

STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
300 Capitol Mall, 17th Floor
Sacramento, CA 95814

PROPOSED DECISION AND ORDER

**JANUARY 1, 2019 WORKERS' COMPENSATION CLAIMS COST
BENCHMARK AND ADVISORY PURE PREMIUM RATES**

FILE NUMBER REG-2018-00018

In the Matter of: Proposed adoption or amendment of the Insurance Commissioner's ("Commissioner") regulations pertaining to the Workers' Compensation Insurance Claims Cost Benchmark and Advisory Pure Premium Rates. These regulations will be effective on January 1, 2019.

SUMMARY OF PROCEEDINGS

The California Department of Insurance ("Department") held a public hearing in the above-captioned matter on October 5, 2018, at the time and place set forth in the Notice of Proposed Action and Notice of Public Hearing, File Number REG-2018-00018, dated August 27, 2018 ("Notice"). A copy of the Notice is included in the record. The record closed on October 8, 2018 at 5:00 p.m.

The Department distributed copies of the Notice to the persons and entities referenced in the record. The Notice included a summary of the proposed changes and instructions for interested persons who wanted to view a copy of the information submitted to the Insurance Commissioner in connection with the proposed changes. The filing letter dated August 20, 2018, submitted by the Workers' Compensation Insurance Rating Bureau of California ("WCIRB"), and related documents were available for inspection by the public at the San Francisco office of the Department and were available online at the WCIRB's website, www.wcirb.com.

The WCIRB's filing proposes a change in the Workers' Compensation Claims Cost Benchmark and Advisory Pure Premium Rates ("Benchmark") in effect since July 1, 2018, that reflects insurer loss costs and loss adjustment expenses ("LAE").

In its filing, the WCIRB requested that the Commissioner adopt a set of pure premium rates for each classification to be effective January 1, 2019. The WCIRB recommended

an average pure premium rate of \$1.70 per \$100 of payroll, which is 20% less than the average pure premium rates California insurers filed as of July 1, 2018.

The Department accepted testimony and written comments at a hearing in San Francisco on October 5, 2018, and also received exhibits into the record. Members of the public submitted additional materials along with correspondence and documents prior to the hearing. The Commissioner announced that the record would close on October 8, 2018. After the hearing and before the closure of the record, the Department received into the record additional comments from the WCIRB. The matter was submitted for decision at 5:00 p.m. on October 8, 2018. Having been duly heard and considered, the Department now presents the following review, analysis, Proposed Decision, and Proposed Order.

**REVIEW OF WORKERS' COMPENSATION CLAIMS COST BENCHMARK
AND ADVISORY PURE PREMIUM RATES FILING**

Subdivision (b) of California Insurance Code Section 11750 states that the Insurance Commissioner shall hold a public hearing within 60 days of receiving an advisory pure premium rate filing made by a rating organization pursuant to subdivision (b) of Insurance Code Section 11750.3 and either approve, disapprove, or modify the proposed rate. Subdivision (b) of Section 11750.3 states a licensed rating organization, such as the WCIRB, shall collect and tabulate information and statistics for the purpose of developing pure premium rates for its insurance company members to be submitted to the Commissioner. Pure premium rates are the cost of workers' compensation benefits and the expense to provide those benefits.

The pure premium rates approved in this process by the Commissioner are only advisory. Insurers are permitted under California law to make their own determinations as to the pure premium rates each insurer will use, as long as the ultimate rates charged do not threaten the insurer's financial solvency, are not unfairly discriminatory, and do not tend to create a monopoly in the marketplace.

The Department's actuaries, Mitra Sanandajifar and Giovanni Muzzarelli, provide below in the Actuarial Evaluation a review and analysis based upon the filing information presented by the WCIRB and the public's comments about the filing. The Department's actuarial review is consistent with the approach used for prior pure premium rate filings. The pure premium rate process serves as an important gauge or benchmark of the costs in the workers' compensation system, but must also reflect the reality of insurer rate filings and the premiums insurers charge to employers.

The pure premium rate process does not reflect an employer's final paid insurance rate or premium. Instead, the pure premium process is narrowly tailored to project a specific sub-component of an overall rate. For example, the pure premium rate does not include the costs associated with underwriting expenses, profit, or a return on an insurer's investments. The analysis of pure premium in California projects the cost of benefits and LAE for the upcoming policy period beginning January 1, 2019. The term "rate" can be confusing in the pure premium context since it is a measurement of claim cost per \$100 of employer payroll rather than the rates insurers may charge. The information provided in the current filing shows the following:

- Based upon a review of insurance company rate filings made with the Department as of July 1, 2018, insurers are using an average pure premium rate level of \$2.13 per \$100 of employer payroll. This figure is higher than the WCIRB's recommended pure premium rate level of \$1.70.
- These figures are not predictive of an individual employer's insurance premium. That premium may fluctuate greatly from these figures based upon an employer's business, the mix of employees and operations, and the employer's actual claims experience. It is not possible to determine an individual employer's premium from these figures or from the Commissioner's pure premium determination because the review of pure premium rates represents just one component of insurance pricing.

ACTUARIAL RECOMMENDATION

The WCIRB has proposed an average pure premium rate level of \$1.70 per \$100 of payroll in its January 1, 2019 filing. The Department's staff actuaries' analysis, as set forth in the following Actuarial Evaluation section, results in an average pure premium rate level of \$1.63 per \$100 of payroll. The most recently available industry average level of pure premium rates filed by insurers with the Department is \$2.13 per \$100 of payroll as of July 1, 2018. While the indicated pure premium rate level represents our central estimate, and thus our recommendation, we note that the WCIRB's estimate of \$1.70 is within a reasonable actuarial range. The WCIRB's proposed pure premium rate level of \$1.70 is based on data evaluated as of March 31, 2018. In contrast, both the Department's and Bickmore's analyses utilize the data as of June 30, 2018. While the WCIRB reviewed the data evaluated as of June 30, 2018, the review did not result in an amended filing due to the modest difference in the indication compared to the indicated average pure premium rate level based on the March 31, 2018 data (\$1.68 versus \$1.70). However, the data was provided to the Department and the general public.

The WCIRB's filing compares its proposed average pure premium rate level to the average industry filed pure premium rate level. We believe this comparison is useful. It provides an appropriate basis for assessing both the industry's ability to adapt to the proposed pure premium rate level and the size of the potential market impact of such an adjustment. We note that under California law, the Insurance Commissioner's adopted pure premium rates are advisory, and that under California law insurers are free to make their own decisions as to what pure premium rates they will use in their rate filings and what rates to charge. The most recently filed pure premium rates by insurers are higher than the Insurance Commissioner's most recently adopted pure premium advisory rates.

The California workers' compensation market appears to be competitive and financially healthy. Collected premiums in the first quarter of 2018 produced an average charged rate of \$2.38, which compares to \$2.52 and \$2.81 observed in 2017 and 2016 respectively, showing a continuation of a downward trend in charged market rates that has been in progress since the first half of 2015 when the average charged rate was \$3.01. The average charged rate of \$2.38 for the first quarter of 2018 (which reflects all insurer expenses) was approximately 20% more than the Insurance Commissioner's adopted January 1, 2018 average advisory pure premium rate of \$1.98¹, and about 34% more than the Insurance Commissioner's adopted July 1, 2018 average advisory pure premium rate of \$1.78², which reflects loss and loss adjustment expense only. It was also approximately 23% less than the industry average filed manual rate of \$3.10, thus indicating the average effect of schedule rating and other rating plan credits.

As of March 31, 2018, the WCIRB estimates overall industry combined ratios of 85% and 84% for accident years 2015 and 2016 respectively, and a combined ratio of 89% for accident year 2017. After a period of combined ratios in excess of 100% over the 2008 through 2012 accident years, the 2017 accident year is the fourth consecutive year for the industry with a projected combined ratio of less than 90%. However, current charged rate levels are somewhat lower than the charged rates that underlay the combined ratios for accident years 2015, 2016 and 2017.

Actuarial Evaluation

The actuarial evaluation will focus on the following main components of the analysis: (1) loss development; (2) loss trends; (3) loss adjustment expense ("LAE") provision: allocated loss adjustment expense ("ALAE") and unallocated loss adjustment expense

¹ Updated from Insurance Commissioner's adopted January 1, 2018 Pure Premium Rate of \$1.94 based on updated exposure weights.

² Updated from Insurance Commissioner's adopted July 1, 2018 Pure Premium Rate of \$1.74 based on updated exposure weights.

(“ULAE”); and (4) the impact of reform legislation contained in Senate Bill 863 (“SB 863”), Senate Bill 1160 (“SB 1160”), Assembly Bill 1244 (“AB 1244”), and Assembly Bill 1124 (“AB 1124”).

Table 1 shows the medical, indemnity, and LAE components of the WCIRB’s pure premium rate indications over the past several years along with a comparison to Bickmore’s current indication. Table 2 displays the percentage impact of the various differences in assumptions and methods from WCIRB’s recommendation as compared to those of both the Department and Bickmore.

	WCIRB Filed Rates								Bickmore		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
	1/1/15	7/1/15	1/1/16	7/1/16	1/1/17	7/1/17	1/1/18	7/1/18	1/1/19	1/1/19	7/1/18
Medical \$	1.41	1.14	1.10	1.00	0.95	0.87	0.84	0.76	0.70	0.69	0.66
Indemnity \$	0.76	0.72	0.69	0.70	0.67	0.64	0.63	0.58	0.54	0.48	0.57
LAE \$	0.60	0.61	0.63	0.61	0.60	0.51	0.49	0.46	0.46	0.46	0.47
Total \$	\$ 2.77	\$ 2.47	\$ 2.42	\$ 2.30	\$ 2.22	\$ 2.02	\$ 1.96	\$ 1.80	\$ 1.70	\$ 1.63	\$ 1.70
Industry Avg Filed PP Rate						\$ 2.34	\$ 2.22	\$ 2.13			
Industry Avg Filed Manual Rate (with expenses)						\$ 3.43	\$ 3.28	\$ 3.10			
Industry Avg Charged Rate (net discounts)						\$ 2.56	\$ 2.46	\$ 2.38			

	Impact of Difference in Assumptions & Methods Between WCIRB and Alternative Recommendations								
	Recommended 1/1/2019 Pure Premium Rates	Total	Evaluation Date	Updated Lien Reduction Assumption	Ultimate Medical and Indemnity	Medical Severity Trend	Indemnity Severity Trend	Claim Frequency	Loss Ratio Trend
WCIRB	\$1.70								
CDI	\$1.63	-4.1%	-1.2%	-0.6%	-0.6%	-1.2%	-0.6%	0.0%	N/A
Bickmore (Middle)	\$1.63	-4.1%	-1.2%	N/A	-0.4%	N/A	N/A	0.0%	-2.4%

1. Loss Development

Some form of the paid loss development method has consistently served as the basis for determining ultimate loss estimates for both indemnity and medical losses in the WCIRB’s advisory pure premium rate filings for many years. While focusing on the paid method, the WCIRB has also reviewed the results of other methods, particularly the incurred development method, along with multiple variations on these basic methods. At the same time, Bickmore has been giving equal weight to both the paid and incurred

development methods in its analysis. The WCIRB's final selection, however, has always been based on the paid development method.

In recent years, particularly after the implementation of SB 863 in 2013, it has become increasingly apparent that claims are closing more quickly than in years past. This phenomenon is very likely to cause the paid development method to overestimate ultimate losses. In order to try to prevent such overstatement, the WCIRB has incorporated a Berquist-Sherman adjustment for changes in claim settlement rates to the historical paid loss triangles for both indemnity and medical losses in its filings. In addition, the WCIRB has incorporated the impact of various reforms in the paid development factors. In this filing, the paid medical development factors are adjusted for the impact of SB 1160, and AB 1244 provisions.

In prior filings the WCIRB had also reflected adjustments for the impact of the SB 863 provisions in both the indemnity and medical paid loss development factors. Following a re-evaluation of these adjustments, the WCIRB has determined that the impact of these adjustments has lessened due to the length of time since the effective date of the reforms, and that these adjustments no longer resulted in more accurate estimates of emerging paid losses. Consequently, for this filing the WCIRB has made the methodological change of removing the adjustments for the impact of SB 863 from loss development factors and moving them to the on-level factors as necessary. The Department appreciates the WCIRB's continued efforts in re-evaluating the impact of various reforms, and appropriateness of the adjustments incorporated in the projections.

In our reviews of most of the past filings, we had declined to give any weight to the incurred loss development method, noting that there were several drawbacks with the use of this method, especially on an industrywide basis for the workers' compensation line of insurance. While we had outlined the range of estimates produced by the various actuarial methods utilized by the WCIRB, and provided our commentary on the relative merits of the alternatives, we eventually concluded that the WCIRB's reliance on the paid development method, after adjustment for changes in settlement rates and for the effects of reforms, was appropriate.

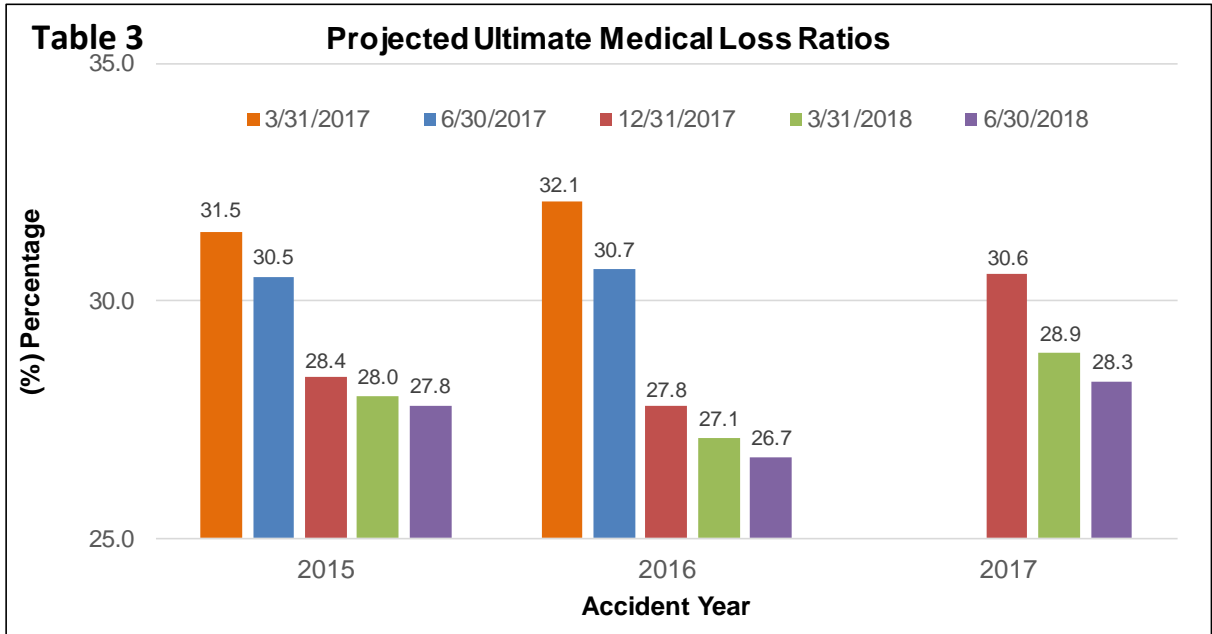
However, in the review of the more recent July 1, 2018 WCIRB Proposed Pure Premium filing we found it appropriate to give some weight to the incurred loss development method for projecting ultimate medical losses, despite the impediments to properly adjust the incurred method. Given the shortcomings identified with the incurred method stated below, we chose to give 75% weight to the WCIRB's paid development method, which included the adjustments for reforms and changes in claim settlement rates, and 25% weight to the unadjusted incurred development method. Our selection was made in

consideration of the strong evidence that the paid development method has been overestimating ultimate medical losses—and can be expected to continue to do so—and that the lower projections based on the incurred method—despite its shortcomings and distortions—could be utilized as an offset to moderate the overstatement in projected ultimate medical losses by the paid method.

The drawbacks with the use of the incurred method lie in the challenges associated with formulating the proper adjustments to make the incurred method more accurate, which include the difficulty of adjusting incurred losses for the impacts of the various reforms that have affected the historical data. Making such adjustments to historical paid loss data is relatively straightforward, but knowing how much the reforms have influenced the setting of case reserves across the entire insurance industry would seem to be well-nigh impossible.

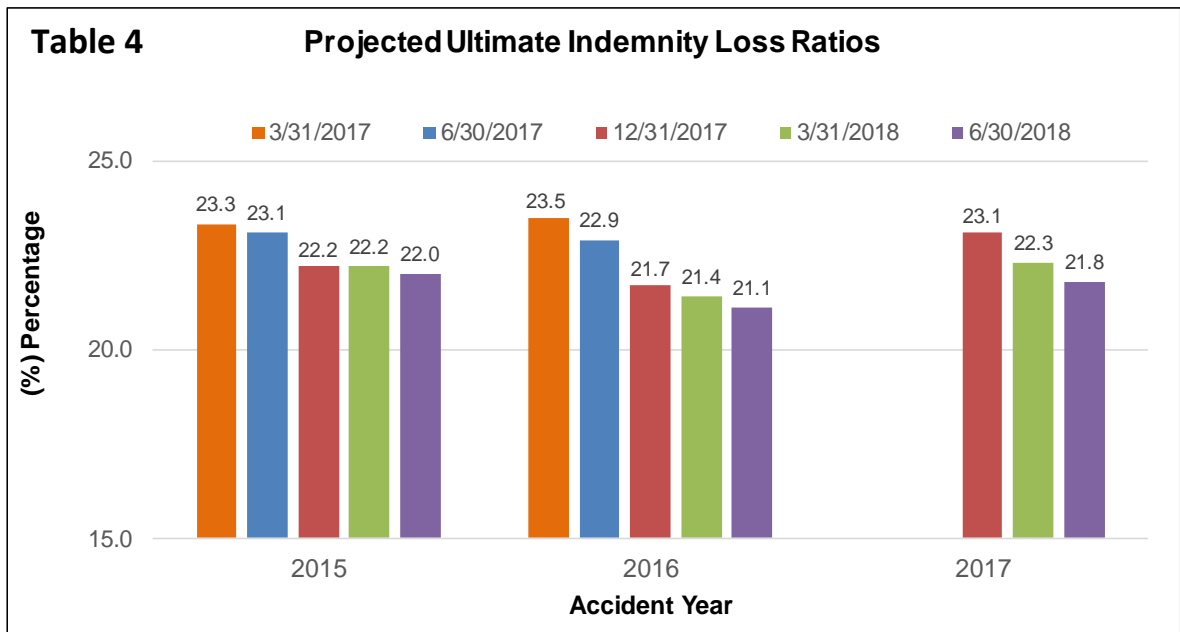
There is also difficulty in adjusting historical case reserve data to the current level of case reserve adequacy when there are likely to have been different claims handling procedures and case reserving philosophies across the industry, as well as a changing mix of insurers over time. Sorting these effects out would also be quite difficult.

On the other hand, despite the use of the Berquist-Sherman adjustment, estimated ultimate medical loss ratios have continued to decline. Information provided in the Hearing and in the Executive Summary of the filing demonstrate that the quarterly evaluations of the latest three accident years' medical losses have shown substantial downward development (see Table 3), and while the decline has moderated over the latest quarter, the accident year 2017 loss ratio has declined by about 7.5% between December 31, 2017 and June 30, 2018. These loss ratios have been adjusted for changing claim settlement rates, as well as impact of SB 1160, and AB 1244 provisions.



Note: All loss ratios are adjusted to the loss development methodology presented in the WCIRB 1/1/2019 filing.

At the same time, the quarterly estimates for indemnity losses have also shown declines in estimated ultimate loss ratios, but are somewhat less pronounced.



Note: All loss ratios are adjusted to the loss development methodology presented in the WCIRB 1/1/2019 filing.

While the Berquist-Sherman adjustment for changes in claim settlement rates should be effective in adjusting for such changes that have already taken place, it cannot anticipate future changes in settlement rates or payment patterns.

Moreover, there are several factors that can be expected to have an impact on shortening the payout pattern for medical losses. Bickmore has provided some commentary on this in its review of this current filing. Bickmore cites three reasons for believing future medical paid loss development patterns will be less than what is indicated from historical patterns. These are that first, permanent disability claims are closing more quickly, while the closing rates for temporary disability claims appear to be relatively stable; second, there has been an increase in the proportion of claims that are closed through compromise and release; and third, the change in the medical fee schedule to a resource-based relative value scale (“RBRVS”) basis should result in higher payments earlier in the life of a claim.

Our evaluation would add to this list the increased use and effectiveness of IMR and the effectiveness of recent lien reforms. While the WCIRB has been able to make an adjustment for the lien reforms, the impacts of IMR, RBRVS, and the increased use of compromise and release settlements on development patterns have been difficult to quantify and are being allowed to work their way through the indications over time. Accordingly, we believe it is appropriate to continue to give some weight to the incurred loss development method for projecting ultimate medical losses in this filing. Hence, we choose to give 75% weight to the WCIRB’s paid development method, which includes adjustments for SB 1160 and AB 1244 provisions and changing claim settlement rates, and 25% weight to the unadjusted incurred development method. However, given the sharp decline in the medical case reserves in recent calendar periods, we use the projected ultimate incurred losses based on the 3 year average incurred development factors for this purpose. This weighting approach should recognize the continuing tendency of the paid development method to overstate ultimate medical losses while still preserving an element of caution that we believe is necessary when estimating future medical costs in California’s uncertain workers’ compensation environment.

Moreover, since the recent level of lien filings has declined in comparison to the assumption incorporated in the WCIRB filing, the Department has adjusted the paid development factors to include a 50% decline in filed liens, as reflected in Attachment A of the document provided by the WCIRB in response to the questions raised in the Hearing. This is discussed in more detail in section (4) of this document.

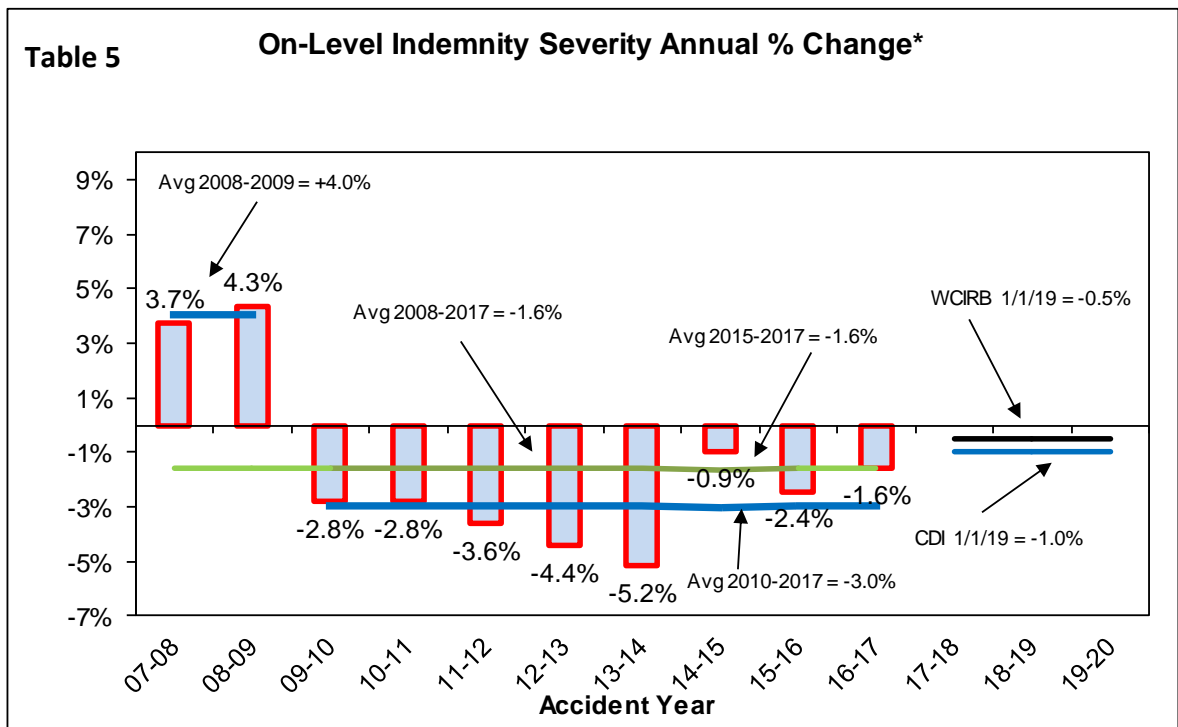
2. Loss Trends

The WCIRB analyzes a range of trending assumptions to roll forward the estimates of ultimate losses developed above to the future time period during which the filing's proposed pure premium rates will be in effect.

The various trend assumptions differ in terms of (1) the particular historical time period used to determine severity and frequency trends, and (2) the experience period that these trends are applied to, in order to roll forward to the future time period of the filing.

The preferred method utilized by the WCIRB has been the use of separate trends for frequency and severity and the application of these trends to the latest two years of experience. The WCIRB has conducted studies to determine the merits of alternative assumptions about trends in various environments such as reform, transition, and recession periods, and used the results to guide its selections based on the perceived current state of the environment.

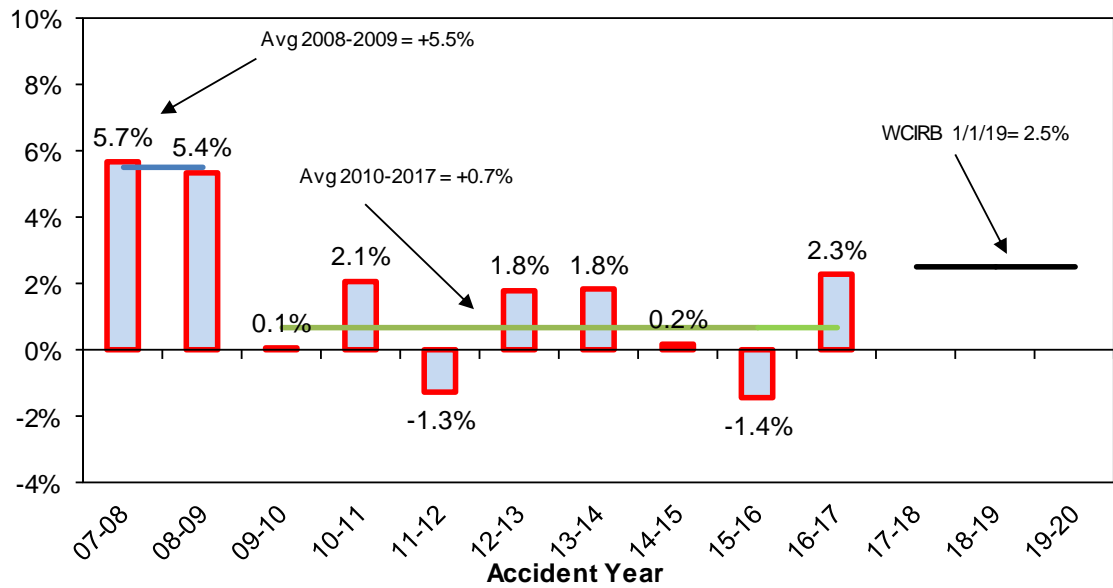
As shown in Tables 5 and 6, indemnity and medical severity trends over the time period 2010-2017 have decreased relative to historical averages prior to 2010, discussed further following the severity and frequency charts, and while the 2017 accident year evaluated as of June 30, 2018, shows a more modest decrease for indemnity compared to the 2010 to 2014 period, the average medical severity for 2017 shows a +2.3% increase.



*Ultimate Indemnity Loss Projections are Based on the Paid Method, and Data Evaluated as of June 30, 2018

Table 6

On-Level Medical Severity Annual % Change*

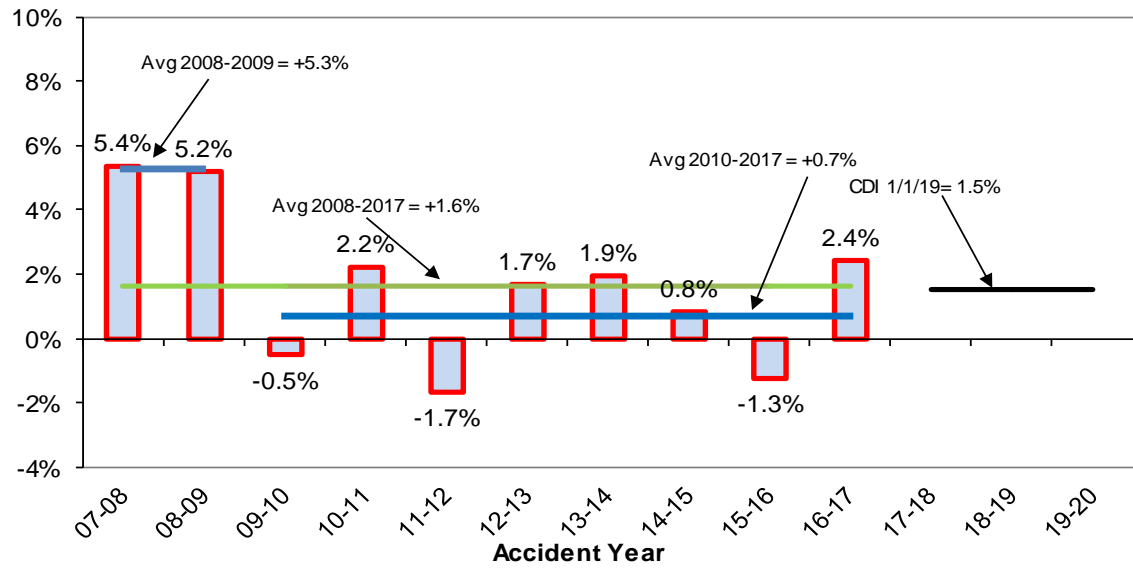


*Ultimate Medical Loss Projections are Based on the Paid Method, and Data Evaluated as of June 30, 2018

The changes in average medical severities in Table 6, as mentioned in the footnote, are based on ultimate medical losses that use the paid loss development method to project losses to ultimate. Table 7 shows the changes in average medical severities based on the department-selected development method, discussed above, which relies on a combination of the paid and incurred development methods.

Table 7

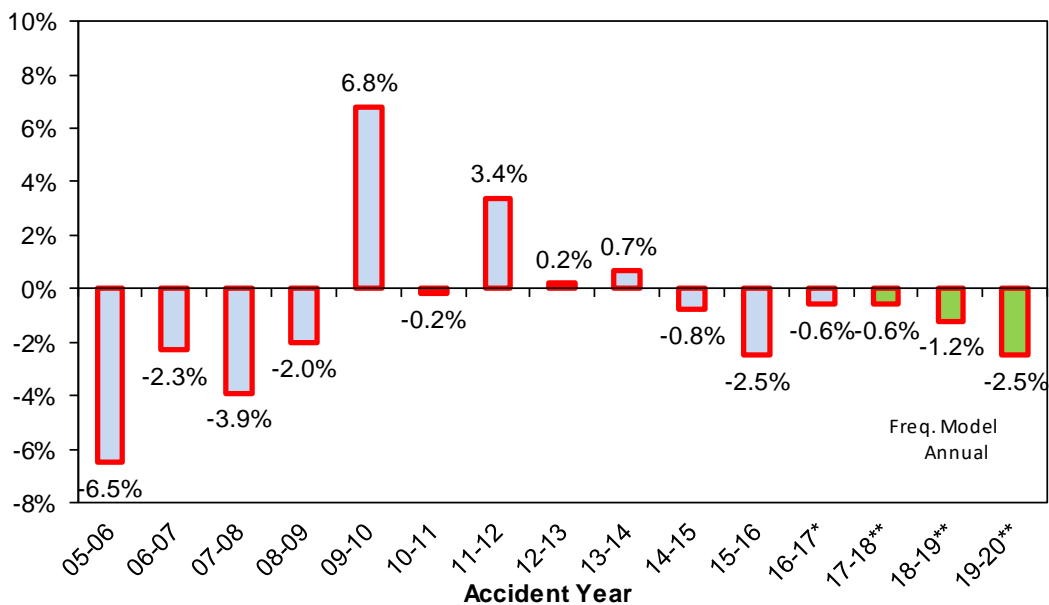
On-Level Medical Severity Annual % Change*



*Ultimate Medical Loss Projections are Based on Mix of Paid and Incurred Methods, and Data Evaluated as of June 30, 2018 (adjustment for additional reduction in liens not included here).

Table 8

Indemnity Claim Frequency Annual % Change



*The 2016-2017 estimate is based on comparison of claim counts based on WCIRB accident year experience as of June 30, 2018 relative to the estimated change in statewide employment. Prior years are based on unit statistical data.

**Projections based on Frequency Model.

We note that the low to negative severity changes indicated for accident years 2010 through 2015 have likely been affected by the unusual changes in frequency shown in Table 8, above, starting in 2010. The pattern prior to 2003 was one of steady, small declines in frequency every year. Following the large decrease in 2006 that can be attributed to the residual impact of the previous round of reform legislation enacted in 2003 and 2004, the modest declines in 2007, 2008, and 2009 were in line with the previous long-term trend. In sharp contrast, 2010 saw a large increase in frequency, and the following years until 2014 have mostly shown flat to increasing frequency, returning most recently to the long-term trend of small annual declines.

In addition, while the estimated changes shown in Table 8 are based on unit statistical plan data for 2016 and earlier periods, for 2017 the estimates also rely on proxies for changes in frequency (i.e. changes in reported aggregate indemnity claim counts compared to changes in statewide employment).

The WCIRB attributes the frequency increases since 2011 to cumulative injury claims, where claims are made with multiple body parts and can include a psychiatric

component, and are more concentrated in the Los Angeles Basin area. The WCIRB has published an in-depth study of the cumulative injury claim patterns earlier this year to provide detailed information on the characteristics of these types of claims, and in its continued efforts to analyze the driver(s) of the frequency pattern.

In terms of methodology, the difference of analyses of the trend issue between the public members' actuary, Bickmore, and the WCIRB is the use of a loss ratio trend versus separate frequency and severity trends. The WCIRB applies separate frequency and severity trends as previously described to the latest two years of the experience period, whereas Bickmore suggests using a loss ratio trend applied to the latest two years. Both the WCIRB and Bickmore agree on the experience period that the trend is applied to on the basis of a study conducted by the WCIRB in regard to the historical performance of various trending methods. Bickmore's annual loss ratio trend selection is based on an exponential fit of pure premium ratios, using accident years 2012 through 2017.

We agree with the WCIRB and Bickmore that the use of two years of experience for the application of the trend is appropriate, as it has also outperformed alternative assumptions based on the WCIRB's most recent study. In examining the merits of the loss ratio trend versus separate frequency and severity trends in various environments, we recognize that separate severity and frequency trends may better reflect the underlying causes in this changing environment. While there is not yet a full understanding of the causes for the changes that are happening, the separate analyses of frequency and severity provides information that the combined trend may smooth or mask.

Following a period of year-over-year decreases in on-leveled indemnity severity between 2010 and 2014, sometimes with sharp declines, the recent decreases in indemnity severity have been more moderate. While the WCIRB has selected a -0.5% annual severity trend for indemnity in this filing, compared to a 0.0% trend selected in the July 1, 2018 filing, we note here that the 2015 through 2017 average change in indemnity severities, similar to the average change between accident years 2008 through 2017, which provides a longer term view, is about -1.6%. Moreover, as reflected in Bickmore's commentary in the review of this current filing, the cap on maximum permanent disability benefits would make it unlikely that in an environment where the projected wage growth is relatively high, the expected growth in the average on-leveled indemnity severity would be positive. It would be informative if WCIRB could perform a study about the impact of the cap on maximum permanent disability benefits on indemnity severity trend. In consideration for the above, the Department has selected an annual indemnity severity trend of -1.0% for this filing.

The Department's staff notes that the medical severity trend of 2.5% selected by the WCIRB in this filing is slightly lower than the 3.0% selected in the July 1, 2018 filing. The WCIRB-selected 2.5% medical severity trend is also comparable to the average on-level medical severity trend over the 2005 to 2017 period, and the estimated on-level medical severity change for 2017. While as shown in Table 6, the average change in medical severities during the 2010-2016 period evaluated as of June 30, 2018 is +0.5%, during the course of evaluation of the recent past filings, similar to the WCIRB, we have been concerned that the latest increase in average medical severity may be a signal for return to higher average medical severity trends observed during the historical post-reform periods.

However, the past few filings have repeatedly shown vanishing spikes in the average medical severities. As a case in point, the initial estimated +5.1% medical severity increase for accident year 2016, as shown in the WCIRB's July 1, 2017 filing (based on data evaluated as of December 31, 2016), increased to +5.7% based on data evaluated as of March 31, 2017, dropped to +3.8% based on data as of June 30, 2017, became almost flat based on data as of December 31, 2017, and -1.4% based on data as of June 30, 2018. Similarly the +5.7% increase in 2017 medical severity based on data as of December 31, 2017, turned into an increase of +3.2% based on data as of March 31, 2018, and +2.3% as of June 30, 2018.

While the Department is sensitive to the WCIRB's concerns about the likelihood of the continued decline in medical average severities that have been observed following the enactment of SB 863, the Department's actuarial staff believes that the favorable impact of subsequent legislation, such as SB 1160 and AB 1244 following the SB 863 enactment, has been a contributing factor to continue the impacts of the SB 863. And while certain attributes of the SB 1160 and AB 1244, such as the reduction in lien filings, have been incorporated into the WCIRB's projected ultimate medical losses, the interaction between these reforms raises the potential to further the realization of the reduction in medical costs, and the postponing of the return to the long term medical inflation trends. As an example, the lower level of lien filings and higher rate of lien dismissals could possibly have an impact on speeding up the claim closure rates, as well as reducing costs.

The Department's actuarial staff appreciates the balance that the WCIRB is trying to achieve in giving some consideration to the more recent trend indications, while recognizing the inherent volatility of severities at early evaluations, the long term medical severity growth rates, the long period over which the medical payments are made, and the high level of increase in average medical severities during the historical post-reform periods. However, while we identify with the need to avoid missing the "turning point"

when past high rates of medical inflation may return, we note that there are differences between the current environment and some of the historical post-reform environments that require consideration.

During the past several years, a sequence of reforms have impacted the California workers' compensation system, starting with the SB 863 reforms in 2013, and continuing with SB 1160, AB 1244, and AB1124, the latter of which became effective in January 2018. Given the timing of these reforms and the interaction between the elements of these reforms, it is not clear whether we are in a post-reform period, as various elements of these reforms are continuing to interact to lower medical costs.

The Department's actuarial staff believe that it is important to keep in mind that the workers' compensation system is an adaptive system where the various service providers respond to changes in the environment brought on by reform or court decisions. We recognize that particular attention needs to be paid to medical trends, as belated recognition of increasing medical costs has been a major problem in the not-too-distant past. However, the average change in medical severities during the 2008-2017 period evaluated as of June 30, 2018, is about 1.6%, and the accident years included in this period build a balance between pre- and post-SB 863 phases. In consideration of factors stated above, the Department is selecting a 1.5% medical severity trend, as shown in Table 7, for this filing, which reflects consideration for both long term and short term changes in the average medical severity, as well as the current environment.

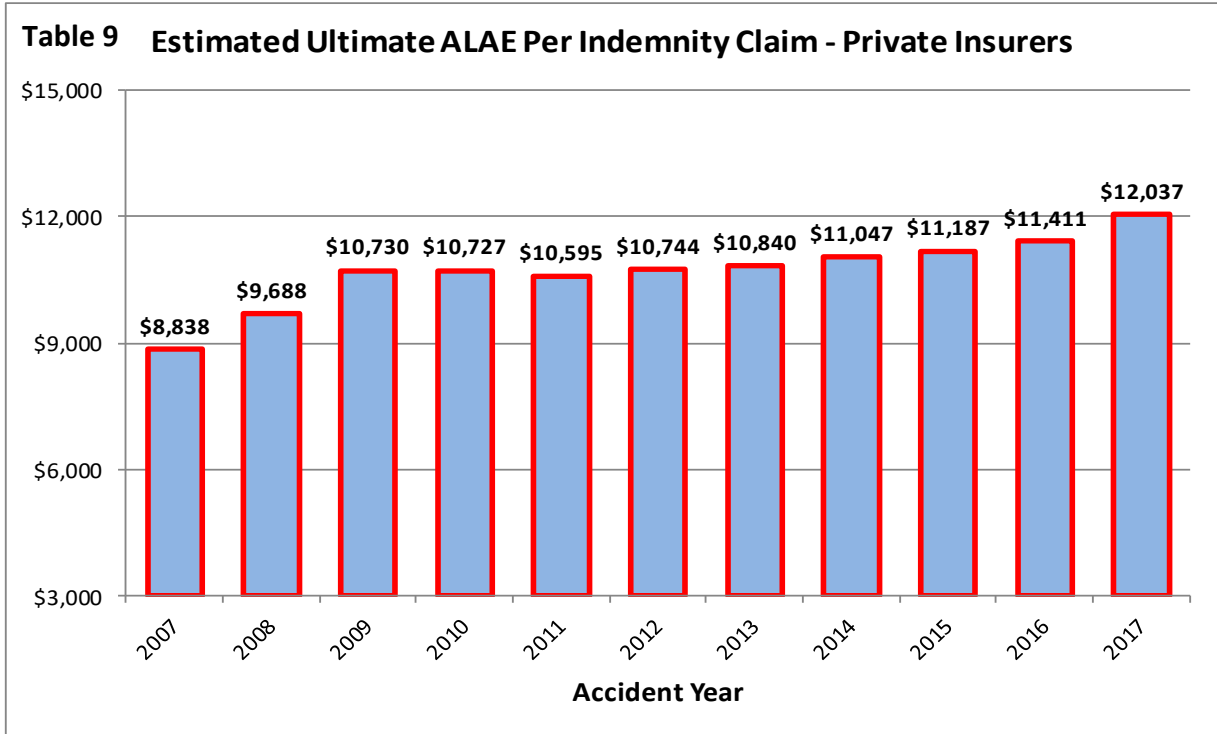
3. Loss Adjustment Expenses

In its determination of the provision for LAE in the proposed rates, the WCIRB developed separate indications for the ALAE and ULAE, and medical cost containment program ("MCCP").

Starting with the January 1, 2015 filing, the WCIRB adopted a change in its methodology to reflect only private carrier data in its evaluation of ALAE and ULAE to avoid distortion due to the impact of the higher expenses of the State Compensation Insurance Fund. The WCIRB has continued to apply this methodology in this current filing. The Department's staff concur with this methodology.

The estimated ultimate ALAE per reported indemnity claim has increased by about 12% following the implementation of SB 863. Although the estimated ALAE for accident year 2017 has improved by about 6% since the prior evaluation as of December 31, 2017, as shown in Table 9, it has had the most significant increase since 2009. While there is an expectation that ALAE costs increase during the immediate periods following the

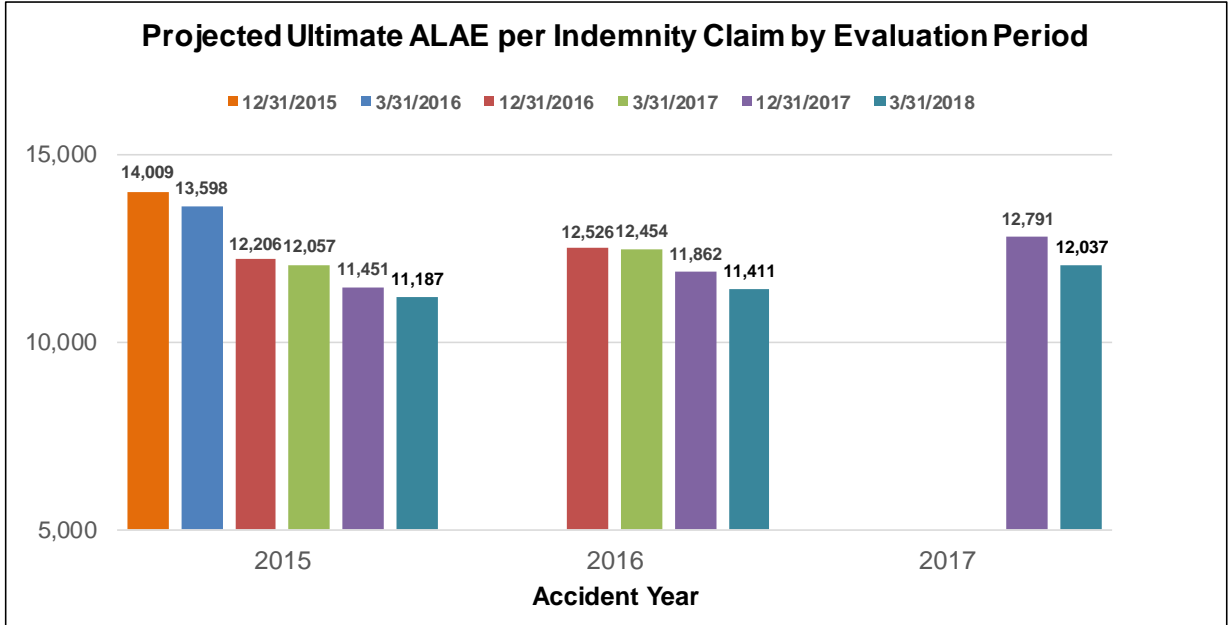
reforms, the sharp increase in ALAE in 2017, compared to 2016, is more than double the increase observed in other periods following the SB 863.



Based on Data as of March 31, 2018.

The sharp increase in average ALAE per indemnity claim raises concerns. However, we recognize that the 2017 data point is still immature and we also wonder whether similar to the indemnity and medical losses, the development factors for ALAE would need to be adjusted for the speed-up in claims settlement rates. Information provided in response to the questions raised during the Hearing, and reflecting the projected ultimate ALAE per indemnity claim at recent quarterly evaluations (see Table 10), shows a downward trend in the projected ultimate ALAE with increased maturity, suggesting a consistent overstatement of the ultimate ALAE. While we recognize that the ALAE development factors are highly leveraged, the persistent downward trend may signal a need for further investigation of the underlying causes.

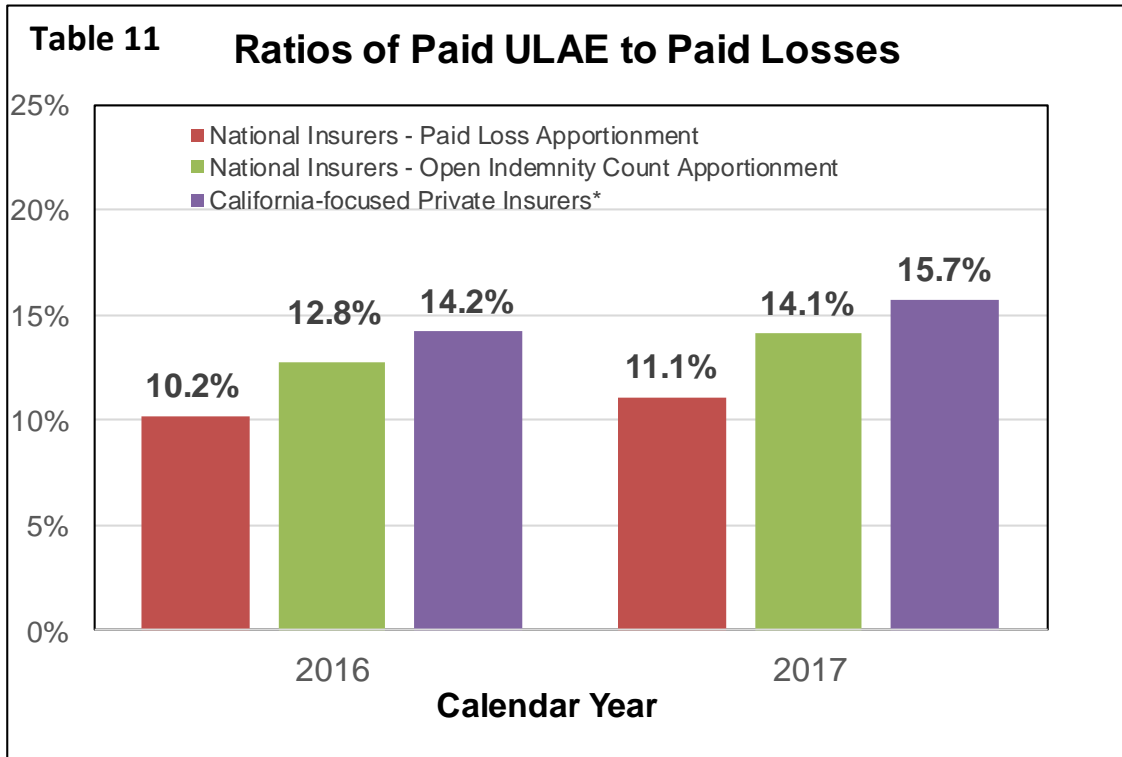
Table 10



Source: WCIRB aggregate financial data for private insurers only and projections

The WCIRB does not give full weight to this immature data point in its projections of ALAE and adjusts the projected ALAE for the impact of SB 1160 and AB 1244 reforms. While the projected ALAE has been adjusted for the impact of SB 1160 and AB 1244, the filing does not include any adjustment to the ULAE for the impact of these reforms.

In this filing the WCIRB has performed an updated analysis of the allocation of national carriers' countrywide ULAE expenses to more completely reflect the additional complexity and duration of California workers' compensation claims. While, in the past, paid losses had been used as the basis to determine California's share of countrywide paid ULAE for national insurers, the updated analysis uses the open indemnity claim count as a basis to apportion the ULAE. As shown in Table 11, using the open indemnity claim count as the basis of apportionment of the ULAE for national insurers has resulted in paid ULAE ratios that are much more comparable to the ULAE ratios for other private insurers that primarily write workers' compensation business in California. The rest of the difference could be attributed to economies of scale, as most of the national insurers tend to be much larger than the California-focused insurers.



Source: WCIRB aggregate financial data as of December 31, 2017

*California-focused Private Insurers are insurers with at least 80% of their workers' compensation writings in California.

This change in methodology has had a significant impact on the ratio of ULAE to losses, which increased by about 19% compared to the July 1, 2018 filing, as shown in Table 12 below.

A comparison of the components of LAE between the prior filing and the current filing is shown below in Table 12. Both ALAE and ULAE have increased as a percentage of losses. In comparison, the ratio of MCCP costs to losses has remained the same.

Table 12

LAE Provision Underlying WCIRB Pure Premium Rate Filings				
	7/1/18 Filing		1/1/19 Filing	
(ALAE ex/MCCP)/Loss	18.5%		18.9%	
MCCP/Loss	4.0%		4.0%	
Total ALE/Loss	22.5%	\$0.30	22.9%	\$0.29
ULAE/Loss	11.4%	\$0.15	13.6%	\$0.17
Total LAE/Loss	33.9%	\$0.46	36.5%	\$0.46
Indicated Pure Premium Rate		\$1.80		\$1.70

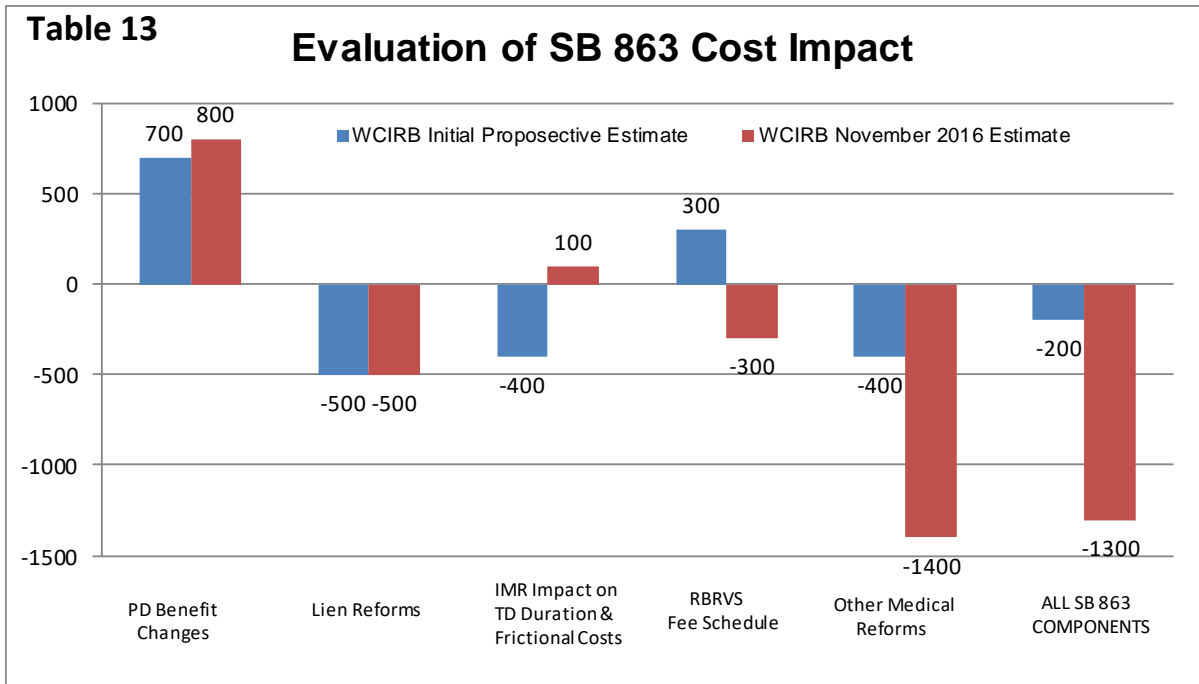
The projected LAE as a percentage of losses considered in the Department’s analysis is 38.3% compared to the WCIRB’s selection of 36.5%. The higher LAE percentage reflects an adjustment for the differences in projected losses in the denominator of the LAE-to-loss ratio and preserves the LAE dollar-value determined by the WCIRB in Attachment A of the document provided by the WCIRB in response to the questions raised in the Hearing, based on the projected LAE evaluated as of June 30, 2018, and adjusted for the more recent level of 50% decline in the lien filings.

4. Impact of SB 863, SB 1160, AB 1244, and AB 1124

In developing its actuarially-indicated pure premium rates, the WCIRB included its updated estimate of the effect of SB 863. In its November, 2016 SB 863 Cost Monitoring Report, which is the latest retrospective report published, the WCIRB estimated that the various provisions of SB 863 have reduced annual system-wide costs by approximately \$1.3 billion, as shown in Table 13, versus an initial assessment of overall savings of \$200 million. The substantial decreases in medical cost projections which have been noted and reflected in filings over the last couple of years have, in large part, been attributed to SB 863. In particular, the impact of IMR on medical costs is thought to represent a substantial portion of the “other medical reforms” component. Assuming this to be true, it far outweighs the increase in frictional costs due to IMRs. The number of eligible IMRs filed has been substantially increasing since 2013 and filed IMR totals for the first six months of 2018 are at a record level high. We appreciate WCIRB’s continuous efforts in reevaluating the impacts of various reforms, some of which are discussed below. As mentioned in the Loss Development section, the WCIRB has performed a retrospective evaluation of the impact of the adjustments incorporated in the loss development factors due to the SB 863 and RBRVS provisions and found that it is no

longer appropriate to reflect these adjustments in the indemnity and medical loss development projections. Medical on-level factors have been adjusted to reflect the estimated impacts of SB 863 and RBRVS that are no longer captured in the development factors.

SB 863 has also resulted in a significant reduction in the utilization of a number of types of medical services, particularly pharmaceuticals. While in the past several pure premium filings, the WCIRB had reflected a 10% reduction in the utilization of medical services resulting from SB 863, for this filing a 17% reduction in utilization is included in the medical on-level factors based on the WCIRB’s retrospective review of updated information. This 17% has been judgmentally spread to accident years 2011 through 2015, based on indications of the relative impact of SB 863 provisions impacting medical utilization on those years’ medical costs.

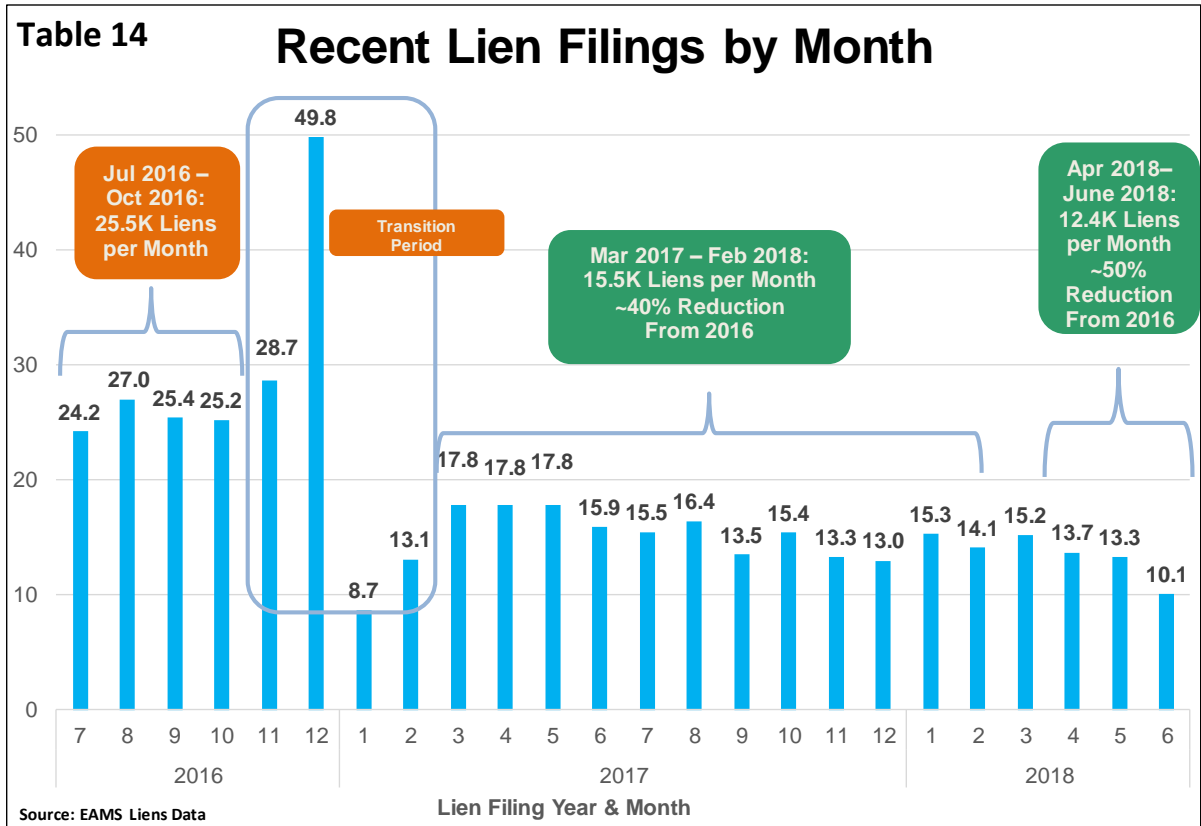


On September 30, 2016, SB 1160 and AB 1244 were signed into law. SB 1160 includes a number of provisions related to utilization review, while SB 1160 and AB 1244 include a number of provisions related to liens. In its January 1, 2017 filing, the WCIRB reviewed the impact of SB 1160 and AB 1244 on losses and loss adjustment expenses for policy year 2017 and estimated the impact at a 0.6% reduction in the indicated pure premium loss costs, which was an approximate savings of \$135 million annually relative to the overall insured and self-insured California workers’ compensation system size of \$22.5

billion. The 0.6% favorable impact was based on an estimated reduction of 10% of liens filed.

Lien activity in 2017 and early 2018 indicated that the reduction in lien volume based on more recent data was in the ballpark of 40%. This reduction level assumed the 2nd quarter of 2016 to be the previous norm, before the transition period of late 2016 through early 2017 started, and the new environment was represented by the March 2017 through February 2018 period. The removal of the transition period from the calculations reflects the concern that the recent reform measures had resulted in many liens being filed before the January 1, 2017 reform effective date, potentially moving some of the 2017 volume into late 2016, and therefore the data for this period is distorted. Accordingly, in the July 1, 2018 pure premium rate filing, the WCIRB reflected a 40% reduction in lien volume in the adjustments applied to the medical loss development factors and the ALAE.

While in this filing the WCIRB has continued to use the 40% reduction in liens as the basis for the adjustments made in consideration for the SB 1160 and AB 1244 provisions, it appears that the number of liens filed through June 2018 have continued to decline, resulting in an approximate 50% reduction based on comparison of the 2nd quarter of 2018 to the 2nd quarter of 2016. In response to the questions raised in the Hearing, the WCIRB provided a sensitivity analysis based on the level of reduction in liens, which showed that the results are not too sensitive to the percentage reduction in lien assumption, and the difference between a 50% and a 40% reduction in liens would correspond to a 0.6% decrease in the indicated average advisory pure premium rates. While the WCIRB is scheduled to reassess these adjustment factors prior to the time of its next filing, the Department has included an adjustment for the higher level of decline in liens in its derived indication for this filing. The adjustments incorporated in the Department's analysis are based on Attachment A of the document provided by the WCIRB in response to the questions raised in the Hearing, and assumes a 50% reduction in liens. Table 14 shows the monthly lien filings between July 2016 and June 2018.



In addition to the volume of the liens filed as part of its evaluations, the WCIRB has reviewed lien settlement amounts and estimated that liens settle for approximately 20% to 30% of the demand amount, depending on the size of the lien. Moreover, information provided on the average lien payments based on the WCIRB medical transaction data showed that average lien payments in 2018 are generally consistent with lien payments in the first half of 2016, which were prior to the enactment of SB1160 and AB1244.

A new medical treatment utilization schedule (“MTUS”) drug formulary as directed by AB 1124 was adopted by the Department of Industrial Relations, Division of Workers’ Compensation, with an effective date of January 1, 2018. The prospective review of the MTUS drug formulary performed by the WCIRB estimated an overall reduction of 0.5% in loss and LAE costs, which were first included in the WCIRB’s July 1, 2018 pure premium rate filing as an adjustment to the overall pure premium rate level. Since sufficient data is not yet available to measure the impact of the MTUS drug formulary based on actual experience, the same adjustment has been included in this filing for the 2019 policy period. The WCIRB intends to have its first retrospective look at the impact of the drug formulary in the near future to reevaluate the impact.

**DETERMINATION OF WORKERS' COMPENSATION CLAIMS COST
BENCHMARK BASED UPON CURRENT FILING**

It is the determination of this Hearing Officer, based upon the current filing and public comments received, that the Insurance Commissioner should adopt advisory pure premium rates that are, on average, 23.5 % less than the insurance industry's average filed pure premium rate of \$2.13 per \$100 of payroll (as of July 1, 2018). Stated another way, the Hearing Officer recommends that the Commissioner adopt an average advisory pure premium rate of \$1.63 per \$100 of payroll. This recommended average rate is proposed for new and renewal policies effective on or after January 1, 2019. The change in the Benchmark is based upon the hearing testimony and an examination of all materials submitted in the record as well as the Actuarial Recommendation and Evaluation set forth above by the Department's actuaries, Mitra Sanandajifar and Giovanni Muzzarelli.

PROPOSED ORDER

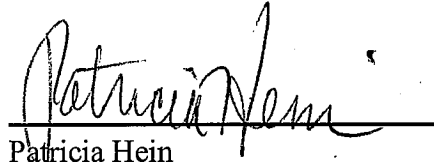
IT IS ORDERED, by virtue of the authority vested in the Insurance Commissioner of the State of California by California Insurance Code sections 11734, 11750, 11750.3, 11751.5, and 11751.8, that the WCIRB's filed advisory workers' compensation pure premium rates and sections 2353.1 and 2318.6 of Title 10 of the California Code of Regulations shall be amended and modified in the respects specified in this Proposed Decision;

IT IS FURTHER ORDERED that the advisory pure premium rates for individual classifications shall change based upon the classification relativities reflected in the WCIRB's filing and consistent with the October 12, 2018 Decision and Order in Filing number REG-2018-00008, to reflect an average Workers' Compensation Claims Cost Benchmark and Advisory Pure Premium rate of \$1.63 per \$100 of employer payroll, to be adjusted to the relative classifications consistent with this Proposed Decision;

IT IS FURTHER ORDERED that these advisory pure premium rates shall be effective January 1, 2019 for all new and renewal policies.

I CERTIFY that this is my Proposed Decision and Order as a result of the hearing held on October 5, 2018, as well as additional written comments entered into the record, and I recommend its adoption as the Decision and Order of the Insurance Commissioner of the State of California.

Date: November 6, 2018

A handwritten signature in cursive script, appearing to read "Patricia Hein", written over a horizontal line.

Patricia Hein
Attorney IV