the WCRIB, without objection, identified values for offsets to manual premiums for the F-Class as taken from the "9/1/2010 Stipulation." We are persuaded that the WCRIB intended to use in its calculations values applicable to current rates that were derived as a result of the 2010 Stipulation, rather than claim precedential effect for the values themselves or for the methodology that produced them. We recognize the constraints in the 2010 Stipulation, but conclude that, taken in context, any violation of its terms was harmless. We deny the AG's request to strike.

Filing, commenting that lower swing limits would help reduce the effect of those increases. He testified that any change from the current 20 percent would not necessarily continue in the future.

The WCRIB, in its brief, does not object to adoption of the SRB's recommendation for the rate year beginning September 1, 2012, but indicates that it may again address swing limits in future filings. Our decision on the Filing moots the need for any extended discussion of the SRB's proposal. In future rate filings the WCRIB should assess the effect of proposed rate increases on policyholders and consider whether it is appropriate to moderate the effect of its proposals through adjustments to such factors as the formula for swing limits.

F. Expenses

1. Wage trend

The company expense trend factor in the rates encompasses anticipated changes in a range of items, including the wages of insurance industry employees. About 80 percent of the total overall expense trend calculation consists of the earnings component. The WCRIB's proposed annual overall expense trend is 4.6 percent, derived from an annual 2.1 percent trend for non-wage components and 5.3 percent for the wage component. It develops the wage component from data reported by the federal Bureau of Labor Statistics ("BLS") for Massachusetts property and casualty insurers for calendar years 2004 through 2010. The Attorney General objects to the WCRIB's recommended wage trend because it is significantly higher than the 2 percent State Average Weekly Wage trend that it uses to calculate the net trend.

The WCRIB argues that the BLS data captures exactly what it is forecasting, *i.e.*, changes in insurers' payroll expenses in Massachusetts during the rate period. It asserts that the AG has offered no convincing evidence that the SAWW trend, which is based on payroll for all employers in Massachusetts, is a better predictor of insurance company wages than data that is specific to the insurance industry. That the BLS trend is higher than the SAWW trend is, the WCRIB contends, irrelevant; changes in wages for any particular industry may differ from the average for the entire workforce.

The AG argues that it is inappropriate to require employers to fund raises for insurance company employees that are significantly higher than the projected increase in wages for average workers in Massachusetts. She notes, as well, that part of the differential in the filing arises because the WCRIB calculates the trends using different methodologies; the SAWW calculation is based on five data points while the insurance company earnings trend is based on seven. She further observes that wage increases based on the three most recent points from each data source are relatively close; the SAWW data points show a 3.8 percent increase and the normalized BLS data points show a 4 percent increase. The AG argues that the most recent data reflect current economic influences and are those most likely to predict subsequent wage changes.

No party challenges the accuracy of the data underlying the various wage trend calculations. The AG's conclusion that the WCRIB's measure of wage increases based on the BLS is excessive compared to increases based the SAWW results in part because the measures are developed over different time periods. As the AG argues in her brief, the percentages over shorter, more recent time periods are relatively similar. Comparison of data from the same time period is a more appropriate method for identifying differences between the SAWW trend and the insurance industry wage trend and determining whether such differences are within a range of reasonableness. While wage trends developed from BLS data and from the SAWW will not necessarily match precisely, they are useful as a reasonability check on each other.

Although the WCRIB observes that wage changes in an industry may differ from an average based on the whole workforce, it has offered no data to suggest that wage trends in the insurance industry have historically outstripped average trends in the SAWW and no basis on which to conclude that wages in the insurance industry are likely to increase during the rate period at a percentage that is over twice the percentage of the WCRIB's proposed SAWW trend. On this record, we find that the WCRIB's inclusion of a 5.3 percent wage trend in its expense calculation will produce rates that are excessive. We therefore disapprove the Filing for that reason.

2. *Commissions*

Chapter 152, §53(A)(12) provides, in pertinent part, that the Commissioner shall not approve classifications or rates that contain provisions for agent or broker commission allowances that are not "demonstrated both to be reasonable and to reflect the actual cost to agents or brokers of the services they provide."[50] The WCRIB includes in its proposed rates a commission ratio of 8 percent of direct written premium, based on averaging ratios of

[50] Although the statute refers to agents and brokers, in 2003 the separate statutory provisions for licensing insurance agents and insurance brokers were replaced by a single provision licensing insurance producers. We will therefore address in this decision commission payments to producers.

commissions paid to direct written premiums for the three calendar years 2008, 2009 and 2010.[51] Direct written premiums are net of company deviations, discounts, retrospectively rated policy adjustments, and credits for large deductible policies, and are therefore less than the standard (*i.e.*, manual) premium.

The SRB and the AG contest the WCRIB's approach with respect to the treatment of commissions paid on large deductible policies. The SRB questions the inclusion of such commissions in calculating the commission ratio, pointing out that data on large deductible policies are generally excluded from the data set used to make workers' compensation rates in Massachusetts. It further comments that generally rates are made on a standard, rather than a net premium basis. The SRB argues that the WCRIB assumes that insurers pay commission on the net premium for large deductible policies rather than on the premium that the policyholder would pay if it purchased a guaranteed cost or retrospectively rated policy.

Because the net premium on a large deductible policy may be significantly lower than the standard premium, the SRB considers it implausible that on such policies insurers actually pay the relevant percentage commission only on the net premium, rather than compensate the producer at the level that would be generated on the standard premium. It observes, as well, that the guidelines promulgated by the Division of Insurance for rating large deductible policies require the premiums to assume that the insurer will pay commission on the basis of standard premium. The SRB estimated that the commission rate on large deductible policies, if paid at a rate consistent with the Division's rating plan, would be roughly 6.9 percent of standard premium.

The SRB suggests that removing the premiums associated with large deductible policies and the associated commissions paid on those policies would produce historical commission ratios for the set of policies that are used to develop other aspects of workers' compensation rates. It points out, however, that such a calculation cannot be made on this record because, while data displayed in Filing Section VI, p. 39 estimate the amount of standard earned premium that would be paid on large deductible policies, no data separately report commission payments actually made on the reduced premium. However, as a step toward providing a more accurate

[51] The values are taken from data that insurers report on their Annual Statements filed with the Division of Insurance. The actual average, as shown in Exhibit 3A, was 7.8 percent. The WCRIB adjusts the result to produce a commission load relative to standard premium.

commission ratio, the SRB recommends reducing the WCRIB's three-year 7.8 percent average by half a percentage point.

The SRB also argues that the Filing does not demonstrate that the WCRIB's proposed commission allowance is reasonable and "reflects the actual cost [to producers] of the services they provide." It points out that acquisition costs, expressed as a percentage of premium, have steadily risen over the past decade. The SRB also observes that recent NCCI audits of four large Massachusetts writers of workers' compensation insurance found that insurers had overpaid commissions on policies written through the residual market.[52]

The AG points out that the WCRIB, in this Filing, has altered its methodology for calculating the commission percentage from that used in the 2003 rate filing. She argues that the WCRIB's assumption on commission payments made on retrospectively rated policies is contrary to the provisions for such policies shown in the Filing, Section XII. The AG supports the SRB's proposed adjustment to the commission percentage to reflect the uncertainty in the WCRIB's proposed commission ratio. She also asks the Commissioner to order the WCRIB in the future to collect data sufficient to determine how companies calculate commissions on large deductible and retrospective policies and to quantify the average premium base for such policies and to collect, as well, data on the contingent and override commissions that are included in the commission dollars that insurers report.

The WCRIB argues that the SRB's proposal is based on unsupported assumptions about how agents are compensated for placing large deductible policies and that its proposed adjustment should not be made. It also comments that it is prepared to work with the Division of Insurance on the practicality and utility of collecting such data, but that no change should be directed without more information on reporting issues related to large deductible policies.

The WCRIB does not contend that issues relating to commission payments on large deductible policies are not relevant to determining whether its proposed commission allowance is reasonable. Mr. McCarthy testified that the WCRIB changed its methodology for calculating commissions at some time after 2003, with the expectation that the new approach would remove complications associated with assessing the effect of large deductible policies. It is not apparent on this record that the revised methodology has achieved that goal. The WCRIB offers no

[52] Commissions on such policies are regulated by the Commissioner; the percentage is reduced as the standard premium increases.

documentation to support its own assumptions about the commission structure on large deductible policies.[53]

The SRB points out apparent inconsistencies between the WCRIB's assumptions about those commission payments and the Division's guidelines, and notes that information is not available on the commissions paid on such policies.[54] The AG urges the Commissioner to order the WCRIB to collect data on insurer practices with respect to computing those commissions on large deductible and retrospectively rated policies and to quantify the average premium base for such policies. The WCRIB does not argue that it is impossible to collect such data, but would prefer to work with the Division to develop appropriate practices.[55]

In addition to the lack of information on commissions on large deductible policies, the SRB correctly observes that the Filing does not demonstrate that the proposed commission ratio is reasonable or that it reflects producers' costs of providing their services. Assuming, *arguendo*, that the higher commission ratio is reasonable, combining it with the WCRIB's proposed average rate increase of over 18 percent, if approved, generate a significant increase in commissions. The record offers no evidence, however, that the cost of producing policies would rise.

The AG asks also that insurers be required to report contingent and override commissions that are included in the commission dollars used to calculate the commission ratio. Her concern reflects an issue that has arisen in proceedings to fix and establish private passenger motor vehicle insurance rates. The industry filings sought to include in the rates, in addition to the fixed commission percentage set by the Commissioner, a factor to cover contingent and override commissions ("competitive commissions") that insurers paid to producers, even though such payments were discretionary.

The Commissioner consistently declined to do so, concluding that the inclusion of such commissions would not comply with the Commissioner's statutory duty to set "adequate, just,

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53 Mr. McCarthy testified that the WCRIB has no readily available data on expense information exclusive of large deductible policies. He noted that the NAIC does not collect that data, but admitted that the WCRIB could include it on its expense call, although he expressed unspecified concerns about the quality of the data that would be reported.

54 The WCRIB suggests that those guidelines may not have been in effect when some large deductible policies were written.

55 The AG also argues that the WCRIB's assumptions that, for all large deductible policies, the Defense and Cost Containment Expense Ratio is subject to the deductible and that 50 percent of the Adjusting and Other Expense Ratio is subject to the deductible are unsupported by any data. She contends that those assumptions are inconsistent with the Division's large deductible policy rating advisory bulletin, Hearing Exhibit 8. That document indicates that policyholders with large deductible policies and insurers have options with respect to responsibility for defense and cost containment and adjusting and other expenses. The AG does not suggest that the WCRIB's assumptions are incorrect or that the ratios in the Filing should be adjusted. Nevertheless, as with other aspects of insurer practices with respect to large deductible policies, it is reasonable to collect data to support rating assumptions.

reasonable and nondiscriminatory rates." This conclusion was based largely on findings that payments of competitive commissions: (1) did not provide a direct benefit to policyholders; (2) are partially based on sales of other lines of insurance or involve characteristics of a producer's book of business; (3) are not statutorily required; and (4) are not made based on any uniform approach. *See Decision on 2005 Private Passenger Insurance Rates*, DOI Docket Nos. R2004-11, 12, 13, p. 26.

The extent to which workers' compensation commissions, in total, include competitive commissions is uncertain. The specific statutory provisions relating to commissions for private passenger motor vehicle insurance, *e.g.*, Chapter 175, §§162 and 162E, do not apply to workers' compensation insurance commissions. Nevertheless, the Commissioner's reasoning may equally apply in determining that the commission ratio in a workers' compensation rate filing is reasonable. To that end, information on the extent, if any, to which competitive commissions are included in insurers' reported commissions is relevant.

With respect to this Filing, we conclude that the WCRIB has not met its burden to demonstrate that the commission expense provisions are not excessive and will not result in rates that fall outside a range of reasonableness. We will not order specific changes in the data collection or reporting process, however, but instead direct the parties to collaborate on developing systems that will provide adequate data relating to commission payments on large deductible and retrospectively rated policies as well as data on the allocation in such policies of other expenses between insurers and policyholders. The WCRIB must also provide evidence sufficient to support a finding that its commission recommendations are reasonable and reflect producers' costs of providing services.

G. Cost Containment

The WCRIB's cost containment filing consists of a brief introductory statement, a copy of the 2010 cost containment survey sent to ten insurers writing workers' compensation insurance in Massachusetts, and copies of the companies' responses to the survey.[56] It also includes copies of six pages from the Annual Report on the State of the Massachusetts Workers' Compensation System for Fiscal Year 2011 which provide statistical information on field investigations conducted and stop work orders issued by the Department of Industrial Accidents

[56] The ten companies are: Acadia Insurance Company, ACE Insurance Company, A.I.M. Mutual Insurance Company, Atlantic Charter Insurance Company, Chartis Insurance Company, Guard Insurance Group, the Hartford Fire Insurance Company, Liberty Mutual Insurance Company, Travelers Insurance Company, and Zurich Insurance Company.

("DIA"), the DIA case load and conference queue, and the work of the DIA's Office of Safety. The WCRIB also submitted documents reporting the Insurance Fraud Bureau's ("IFB") case load through December 31, 2011, a copy of the IFB's 2010 Annual Report, and copies of its newsletter, "e-focusFraud", with issue dates of March, June and November 2011.

The WCRIB argues that the Commissioner approved the WCRIB's cost containment filing format in the *Decision on 1999 Workers' Compensation Rates*, and should do so again this year. It asserts that company responses to the WCRIB's survey "continue to confirm that their programs and procedures have had a significant impact on reducing costs, as required by §53A(13)," further observing that neither the SRB nor the AG proposes to reject the cost containment portion of the Filing.

The cost containment survey addresses nine general areas: claims operations; medical bill audits; utilization review; preferred provider organization (PPO) programs; capitated medical arrangements; other medical cost containment arrangements not included in PPO and capitated medical arrangements; control of fraudulent claims; loss prevention and engineering programs; and premium collection, audit and fraud control. In addition, it offers respondents an opportunity to comment on the requested information. Mr. McCarthy's testimony confirmed that the survey focuses on loss costs and premium collection and does not address other expenses that workers' compensation insurers incur, such as general expenses, overhead, and commissions. The survey questions do not require insurers to quantify the effectiveness of their practices, such as the extent to which their policyholders utilize loss prevention programs, the actual savings generated by programs to reduce medical costs, the accuracy of commission payments, or the time frames for and ultimate success of an insurer's premium collection activities.[57]

The statute requires the Commissioner to make a finding not only that insurers employ "acceptable" cost control programs but that such programs "have had or are expected to have a substantial impact on fraudulent claim costs, unnecessary health care costs, any other unreasonable costs and expenses, and on the collection of appropriate premium charges owed to the insurer." Cost containment filings that do not provide information on the impact of insurers'

[57] In response to questions about prescription drug pricing, Mr. McCarthy testified that he did not recall any specific discussions with insurers about pharmacy benefits, and did not know if providers were complying with Massachusetts regulations about prescription pricing. The SRB argues that the WCRIB's commission expense should be rejected in part, at least, because the WCRIB provided no evidence that commission expense is being contained; it also commented that recent NCCI audits identified commission overpayments by some insurers. We are of the opinion that it would be reasonable for the WCRIB, as part of the cost containment filing, to obtain from insurers data on the accuracy of commission payments.

programs are insufficient to support such a finding. In the *Decision on 2003 Workers' Compensation Rates* we faulted the cost containment filing for failure to document changes in company practices over time and to analyze issues such as the relationship between the use of managed care organizations and improvements in the implementation of certain loss control techniques, *e.g.*, return to work and modified duty. While we do not disapprove the 2012 Filing on the basis of the Cost Containment Filing, we direct the WCRIB, in future filings, to provide sufficient documentation to support a finding that cost control programs are effective.

V. CONCLUSION

We find that, on the record of this proceeding, the WCRIB's 2012 Filing contains proposed classifications or premiums that cannot be approved as "not excessive, inadequate, or unfairly discriminatory for the risks to which they respectively apply, and within a range of reasonableness." We therefore disapprove the WCRB's 2012 Filing. The WCRIB may, pursuant to §53A (7), submit for approval a new filing that conforms to the findings in this decision on disputed issues and relies on appropriate data. In addition, we decline to exercise our authority to order a rate reduction at this time.

So Ordered this 30th day of August 2012.

Stephen M. Sumner
Presiding Officer

Jean F. Farrington
Presiding Officer

Affirmed this 30th Day of August, 2012

Joseph G. Murphy
Commissioner of Insurance