

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

PROPOSED DECISION AND ORDER

**JANUARY 1, 2020 WORKERS' COMPENSATION CLAIMS COST
BENCHMARK AND ADVISORY PURE PREMIUM RATES**

FILE NUMBER REG-2019-00020

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, 2020.

SUMMARY OF PROCEEDINGS

The California Department of Insurance ("Department") held a public hearing in the above captioned matter on October 14, 2019, at the time and place set forth in the Amended Notice of Proposed Action and Notice of Public Hearing, File Number REG-2019-00020, dated September 9, 2019 ("Notice"). A copy of the Notice is included in the record. The record closed on October 16, 2019 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, 2019, 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 January 1, 2019, 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, 2020. The WCIRB recommended an average pure premium rate of \$1.58 per \$100 of payroll, which is 5.4% less than the approved pure premium rates as of January 1, 2019.

The Department accepted testimony and written comments at a hearing in San Francisco on October 14, 2019, 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 16, 2019. After the hearing and before the closure of the record, the Department received into the record additional comments from the WCIRB and Bickmore, the public members' actuary. The matter was submitted for decision at 5:00 p.m. on October 16, 2019. 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, 2020. 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.

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 \$1.58 per \$100 of payroll¹ in its January 1, 2020 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 \$1.52 per \$100 of payroll. The most recently available industry average level of pure premium rates filed by insurers with the Department is \$1.99² per \$100 of payroll as of July 1, 2019. While the indicated pure premium rate level represents our central estimate, and thus our recommendation, we note that the WCIRB's estimate of \$1.58 is within a reasonable actuarial range.

The WCIRB's proposed pure premium rate level of \$1.58 is based on data evaluated as of March 31, 2019. In contrast, both the Department's and

¹ Includes the impact of new payroll limitations applicable to five classifications that were approved by the Insurance Commissioner to be effective in 2020.

² Adjusted to reflect the new payroll limitations for the five classifications adopted to be effective in 2020, to be comparable to the average of the proposed January 1, 2020 advisory pure premium rates. Without adjustment for the impact of these payroll limitations, the industry average filed rate as of July 1, 2019 is \$1.89 per \$100 of payroll.

Bickmore's analyses utilize the data as of June 30, 2019. While the WCIRB reviewed the data evaluated as of June 30, 2019, 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, 2019 data (\$1.56 versus \$1.58). However, the data was provided to the Department and the general public. Moreover, the WCIRB evaluated the impact of updated UCLA wage forecast as of September 2019 on the indication based on June 30, 2019 data, and determined that it would reduce the pure premium rate level from \$1.56 to \$1.55 per \$100 of payroll. The updated wage forecast as of September 2019 has not been incorporated in the Department's analysis, given that the impact is insignificant, when considered with the other assumptions incorporated in the Department's analysis³.

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 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 2019 produced an average charged rate of \$2.04, which compares to \$2.25 and \$2.53 observed in 2018 and 2017 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 \$2.04 for the first quarter of 2019 (which reflects all insurer expenses) was approximately 22% more than the Insurance Commissioner's adopted January 1, 2019 average advisory pure premium rate of \$1.67⁴, which reflects loss and loss adjustment expense only. It was also approximately 28% less than the industry average filed

³ As discussed in the LAE section, the Department preserves the dollar-value of LAE as reflected in WCIRB filing based on data as of March 31, 2019, in determination of the pure premium rate level.

⁴ Updated from Insurance Commissioner's adopted January 1, 2019 Pure Premium Rate of \$1.63 based on updated exposure weights by classification and the impact of the new payroll limitations for the five classifications adopted to be effective in 2020.

manual rate of \$2.82⁵, thus indicating the average effect of schedule rating and other rating plan credits.

As of March 31, 2019, the WCIRB estimates overall industry combined ratios at or below 85% for accident years 2014 through 2017, and a combined ratio of 91% for accident year 2018. After a period of combined ratios in excess of 100% over the 2008 through 2012 accident years, the 2018 accident year is the sixth consecutive year for the industry with a projected combined ratio at or below 92%. However, current charged rate levels are somewhat lower than the charged rates that underlay the combined ratios for accident years 2015 through 2018.

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"), unallocated loss adjustment expense ("ULAE") and medical cost containment programs ("MCCP"); 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 based on its middle scenario. 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's middle projection.

⁵ Includes adjustment for the new payroll limitation adopted to be effective in 2020 for five classifications.

Table 1	WCIRB Filed Rates								Bickmore		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
	7/1/15	1/1/16	7/1/16	1/1/17	7/1/17	1/1/18	7/1/18	1/1/19	1/1/20	1/1/20	1/1/19
Medical \$	1.14	1.10	1.00	0.95	0.87	0.84	0.76	0.70	0.65	0.59	0.69
Indemnity \$	0.72	0.69	0.70	0.67	0.64	0.63	0.58	0.54	0.51	0.48	0.48
LAE \$	0.61	0.63	0.61	0.60	0.51	0.49	0.46	0.46	0.42	0.45	0.46
Total \$	\$ 2.47	\$ 2.42	\$ 2.30	\$ 2.22	\$ 2.02	\$ 1.96	\$ 1.80	\$ 1.70	\$ 1.58	\$ 1.52	\$ 1.63
Industry Avg Filed PP Rate						\$ 2.22	\$ 2.13	\$ 1.99			
Industry Avg Filed Manual Rate (with expenses)						\$ 3.28	\$ 3.10	\$ 2.82			
Industry Avg Charged Rate (net discounts)						\$ 2.46	\$ 2.38	\$ 2.04			

Table 2		Impact of Difference in Assumptions & Methods Between WCIRB and Alternative Recommendations						
	Recommended 1/1/2020 Pure Premium Rates		Evaluation Date*	Ultimate Medical and Indemnity	Medical Severity Trend	Indemnity Severity Trend	Claim Frequency	Loss Ratio Trend
		Total						
WCIRB	\$1.58							
CDI	\$1.52	-3.8%	-1.3%	-0.6%	-1.3%	-0.7%	0.0%	N/A
Bickmore (Middle)**	\$1.52	-3.9%	-1.1%	-2.1%	N/A	N/A	N/A	-0.7%

*Does not include impact of updated UCLA wage forecast as of September 2019.

**Bickmore percentage impacts is based on the information provided in October 7, 2019 written testimony.

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 of ultimate medical losses. 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. Similar to the January 1, 2019 filing, the cumulative paid medical development factors have been adjusted for the impact of SB 1160, and AB 1244 lien- related provisions. The updated impact reflects the considerably higher decline in the filed liens in the most recent calendar period.

In this filing, WCIRB has also made an adjustment to the paid losses underlying the paid medical development factors for the impact of the significant decline in pharmaceutical costs, which represent a much larger proportion of later period development compared to earlier periods (i.e. varies widely by maturity) and, if left unadjusted, would distort projected age-to-age medical development factors. The adjustments have been determined following a study performed by WCIRB this year.

The Department appreciates the WCIRB's continued efforts in re-evaluating the impact of various reforms and suitability of the adjustments incorporated in the projections, as well as conducting studies to monitor appropriateness of the projections.

In our reviews of filings prior to July 1, 2018, 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.

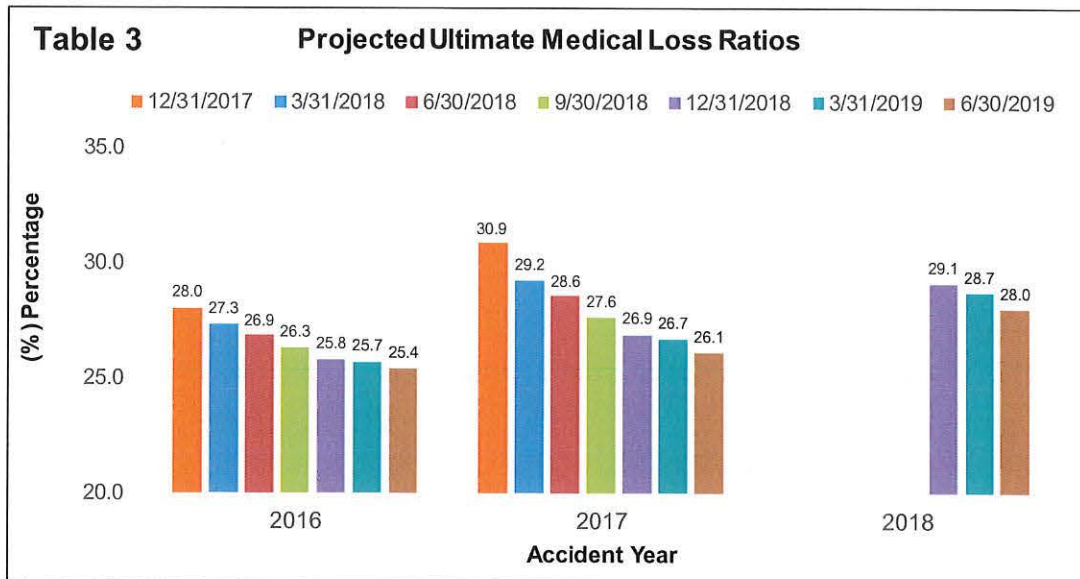
However, in the review of the July 1, 2018 WCIRB proposed pure premium rate filing, we found it appropriate to give some weight to the incurred loss development method for projecting ultimate medical losses, despite the impediments to properly adjust the incurred method. Given the shortcomings identified 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.

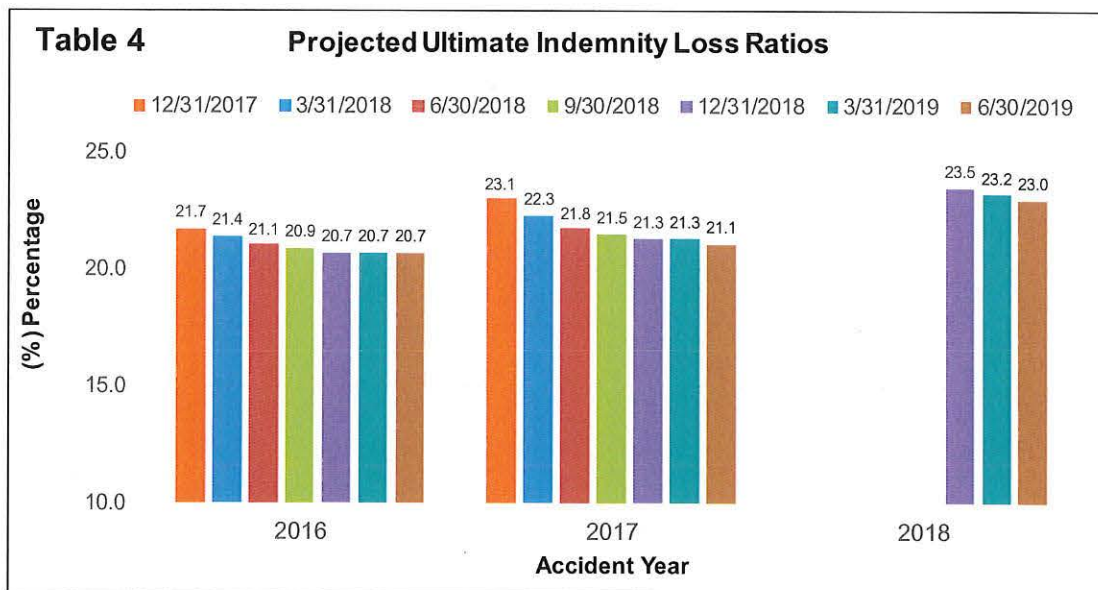
There is also difficulty in adjusting historical case reserve data to the current level of case reserve adequacy when there are likely to have been different claims handling procedures and case reserving philosophies across the industry, as well as a changing mix of insurers over time. Sorting these 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' ultimate medical losses have shown continued downward development since December 2017 (see Table 3), and while the decline has moderated over the last few quarters, the accident year 2018 loss ratio has declined by about 3.8% between December 31, 2018 and June 30, 2019, and during the same period, the loss ratio for the more mature accident year 2017 also declined by 3.0%. These loss ratios have been adjusted for changing claim settlement rates, the impact of pharmaceutical cost reductions to bring the historical payments to the current pharmaceutical cost level, as well as the impact of SB 1160, and AB 1244 provisions.



Note: All loss ratios are adjusted to the loss development methodology presented in the WCIRB 1/1/2020 filing.

At the same time, the quarterly estimates for indemnity loss ratios show that while accident year 2018 has declined by about 2.1% between December 31, 2018 and June 30, 2019, the estimated ultimate losses for more mature accident years seem to have more or less stabilized in recent two quarters.



Note: All loss ratios are adjusted to the loss development methodology presented in the WCIRB 1/1/2020 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 increasing at a much slower pace; second, the change in the medical fee schedule to a resource-based relative value scale ("RBRVS") basis should result in higher payments associated with medical services that occur earlier in the life of a claim; and third, IMR has most likely sped up the resolution of medical disputes, thus speeding up the payments for medical benefits.

Our evaluation would add to this list the significant reduction in opioid use and the effectiveness of recent lien reforms. While the WCIRB has been able to make an adjustment for the lien reforms, the indirect impacts of IMR, RBRVS, and the significant reduction in opioid use and other narcotics on future development of indemnity and medical losses have been difficult to quantify and are being allowed to work their way through the indications over time.

As an example, based on the information provided in the Hearing, and reflected in WCIRB's study⁶, claims that involve high-risk opioid use are about two to three times more costly both on the medical and the indemnity side, and are almost twice as likely to remain open after four years compared to similar lower-dose opioid use claims that are essentially identical in all aspects except for the level of opioid use. Given that the differences in cost and proportion of permanent disability for claims subject to high-risk opioid usage appear to be more pronounced beyond four years since injury date⁷, the impact of reduced opioid use, and more appropriate courses of treatment for injured workers (which may have shifted the cost to earlier development periods), on future development of indemnity and medical losses for these accident years may not have been fully realized.

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 the impact of pharmaceutical cost reductions to bring the historical payments to the current pharmaceutical cost

⁶ See Item AC 19-04-03 of the April 2, 2019 WCIRB Actuarial Committee Agenda.

⁷ WCIRB Study, "Early Indicators of High-Risk Opioid Use and Potential Alternative Treatments."

level, changing claim settlement rates, and SB 1160 and AB 1244 provisions, 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.

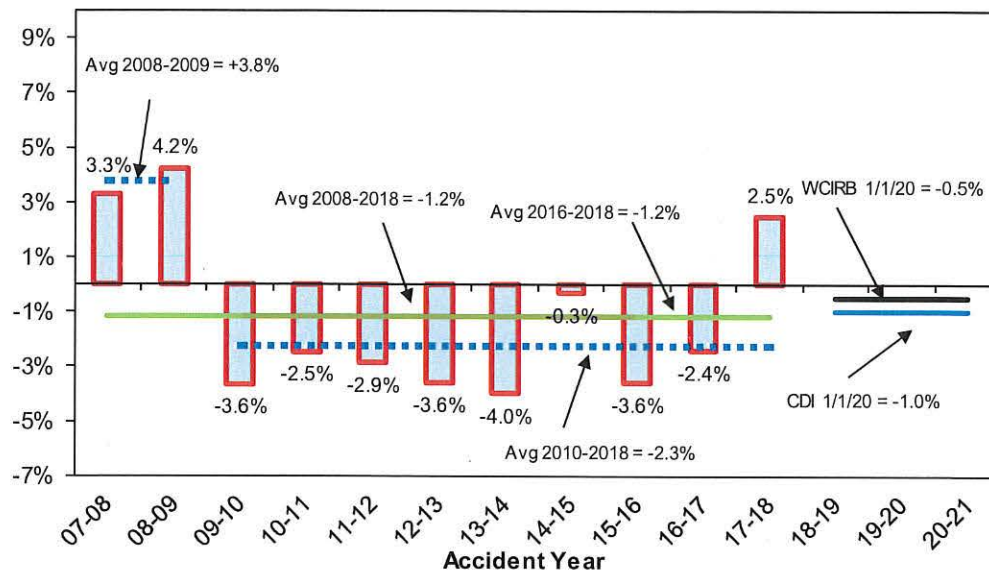
2. Loss Trends

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.

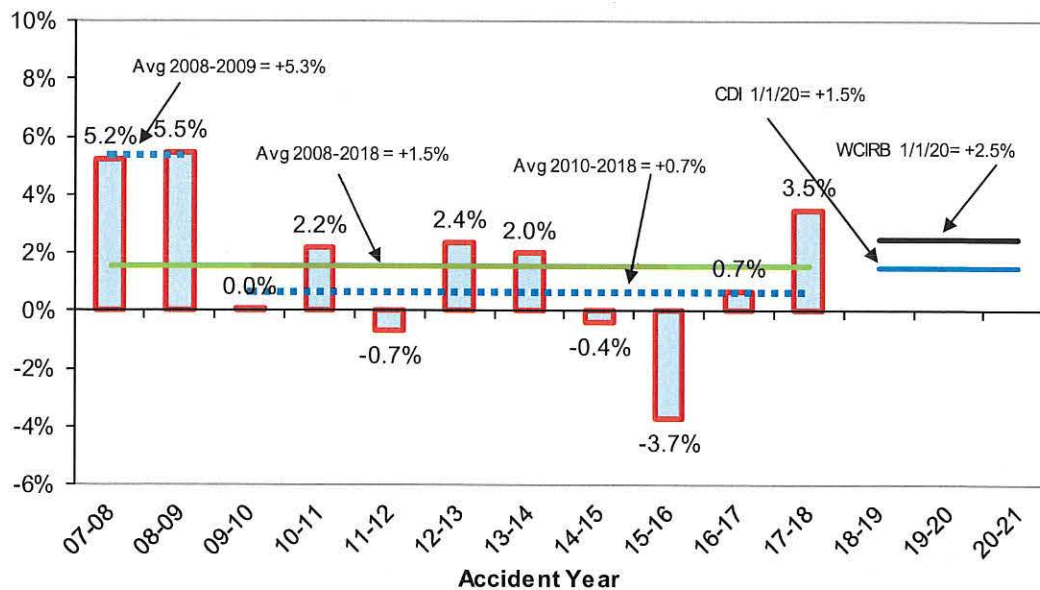
The various trend assumptions differ in terms of (1) the particular historical time period used to determine severity and frequency trends, and (2) the experience period that these trends are applied to, in order to roll forward to the future time period of the filing.

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 2010-2018 have decreased relative to historical averages prior to 2010, discussed further following the severity and frequency charts. The 2018 accident year evaluated as of June 30, 2019, shows moderate increases for both indemnity and medical severities.

Table 5**On-Level Indemnity Severity Annual % Change***

*Ultimate Indemnity Loss Projections are Based on the Paid Method, and Data Evaluated as of June 30, 2019

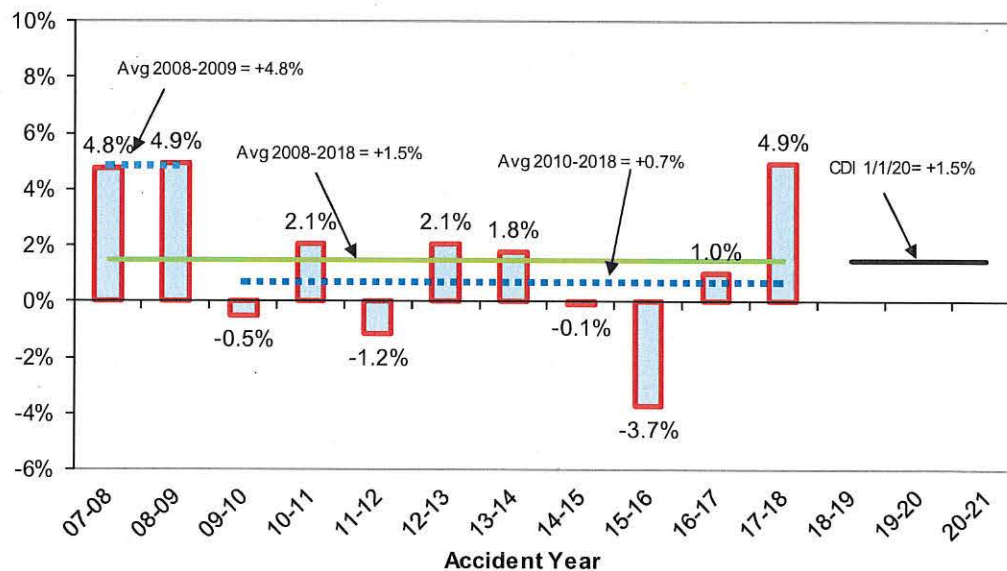
Table 6**On-Level Medical Severity Annual % Change***

*Ultimate Medical Loss Projections are Based on the Paid Method, and Data Evaluated as of June 30, 2019

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. While the individual data points may differ between Tables 6 and 7, the averages remain the same.

Table 7

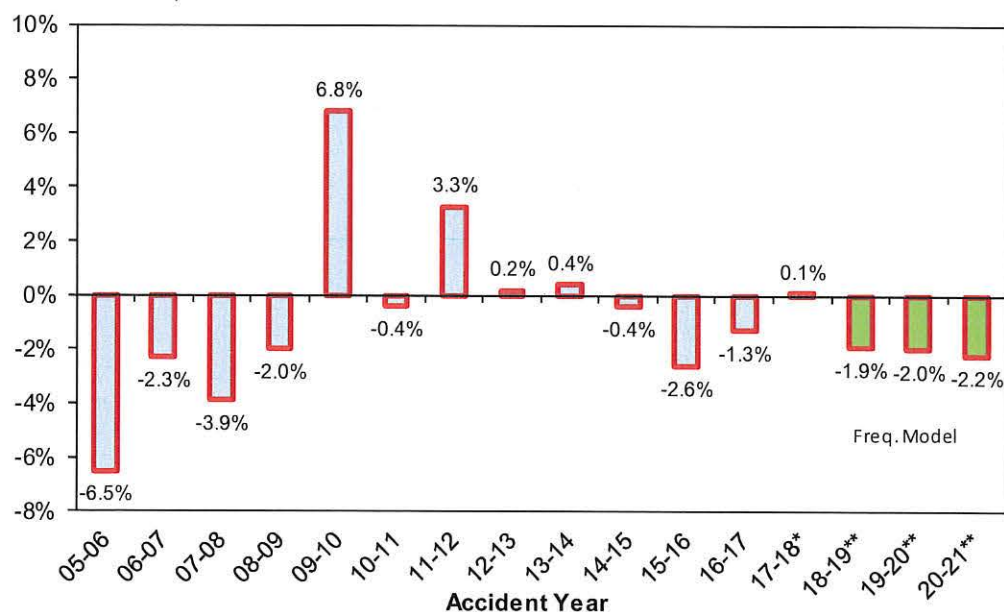
On-Level Medical Severity Annual % Change*



*Ultimate Medical Loss Projections are Based on Mix of Paid and Incurred Methods, and Data Evaluated as of June 30, 2019

Table 8**Indemnity Claim Frequency Annual % Change**

As of March 31, 2019



*The 2017-2018 estimate is based on comparison of claim counts based on WCIRB accident year experience as of March 31, 2019 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 unusual changes in claim frequency shown in Table 8 above for accident years 2010 through 2012 were due to extraordinary circumstances following the great recession of 2008-2009. 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 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 2017 and earlier periods, for 2018 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 ("CT") claims, where claims are much more likely to involve multiple body parts,

often include a psychiatric component, and are more concentrated in the Los Angeles Basin area. A significant portion of CT claims are filed post-termination of the employee, and had been initially denied. The WCIRB has published an in-depth study of the cumulative injury claim patterns in 2018 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 2013 through 2018.

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 2017, sometimes with sharp declines, the 2018 accident year shows an increase in indemnity severity of +2.5% based on data as of June 30, 2019. While the WCIRB has selected a -0.5% annual severity trend for indemnity in this filing, we note here that the 2016 through 2018 average change in indemnity severities, similar to the average change between accident years 2008 through 2018, which provides a longer term view, is about -1.2%. In addition, the uptick in the indemnity severity for 2018 has moderated from +3.0% as of March 31, 2019 to +2.5% with one additional quarter of data. Moreover, given that at this stage in maturity, the underlying losses are mostly from temporary disability claims, which have higher indemnity benefits, but comprise about fifty percent of the indemnity claim counts, it does not appear that this one data point should be considerably relied upon in determination of future trend.

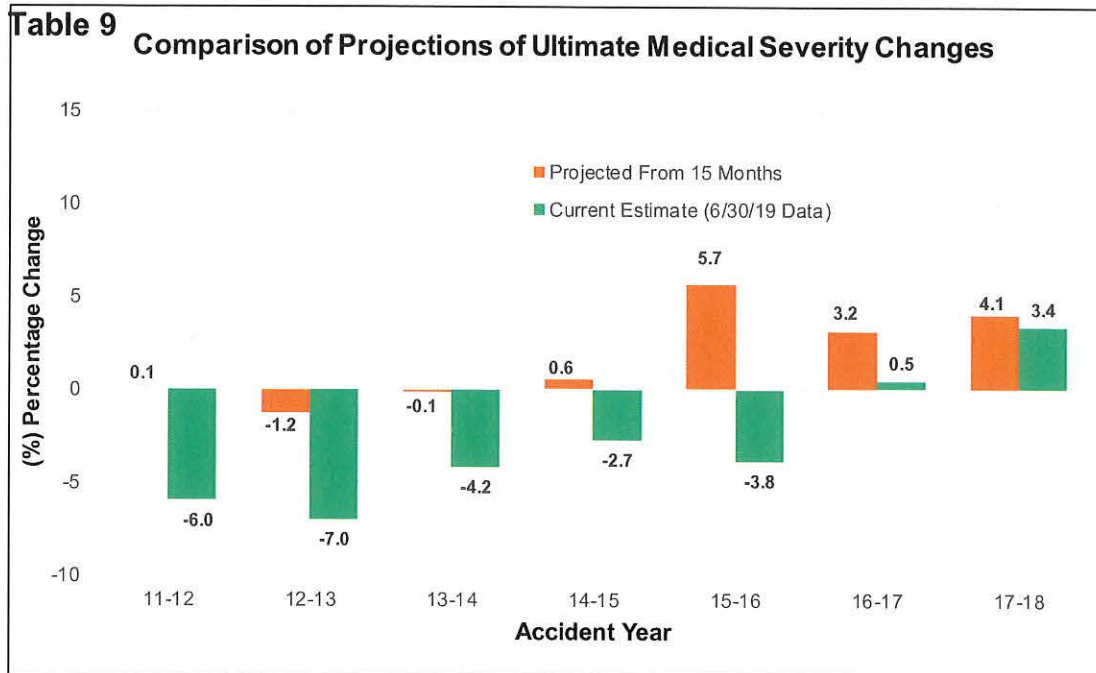
In review of the WCIRB January 1, 2019 filing the Department conjectured that the cap on maximum permanent disability weekly benefits would make it unlikely that the expected growth in the on-leveled indemnity severity would be positive in an environment where the projected wage growth is relatively high, citing Bickmore's testimony. Since then, the WCIRB performed an analysis on the impact of wage inflation on indemnity benefit levels and found that although there is a modest diminishing impact of wage inflation on indemnity benefits resulting from the cap on permanent disability weekly benefit, the relatively low permanent disability weekly maximum is not perceived to have a significant impact on the indemnity severity trend. The Department is appreciative of the WCIRB performing this study and clarifying that the WCIRB's model already accounts for the different impacts on temporary and permanent disability benefits, and therefore any impact on indemnity severity due to the above stated provisions would be minimal.

The impact of wage inflation on the indemnity severity trend was an additional consideration alluded to by the Department in the selection of a -1.0% annual indemnity severity trend in the prior filing; however the Department did not principally rely on this information for making the selection. Similar to the prior filing, the Department selects a -1.0% annual indemnity severity trend, based on consideration given to long term and short term changes in indemnity severity, and the notion that there is not yet strong evidence that the latest uptick is a turning point for the observed pattern in the indemnity severity.

The Department's staff notes that the medical severity trend of +2.5% selected by the WCIRB in this filing is comparable to the average on-level medical severity trend over the 2005 to 2018 period evaluated as of March 31, 2019, and is lower than the estimated on-level medical severity change for 2018. While as shown in Table 6, the average change in medical severities during the 2010-2018 period evaluated as of June 30, 2019 is +0.7%, 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 -1.4% based on data as of June 30, 2018, and is currently -3.7% evaluated as of June 30, 2019. 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 +0.7% as of June 30, 2019. Table 9 compares the projections of ultimate medical severity changes as of 15 months to the estimated change in severity as of June 30, 2019.



Source: WCIRB aggregate financial data and projections. Excludes MCCP costs. All ultimate losses are based on the WCIRB projections. Severities are not on-leveled.

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 enactment of SB 863, has been a contributing factor to continue the impacts of SB 863. And while certain attributes of 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. Another example is reduction in opioid use, which may facilitate earlier return to work, and result in lower indemnity and medical costs. Moreover, as discussed in the development section, the significant reduction in opioid use, and the increased utilization of alternative medical services, appears to have the effect of shifting the cost to earlier development periods, where alternative

treatments such as physical medicine, along with evaluation and management, comprise a significant portion of payments for medical services.

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 in conjunction with anti-fraud efforts, 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 2008-2018 period evaluated as of June 30, 2019, is about 1.5%, 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 Tables 6 and 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

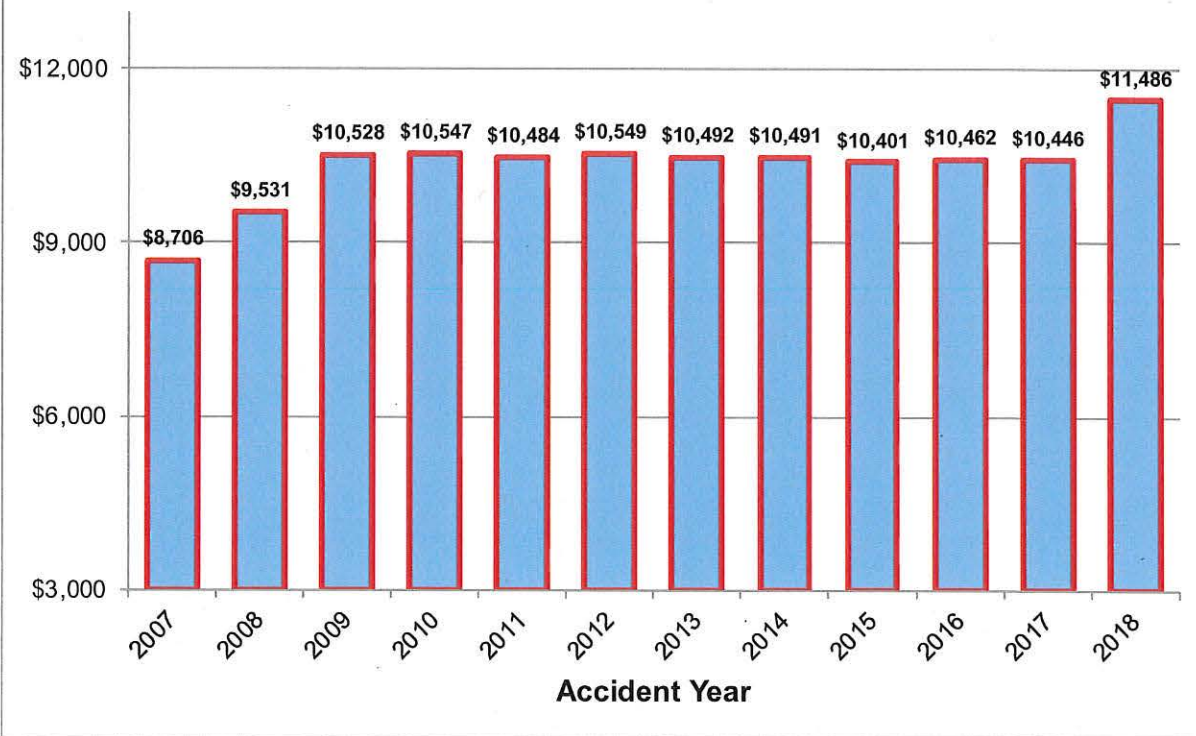
In its determination of the provision for LAE in the proposed rates, the WCIRB developed separate indications for the ALAE and ULAE, and medical cost containment programs ("MCCP").

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.

ALAE

After several evaluations underlying the past filings where the estimated ultimate ALAE per indemnity claim showed steady increases following the implementation of SB 863, the March 31, 2019 evaluation of the estimated ultimate ALAE per indemnity claim shows relatively flat ALAE per indemnity claim between 2009 and 2017 (Table 10). While there is an expectation that ALAE costs decrease after the immediate periods following the reforms have elapsed, the ultimate ALAE per indemnity claim does not show a pattern of decline in more recent periods, given the length of time since the enactment of SB 863. This may be the consequence of the additional legislation that followed SB 863, as noted in the development and trend sections, inducing higher than expected ALAE costs, while reducing medical costs.

Table 10 Estimated Ultimate ALAE Per Indemnity Claim - Private Insurers



Based on Data as of March 31, 2019.

In the review of the January 1, 2019 WCIRB pure premium rate filing, the Department noted that the projected ultimate ALAE per indemnity claim at recent quarterly evaluations had shown a downward trend in the projected ultimate ALAE with increased maturity, suggesting a consistent overstatement of the ultimate ALAE, and questioned whether an adjustment due to the speed-up in claims settlement rates would be needed to more accurately project ultimate ALAE.

The WCIRB performed a study to explore the potential impact of claim settlement rate changes on paid ALAE development prior to this filing, and determined that while the changes in claim settlement rates do not appear to significantly impact paid ALAE age-to-age development factors during the period of the change in settlement rates, there is a negative correlation between changes in claim settlement rates in earlier periods and the ALAE development that emerges in later periods, for a given accident year. The Department appreciates the WCIRB's efforts in researching the impact of changes in settlement patterns on ALAE projections, and finding an appropriate way to incorporate the results of the study.

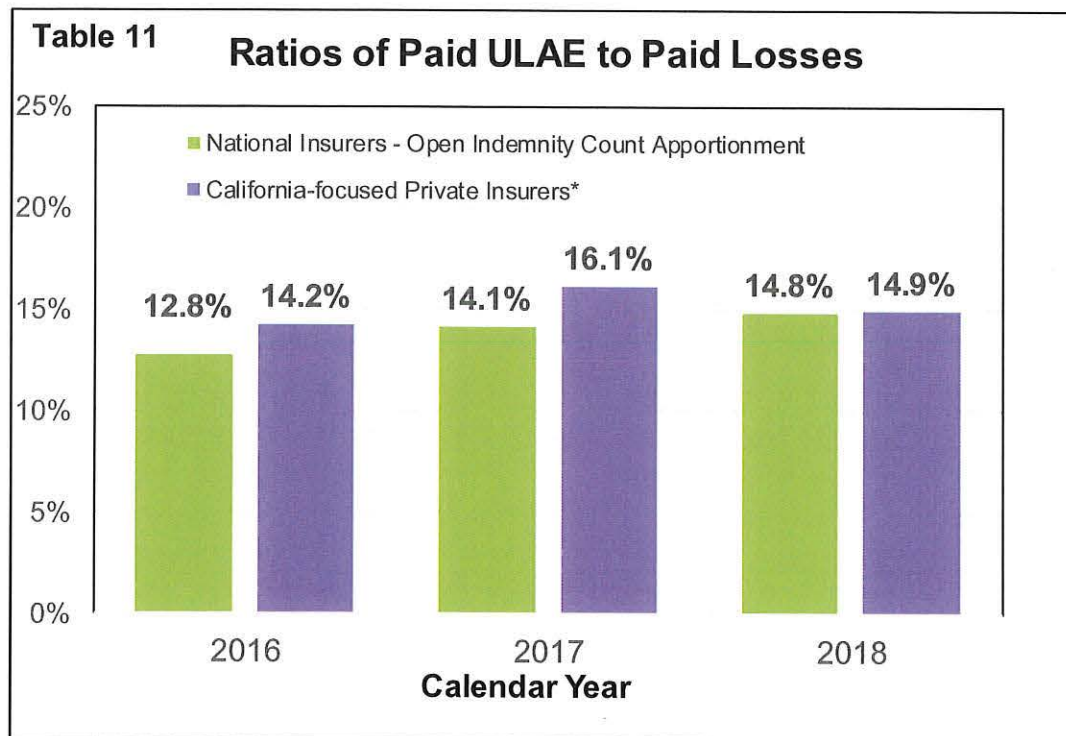
In this filing the WCIRB has incorporated an adjustment to the ALAE age to ultimate development factor for the 2017 accident year based on the results of the above mentioned study, given the significant increase in claim settlement rates between the 2016 and 2017 accident years as of 27 months.

The 2018 data point displayed in Table 10 shows an increase of about 10% over average ALAE per indemnity claim for accident year 2017. However, this data point is still immature, and similar to prior accident years, the 2018 average ALAE per indemnity claim may moderate over time. As an example, the estimated ultimate ALAE per indemnity claim for accident year 2017 declined by more than 13% between the March 31, 2018 and March 31, 2019 evaluations, about 2.8% of which has been due to the adjustment made to the age to ultimate development factor for this accident year in consideration for the level of increase in claim settlement rate observed at 27 months. In addition, since the 2017 accident year age to ultimate ALAE development factor has been adjusted for higher claim settlement rates as of 27 months, but no adjustment has been made to the 2018 age to ultimate development factor, the difference between the 2017 and 2018 accident years increases from about 7% before adjustment to ALAE development factors to about 10% following the adjustment.

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.

ULAE

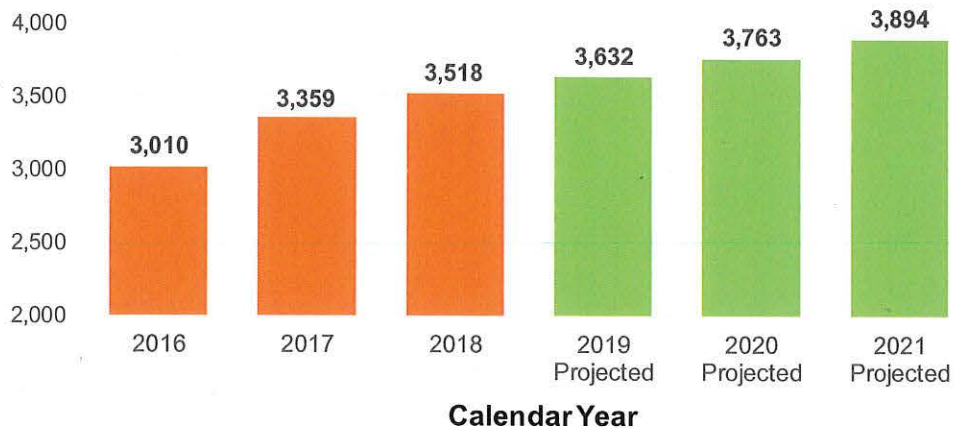
Similar to the January 1, 2019 filing, the WCIRB has allocated national carriers' countrywide ULAE expenses on the basis of open indemnity claim count, in order to more completely reflect the additional complexity and duration of California workers' compensation claims. The allocation method uses the open indemnity claim count as a basis to apportion the ULAE, compared to the method utilized before the January 1, 2019 filing that had used paid losses to determine California's share of countrywide paid ULAE for national insurers. As shown in Table 11, using the open indemnity claim count as the basis of apportionment of the ULAE for national insurers' results in paid ULAE ratios that are comparable to the ULAE ratios for other private insurers that primarily write workers' compensation business in California. The rest of the difference, which appears to be negligible for the 2018 calendar year, 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, 2018

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

The average paid ULAE per open indemnity claim, as well as the ratio of paid ULAE to paid losses increased significantly in Calendar Year 2017, and has remained relatively at the same level, i.e. a modest increase in 2018, considering wage inflation. Information provided in response to the questions raised during the hearing, point to a number of attributes in the current environment that tend to have an indirect impact on the ULAE costs such as higher number of IMRs that need to be processed by the claims department before forwarding them for review, a higher number of expedited hearings, and additional work imposed on the claims departments by providers who try hard to receive payments, before they would need to file a lien due to the statute of limitations. It is not clear which of these indirect causes have been the major driver of the increase between 2016 and 2017. However, given that the 2018 ULAE level seems to be similar to 2017, it may be the case that the more influential of these impacts have reached equilibrium. Also, the WCIRB projections based on the paid ULAE per open indemnity method account for wage inflation, and trend the ULAE costs to the prospective period by applying California average annual wage level changes based on UCLA and California Department of Finance Forecasts, as shown in Table 12.

Table 12**Paid ULAE per Open Indemnity Claim -- Private Insurers**

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

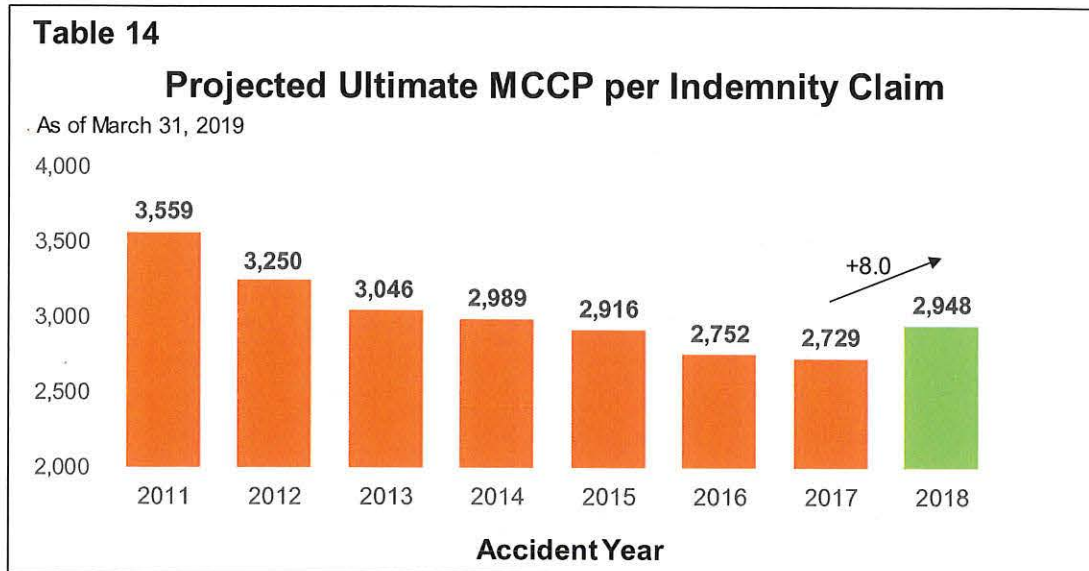
The recent higher ULAE costs have led to an increase of about 8% in the projection of this component of the LAE between the January 1, 2019 filing and the filing under review, as shown in Table 13 below.

Table 13

Method	January 1, 2019 Filing ULAE Projection	January 1, 2020 Filing ULAE Projection
Paid ULAE per Open Indemnity Claim	14.9%	15.6%
Paid ULAE to Paid Losses	12.2%	13.8%
Average of Two Projection Methods	13.6%	14.7%

MCCP

After a period of steady decline between 2011 and 2017, accident year 2018 shows a significant increase in ultimate MCCP per indemnity claim, as shown in Table 14.



Source: WCIRB aggregate financial data and projections. Excludes the cost of IMR and IBR from all years.

The 2018 increase in ultimate MCCP costs per indemnity claim is counterintuitive, given that SB 1160 has imposed some restrictions on utilization review ("UR") within the first 30 days of a claim beginning with 2018 injuries, and the New Drug Formulary, implemented as of January 1st 2018, restricts UR on certain types of drugs, both of which were expected to lower the UR component of the MCCP costs. Further research may be required to determine the underlying drivers of this unexpected increase.

The WCIRB does not give full weight to the 2018 data point, and the projected MCCP per indemnity claim is based on the average of 2017 and 2018 accident years, with 0.0% inflation going forward. The Department finds these assumptions reasonable given the unknown drivers of the counterintuitive 2018 increase.

A comparison of the components of LAE between the prior filing and the current filing is shown below in Table 15. While the ratio of ALAE to losses has decreased, both the ULAE and MCCP have increased as a percentage of losses.

Table 15

LAE Provision Underlying WCIRB Pure Premium Rate Filings				
	1/1/19 Filing		1/1/20 Filing	
(ALAE ex/MCCP)/Loss	18.9%		17.2%	
MCCP/Loss	4.0%		4.5%	
Total ALE/Loss	22.9%	\$0.29	21.7%	\$0.25
ULAE/Loss	13.6%	\$0.17	14.7%	\$0.17
Total LAE/Loss	36.5%	\$0.46	36.4%	\$0.42
Indicated Pure Premium Rate		\$1.70		\$1.58

The projected LAE as a percentage of losses considered in the Department's analysis is 38.2% compared to the WCIRB's selection of 36.4%. 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 proposed by the WCIRB in this filing.

In its projection of the LAE component for the middle scenario, Bickmore has assumed a higher LAE-to-loss ratio compared to the WCIRB, based on higher projected indemnity claim count. Information provided in response to the questions raised during the hearing indicate that the difference in the projected indemnity claim count between the WCIRB and Bickmore is due to differences in the perceived frequency trend. Given that Bickmore uses a loss ratio trend, it is not clear what the embedded separate frequency and severity trends in Bickmore's projection may be. Additional information provided following the hearing shows that the projected indemnity claim count is assumed to increase annually by 1.5% between 2018 and 2021, based on Bickmore's analysis. How this assumption compares to the assumptions underlying the projected losses is unclear.

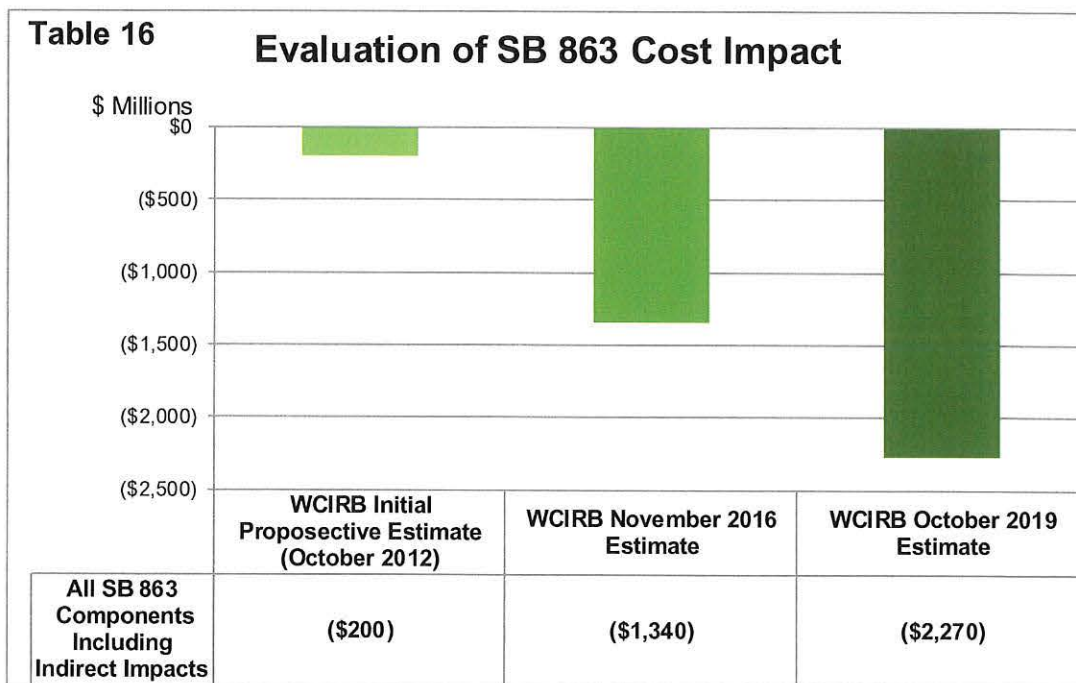
The WCIRB's consistency in using the selected frequency trends in the projection of both the losses and the LAE components provides comparable bases for a determination of the LAE-to-loss ratio, and the Department's staff agrees with this approach.

The Department believes that the continued monitoring of direct and indirect impacts of recent reforms and legislation on LAE costs requires particular attention and appreciates the WCIRB and Bickmore's efforts in this regard.

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

SB 863

In developing its actuarially-indicated pure premium rates, the WCIRB included its updated estimate of the effect of SB 863. In its October, 2019 SB 863 Cost Monitoring Report, the WCIRB has estimated that the various provisions of SB 863 have reduced annual system-wide costs by approximately \$2.3 billion, as shown in Table 16. This estimate is an update to the November 2016 estimate of \$1.3 billion, and 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 “indirect impact” component discussed in the October 2019 retrospective evaluation. 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 between 2013 and 2018, and while the eligible filed IMRs for 2018 reached a record level high, the first six months of 2019 for the first time show a decline in IMRs and a reversion to the 2017 level. It is worth noting here that north of 20% of the filed IMRs in each year are determined to be duplicates, which could be the consequence of the automatic

filing of IMRs, as pointed out by the WCIRB in the hearing held on October 14, 2019, and impose unnecessary frictional costs on the system.

We appreciate the WCIRB's continuous efforts in re-evaluating the impacts of various reforms, some of which are discussed below.

The WCIRB has reviewed the indirect impact of SB 863 on overall indemnity cost levels, which is also reflected in the October 2019 "SB 863 Cost Monitoring Updated" report. Based on this analysis, the WCIRB has estimated that the decline in the average temporary disability duration and the average permanent disability ratings since the full implementation of SB 863, have decreased the indemnity costs by about 4.5% on a combined basis. Given that several provisions of SB 863 impacted outstanding claims in addition to new claims, the WCIRB has distributed the 4.5% decrease in indemnity costs uniformly over the 2012 through 2015 accident years, and incorporated a 1.125% yearly decrease for these accident years in the calculation of indemnity on-level factors underlying the January 1, 2020 pure premium rate filing.

SB 863 has also resulted in a significant reduction in the utilization of a number of types of medical services, particularly pharmaceuticals. In the January 1, 2019 pure premium rate filing, the WCIRB had reflected a 17% reduction in the utilization of medical services resulting from SB 863 in the medical on-level factors. The 17% decrease had 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.

As mentioned in the Loss Development section, this year the WCIRB studied the impact of the recent pharmaceutical cost declines on paid medical loss development factors, and appropriately reflected the results of this study in the adjustments made to the paid medical loss development.

In this filing, given that the decline in pharmaceutical costs have been partially reflected in the adjustments to the paid medical losses underlying paid medical development factors, the WCIRB has judgmentally⁸ reduced the total impact of SB 863 on medical utilization incorporated in the medical on-level factors from 17% to 13%, to avoid double counting for the portion of the decline that has been accounted for in adjustments to the paid medical development factors.

⁸ Based on the differential in pharmaceutical cost declines in California compared to other states.

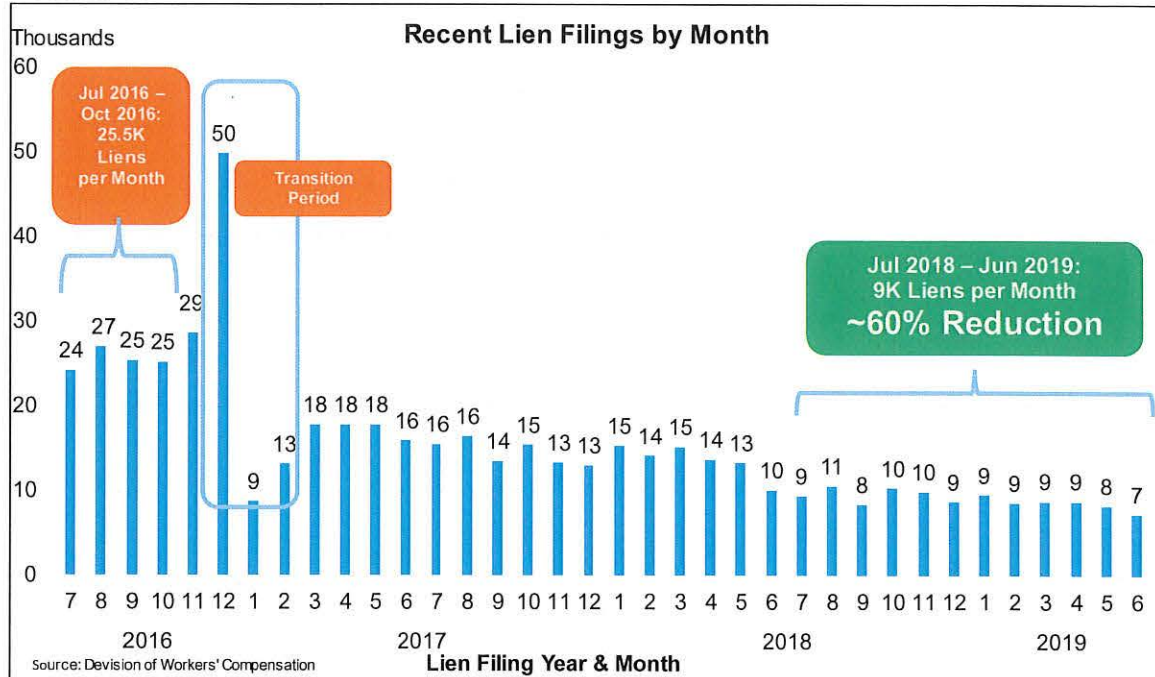
SB 1160, AB 1244, AB 1124

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.

The decline in the number of liens filed continued, and in the review of the January 1, 2019 pure premium rate filing, the Department incorporated a 50% reduction in its analysis, based on the comparison of lien filings in the 2nd quarter of 2018 to the 2nd quarter of 2016.

Due to a further continuation of decline in the number of liens filed, WCIRB has incorporated a 60% reduction in lien volume in the January 1, 2020 pure premium rate filing, on the basis of a comparison of the average number of liens filed during the July 2018 through June 2019 period, to the average level of filings shortly before the reforms. Table 17 shows the monthly lien filings between July 2016 and June 2019.

Table 17

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 primary goals of the formulary were to regulate the prescribing of opioids, reduce frictional costs from utilization review and IMR, and ensure medically necessary and timely medications for injured workers.

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 included in the WCIRB’s July 1, 2018 and January 1, 2019 pure premium rate filings as an adjustment to the overall pure premium rate level. The 0.5% reduction was determined based on an estimated 10% decrease in pharmaceutical costs, amounting to 0.4% of total loss and LAE, and reduction in utilization review costs, estimated at 0.1% of total loss and LAE.

This year, the WCIRB performed its first retrospective analysis of the impact of the drug formulary based on pharmaceutical costs as of December 31, 2018, and found that the 10% reduction in pharmaceutical costs assumed in the prospective evaluation of the formulary has been reasonable in light of the emerged data, which showed that the pharmaceutical costs declined at an approximately 10% greater rate in 2018 compared to the rate of decrease observed in the immediate period before MTUS’s implementation. The WCIRB has reflected an adjustment

for the impact of MTUS on medical costs, in the medical on-level factors applied to 2017 and prior accident years.

On the other hand, since the savings in utilization review costs were not evidenced in the data, and the MCCP costs had actually increased in 2018, no consideration was given to an adjustment for reduction in utilization review, initially anticipated.

**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 an advisory pure premium rate of \$1.52 per \$100 of payroll. This recommended average rate is proposed to be effective with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2020. 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.

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 to reflect an average workers' compensation claims cost benchmark and advisory pure premium rate of \$1.52 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, 2020 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 14, 2019, 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 7, 2019



Patricia Hein
Attorney IV

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

DECISION AND ORDER

**JANUARY 1, 2020 WORKERS' COMPENSATION CLAIMS COST BENCHMARK
AND ADVISORY PURE PREMIUM RATES**

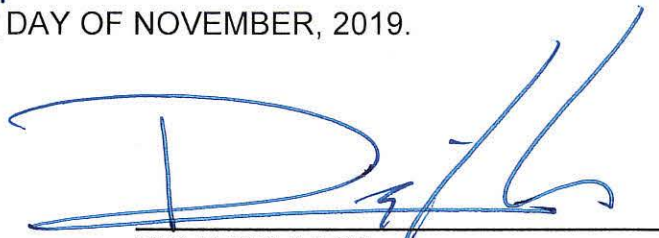
FILE NUMBER REG-2019-00020

In the Matter of: Proposed adoption or amendment of the Insurance Commissioner's regulations pertaining to the Workers' Compensation Insurance Claims Cost Benchmark and Advisory Pure Premium Rates. CDI File Number REG-2019-00020. The benchmark will be effective on **January 1, 2020**.

DECISION AND ORDER

I adopt the Proposed Decision and Order of Patricia Hein dated November 7, 2019, and direct the WCIRB to adopt an average advisory claims cost benchmark of \$1.52 per \$100 of employer payroll and adjust the pure premium rates for individual classifications based upon this benchmark.

IT IS SO ORDERED THIS 13th DAY OF NOVEMBER, 2019.



RICARDO LARA
Insurance Commissioner