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

PROPOSED DECISION

JANUARY 1, 2011 WORKERS' COMPENSATION CLAIMS COST BENCHMARK AND PURE PREMIUM RATES

FILE NUMBER REG-2010-00014

In the Matter of: Proposed adoption or amendment of the Insurance Commissioner's regulations pertaining to pure premium rates for workers' compensation insurance, California Workers' Compensation Uniform Statistical Reporting Plan—1995, Miscellaneous Regulations for the Recording and Reporting of Data, and the California Workers' Compensation Experience Rating Plan—1995. These regulations will be effective on **January 1, 2011, except where a different effective date is specified.**

SUMMARY OF PROCEEDINGS

A public hearing in the above captioned matter was held on October 12, 2010 at the time and place set forth in the Notice of Proposed Action and Notice of Public Hearing, File Number REG 2010-00014 dated August 26, 2010, which is included in the record. At the conclusion of that hearing, and as noticed in the Notice of Proposed Action and Notice of Public Hearing, the hearing officer announced that the record would be kept open for additional written comment until 5:00 p.m. on Tuesday, October 19, 2010, and the record was closed at that date and time.

The record discloses the persons and entities to whom or which the Notices were disseminated. The Notice summarized the proposed changes and recited that a summary of the information submitted by the Insurance Commissioner in connection with the proposed changes was available to the public. In addition, the "Filing Letter" dated August 18, 2010 submitted by the Workers' Compensation Insurance Rating Bureau of California (WCIRB) and related documents were available for inspection by the public at the Sacramento office of the California Department of Insurance (Department) and were available online at the WCIRB website, www.wcirbonline.org.

The WCIRB's filings propose a change in the Workers' Compensation Claims Cost Benchmark and Pure Premium Rates (Benchmark) in effect since January 1, 2010 that reflects insurer loss costs and loss adjustment expenses and adjustments to the California Workers' Compensation Experience Rating Plan—1995 to conform to the proposed Pure Premium Rates. In addition, the WCIRB has proposed amendments to the California Workers' Compensation Uniform Statistical Reporting Plan—1995, Miscellaneous Regulations for the Recording and Reporting of Data, and California Workers' Compensation Experience Rating Plan—1995.

The initial filing of the WCIRB requested that the Commissioner adopt an average increase of 29.6% for the Benchmark to be effective January 1, 2011, due to loss and Loss Adjustment Expense (LAE) experience. On September 27, 2010, the WCIRB submitted a letter amending its Benchmark change and requested the Commissioner adopt an increase of 27.7% to be effective January 1, 2011, in addition to withdrawing changes to the standard classifications in the Uniform Statistical Reporting Plan for engineers, land surveyors, oil or gas geologists or scouts, and geophysical exploration.

Testimony, written and oral, was taken at a hearing in San Francisco on October 12, 2010 and exhibits were received into the record. Additional documentation requested by the hearing panel was submitted subsequent to the hearing but prior to the close of the time period to receive written comment along with correspondence and documents submitted by the public. The matter was submitted for decision at the conclusion of the period to receive written comment on October 19, 2010. The matter having been duly heard and considered, the following review, analysis, and Proposed Decision and Proposed Order are hereby made.

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

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 that a rating organization, such as the WCIRB, shall collect and tabulate information and statistics for the purpose of developing pure premium rates to be submitted to the Commissioner. These provisions were enacted in 1995 when the workers' compensation insurance rate system substantially changed to an open-rating system. Previously, the Commissioner controlled the minimum rate insurers could use to price workers' compensation insurance premiums. Insurers may now file rates for workers' compensation insurance with the Department that have no limitation on what insurers charge or the profit insurers can make so long as the filed rates are not unfairly discriminatory, tend to create a monopoly, or are inadequate or will impair or threaten the solvency of the insurer.

The WCIRB is licensed as a rating organization by the Department, and all workers' compensation insurers are required to be a member of a rating organization. One purpose of a rating organization is to collect insurer loss information and determine pure premium rates, which are the cost of workers' compensation benefits and the expense to provide those benefits, to assist insurers in filing adequate rates. The WCIRB has generally been providing this type of information under the prior minimum rate law and the current open-rating system. However, the WCIRB' current filings do not provide information on the pure premium rates filed by its insurer members.

The pure premium rates approved by the Commissioner through adjustment of the Benchmark are only advisory. Insurers are free to accept or ignore the Commissioner's advice and then make their own determination on the pure premium rates they will use. The WCIRB then calculates any future cost changes based upon the Commissioner's previous advisory Benchmark and ignores what its insurer members have actually filed. While the WCIRB's approach satisfies the narrow requirement of calculating indicated advisory pure premium rates, similar to developing a minimum rate, it does nothing to recognize what is happening with insurance pricing in the marketplace. It is now necessary to go beyond what was done when the minimum rate law was in effect and provide the understanding of how approved pure premium rates are used.

Financial Surveillance Chief Actuary Ron Dahlquist provides below in the Actuarial Evaluation a detailed explanation of the workers' compensation rate-making process and the general confusion over it. The pure premium rate process is important as a gauge or benchmark of costs in the system, but it must reflect the reality of insurer rate filings and the premiums being charged to employers. The initial conclusions are the following:

- **Despite the WCIRB's request for a 27.7% increase, insurers have already exceeded the WCIRB's own recommendation for pure premium rates. It appears that the industry average filed pure premium rate level is already 6% above the WCIRB's filing request and 36% above the Commissioner's previous approved advisory pure premium rate level.**

- **At the same time, insurers are discounting their charged rates so that on average premiums to employers from 2008 to 2010 have only increased 3% according to both data and testimony submitted by the WCIRB. This is more in line with the Commissioner's recommendations to the industry to keep premiums stable and not pass on avoidable costs.**

It should also be noted that the WCIRB has reviewed the Commissioner's previous recommendations on medical cost savings separate from its filing but has not been able to provide any information or studies concerning insurer cost efficiency that would affect its recommendation on pure premium rates.

Actuarial Recommendation

We recommend an increase of 20.4% in the average level of the pure premium rates, for reasons set forth in the "Actuarial Analysis" section which follows. This is approximately 11% below what appears to be the current industry average level of pure premium rates filed by insurers with the Department.

We also recommend that the WCIRB develop several changes to statistical reporting requirements and to future pure premium rate filing presentations as detailed in the final section of the discussion of the actuarial review.

Actuarial Evaluation:

1. Loss Development:

WCIRB Methodology

The WCIRB initiated a significant change to its ratemaking methodology in this filing. It adopted both a Berquist-Sherman adjustment for changes in claim settlement rates and an adjustment for changes in insurer mix. The WCIRB points to significant changes in both claims settlement rates and insurer market shares in recent years as occurrences that require adjustment to the paid loss development data in order to avoid errors in estimation of ultimate losses and thus indicated pure premium rate levels.

Public Members' Actuary Review

Mark Priven of Bickmore Risk Services, actuary for the Public Members of the WCIRB Governing Committee, provided written comments regarding his evaluation of the pure premium rate filing and questioned the appropriateness of placing full reliance on the Berquist-Sherman paid development method. As detailed in his letter, he is concerned with the lack of a track record of applying the Berquist-Sherman adjusted method to pure premium rate filings; a perceived minimal improvement in the stability of projections resulting from application of the Berquist-Sherman adjusted method; his inability to review the inner workings of the adjustment for insurer mix due to the confidential nature of the individual insurer data used; and data quality concerns with the claim count data that surfaced as a result of the updating of the analysis from the original filing using March 31, 2010 data to incorporate data valued as of June 30, 2010.

Due to these concerns, Mr. Priven gives the Berquist-Sherman adjusted projection 50% weight in determining estimated ultimate losses in his middle estimate, and giving the remaining 50% weight to the unadjusted paid loss development method that has been relied on historically.

Our Review

To facilitate our review, we requested at hearing that the WCIRB provide us with detailed calculations of the adjustments and an explanation of the process used to make the adjustments. After reviewing this material, we are satisfied with the WCIRB staff's calculation of the adjusted severities.

Technical Issues

At the public hearing, we questioned whether there was a technical problem with the way the Berquist-Sherman adjustment was applied to indemnity losses. We noted that different basic assumptions are made in the adjustments to indemnity and medical losses: for indemnity losses only the payments on closed claims are adjusted, while for medical losses all payments are adjusted. The basic underlying assumptions appear to be that the timing of partial medical payments is affected by changes in claim settlement rates to the same degree as the final closing payments are affected, but the partial indemnity payments are largely unaffected by changes in settlement rates.

Our specific concern is a technical one and has to do with the fact that no adjustment at all was made to payments on open claims in the indemnity analysis. We are convinced that an adjustment is necessary because the Berquist-Sherman adjustment implies a change in the population of closed claims at each valuation of each accident year prior to the current valuation. Since there is an assumed change in the population of closed claims due to the adjustment, there must also be a corresponding and opposite change in the population of open claims for the same accident year at the same valuation, and there must be partial loss payments associated with the claims that changed categories due to the adjustment. The payments on open claims should change by the amount of these partial payments on the claims that switch categories due to the adjustment.

The WCIRB appears to have recognized this in a letter dated October 19, 2010, that presents a revised insurer mix-adjusted calculation with a Berquist-Sherman adjustment to paid losses that incorporates a change and addresses our concerns. We accept this revised analysis that results in developed ultimate indemnity loss ratios of .227 for accident year 2008 and .250 for accident year 2009. The effect is relatively modest, as the developed indemnity loss ratios in the WCIRB's supplemental filing were .231 for accident year 2008 and .253 for accident year 2009.

We are also of the opinion that part of the insurer mix adjustment is not appropriate. We do agree with the idea that there is improved accuracy in performing separate loss development analyses for each of the largest individual insurer groups as well as for the combined experience of the remainder of the market, and then adding the results together. This makes sense, because different insurers have different philosophies and procedures for handling claims. We do not agree with the practice of calculating mix-adjusted developed industry loss ratios for prior accident years using the most recent accident year's premium weights. This approach seems to assume that each growing insurer's underwriting standards and claims handling procedures will produce the same loss ratio

for the policies it assimilates over time as for the policies it insured at the beginning of the experience period. We think this assumption is demonstrably false for the State Fund, which has had the most dramatic shift in its market share of all California workers' compensation insurers. When the State Fund had more than 50% of the insured market in the middle of the last decade, its portfolio of policies must have been of average risk quality for the industry, almost by definition. Now that its market share has been reduced to a fraction of what it was five years ago, the proportion of its business that the State Fund insures as a result of its mission to serve as the market of last resort is undoubtedly significantly higher than it was at that earlier time. Clearly, this shift is the dominant shift that affects the WCIRB's insurer mix adjustment.

Our Conclusions

We agree with Mr. Priven that it would be wise to give less than full weight to the WCIRB's Berquist-Sherman and insurer mix adjustments, given that this is the first filing in which the method has been applied in the determination of the recommended change to the pure premium rates, and based on our perception that there are some aspects of the methods that are still in need of some refinement. Accordingly, we have given 50% weight to the unadjusted paid loss development method, and 50% weight to the Berquist-Sherman adjusted, insurer mix-adjusted paid loss development method, with the developed adjusted indemnity losses being based on the analysis presented in the WCIRB's October 19 letter.

We calculate the developed loss ratios by the unadjusted paid loss development method to be .223 and .246 for accident years 2008 and 2009, respectively for indemnity, and .471 and .529 for the same years for medical. The corresponding developed loss ratios by the Berquist-Sherman adjusted, insurer mix adjusted paid loss development method are .227 and .250 for indemnity and .487 and .554 for medical. Taking a 50-50 weighting of these loss ratios, our selections for developed loss ratios are .225 for accident year 2008 and .248 for accident year 2009 for indemnity, and .479 for accident year 2008 and .542 for accident year 2009 for medical.

We add the caution that if the observed slowdown in the industrywide claim settlement rate is caused by a change in mix of claims by type of injury, with a reduction in the proportion of temporary only claims, the Berquist-Sherman adjustment will not adequately treat this phenomenon. We suggest that further research into this issue would be worthwhile.

2. Medical Severity:

For reasons detailed below, we select a medical severity assumption of +8% per year.

The aggregate financial data provided in this filing presents a picture of moderating medical cost increases that is in contrast to what was observed in the last filing. In last year's amended filing, the Bureau's ratemaking analysis yielded estimated ultimate medical severity increases of 15.2% for accident year 2006 relative to accident year 2005,

12.9% for accident year 2007 relative to 2006, and 13.8% for accident year 2008 relative to 2007. In this filing, these estimates have been revised to +14.9%, +15.7%, and +12.9%, respectively. While these two sets of estimates are generally similar to each other, the new filing estimates that ultimate medical severity has increased by only 4.2% for accident year 2009 relative to accident year 2008. The WCIRB's estimates of changes in on-level medical severity in this filing are +14.7% from accident year 2005 to accident year 2006, +13.7% from 2006 to 2007, +12.5% from 2007 to 2008, and only +3.9% from 2008 to 2009.

In our review of the WCIRB's July 1, 2009 and January 1, 2010 filings, we observed that detailed transaction level data on medical payments provided by the California Workers Compensation Institute (CWCI) showed that costs associated with medical cost containment, medical legal, and medical management have increased at a greater rate than medical expenses as a whole have increased. We stated then that we believed that these increases are the result of an increased level of effort in those areas that is necessitated by the new post-reform environment that requires greater scrutiny of all medical treatment and expenses. We continue to believe that these are permanent one-time upward adjustments in costs and should not be assumed to be indicative of continuing inflationary trends. The substantial moderation in the medical severity increase seen in accident year 2009 would seem to support that belief.

One of the two letters submitted by the WCIRB dated October 19, 2010, provided a copy of the updated CWCI study of transaction level detail medical cost data dated March 2010, that was previously made available to the Actuarial Committee. This study provides a preliminary look at accident year 2009 data as of 3 months, as well as updated data for prior accident years. On an overall basis, it provides much the same picture of cost increases as did the aggregate data contained in the January 2010 filing. The first three months of accident year 2009 shows a 9.9% increase in severity for the larger data set and an actual decrease in severity for the smaller medical bill review dataset. This data is quite immature and lags the aggregate financial data of this filing by over a year, so it is of limited value for evaluating future trends. A more timely and complete review of transaction level detail medical cost data is needed. We expect that once the WCIRB has succeeded in collecting and validating such data, more complete reviews will be provided on a timely basis.

In this current filing, the WCIRB projects medical severity increasing at 9% per year, citing this selection as a compromise between the recent trend of +11.5% per year over the last four accident years and the longer-term pre-reform average trend of +7.1% per year.

Mr. Priven recommends giving 75% weight to the long-term trend rate and 25% to the post-reform trend rate, based on the observation that there has been a significant lessening of medical severity trend recently. His resulting recommended annual medical severity trend rate is 8.2% per year.

While we agree with the WCIRB that the medical severity trend assumption should not be based solely on the latest data point, we do view the small 4% increase in accident year 2009 estimated ultimate medical severity to be significant, and consistent with our previously expressed view that much of the large post-reform increase in medical severity has been due to a one-time adjustment to a higher level of utilization review activity. Considering both the recent favorable reduction in trend and the considerable uncertainty still surrounding medical costs, we have settled on an 8% annual change as a reasonable assumption. We will watch future developments in this area closely, as it is clear that medical severity trend has not yet reached a steady state post-reform.

3. Indemnity Trend:

Severity

In this filing, the WCIRB calculates historical indemnity severity trends of 2.7% per year based on the long-term pre-reform changes in severity, and 5.7% per year based on post-reform severity changes. The WCIRB's selected prospective indemnity severity trend rate is the calculated post-reform trend rate rounded up to 6.0% per year.

Mr. Priven, in his discussion of his middle range estimate, recommends making the same weighting assumption for indemnity severity trend as he does for medical severity trend; he gives 75% weight to the pre-reform trend rate and 25% weight to the post-reform rate. For indemnity, this approach produces his middle range severity trend assumption of 3.3% per year.

We select an indemnity severity trend assumption of 4.0% per year as a compromise between the recent higher rate of indemnity severity increases and the historical pre-reform average. We hold the opinion that recent severity increases are influenced by the Workers' Compensation Appeals Board's (WCAB) Ogilvie and Almaraz/Guzman case decisions, and that caution as to the future impact of these cases is warranted, so we do not feel comfortable with a lower assumption; at the same time, we do not expect the post-reform rate of increase to continue.

Frequency

For reasons stated in detail in the Proposed Decision on the January 2010 filing, we accept the results of the WCIRB's indemnity frequency model.

4. Permanent Disability Cases:

On September 3, 2009, the WCAB issued its opinion and decision after reconsideration in the Ogilvie and Almaraz/Guzman cases concerning the determination of permanent disability. As the WCIRB noted in its September 29, 2009 letter, the WCAB essentially confirmed its earlier decision in the Ogilvie case. In the Almaraz/Guzman cases, however, the WCAB substantially limited the evidence that can be used to rebut whole person impairments. The WCAB's determination is now final in the Guzman case based

upon a determination of the 6th District Court of Appeal and the California State Supreme Court's refusal to further review the matter. The appeals in the Almaraz and Ogilvie cases are still outstanding.

The WCIRB's current filing analysis assumes that a special adjustment for the impact of these decisions is no longer necessary, as claims are being settled based on these decisions.

Mr. Priven states that there is a substantial amount of uncertainty related to the impact of these cases on workers' compensation costs, but in his middle range estimate he agrees with the WCIRB's decision not to make a specific adjustment for the cases, on the assumption that their impact is already in the loss data.

We agree that there is considerable uncertainty in what impact these cases will ultimately have on indemnity claim costs, and believe that caution is warranted. We have, however, concluded that it is reasonable to accept the Bureau's decision not to make a specific adjustment. We believe that these cases have contributed to the recent post-reform increases in indemnity severity, and have assumed a somewhat higher indemnity severity trend rate than we would have in the absence of these decisions.

5. Loss Adjustment Expense:

The WCIRB filing again derives its loss adjustment expense load by giving the experience of the State Compensation Insurance Fund 50% weight consistent with half of its current market share. The result is a provision of 21.0% of losses. We again reject this approach, for the same reasons we have in previous decisions, and instead approve a loss adjustment expense load based exclusively on the experience of private insurers. This load would be 19.7% of losses if we had concluded that the WCIRB's projected on-level pure premium ratio of 1.055 was appropriate. Since we have arrived at a lower conclusion, a projected ratio of .996, we need to adjust this percentage upward to produce the same dollar provision. This adjustment results in a provision of 20.9% of losses.

Measurement of the Effectiveness of the Reform Legislation

In the Proposed Decision on the January 2010 filing, we discussed the issue of the effectiveness of the reforms of AB 227, SB 228, and SB 899, and recommended that a study be done to determine the extent to which the reforms have been implemented, the extent to which improvements in their implementation can be realized, and the potential for additional cost savings that might exist if the reforms are fully implemented.

At the request of the Department, the WCIRB provided a summary review in March of this year of the 27 cost-saving recommendations contained in the Department's July 7, 2009 addendum to its Proposed Decision on the July 1, 2009 pure premium rate filing. In a letter dated October 8, 2010, the WCIRB provided an updated summary review. One of the most noteworthy pieces of information in this update was the fact that the RAND Corporation, on behalf of the Commission on Health, Safety, and Workers'

Compensation (CHSWC), had performed a preliminary study on the effectiveness of the reforms on medical care in California workers' compensation. This study identified a number of key questions that needed to be answered by further study. These questions appear to be the same types of questions raised in the July 2009 hearing and the document outlining the 27 cost-saving recommendations that resulted from it. While the RAND study called for further study of these issues to be done, no such follow-up study has been done in the ensuing three years, to the best of our knowledge.

We continue to believe that such a study is a very worthy objective, and we urge that it be done. We believe that having the RAND Corporation perform the study under the auspices of CHSWC would be a good approach, but we wish to stress the importance of having such a study completed in any event. We believe it is essential to all parties involved in the system to have the best understanding possible as to how well the reforms are working, and what are the best, most cost-effective ways to deliver needed medical care to injured workers.

Putting the Advisory Pure Premium Rates and Filings in Context

It is increasingly apparent that there is a need to address how the advisory pure premium rates relate to the rates actually charged by insurers in the marketplace. There is ongoing confusion, as evidenced in the pure premium rate hearing process, as to the meaning and use of the pure premiums that are the subject of the hearings. While the basic structure of California's competitive rating system for workers compensation insurance has been outlined many times over the years, it is necessary to repeat the explanation here.

The process begins with the WCIRB's efforts to gather statistics and other qualitative information and use this data and information to develop proposed advisory pure premium rates. These pure premium rates are meant to provide enough funding to cover the industry average cost of workers' compensation benefits and the cost of adjusting and settling the claims for those benefits. They are not meant to cover company underwriting expenses or profit provisions.

These advisory pure premiums are then filed by the WCIRB with the Commissioner for his approval. The Commissioner, after conducting a public hearing, makes a decision whether to accept, reject, or modify the proposed pure premiums. This document is part of that decision process. The final result of this process is a set of approved advisory pure premium rates.

The next step in the process is for each individual insurer to decide what to do with the approved advisory pure premiums. California's open rating law allows each insurer to adopt the advisory pure premiums or to choose to deviate from them. Any deviation can be a uniform deviation that applies the same overall percentage modification to each of the individual classification pure premiums, or it can be different by classification. This essentially allows each insurer to select its own set of pure premium rates. The insurer's pure premium rates must be filed with the Commissioner prior to their use, but are not subject to the Commissioner's prior approval. We define these pure premium rates as the

"filed pure premiums", and define the industrywide average of all of these filed pure premiums as the "industry filed pure premium level".

Rather than allowing the WCIRB to file rates fully loaded for company underwriting expenses and profit, California's rating law requires each individual workers' compensation insurer to make its own determination of the underwriting expense and profit loads that are appropriate to its own situation, and to apply its own loading to its filed pure premiums. This multiplier is called the "loss cost multiplier", and the rates that result from applying the company's loss cost multiplier to its filed pure premium rates are the company's filed manual rates. We define the industrywide average of all of these filed manual rates as the "industry filed manual rate level".

Finally, the rating law allows insurers to file and use their own rate modification plans for use in determining the final price to be paid by each policyholder. Typical rate modification plans include schedule rating and premium discount plans. The result of applying these rating plans to the filed manual rates is often referred to as the "charged rate". We define the industrywide average of all of these "charged rates" as the "industry final price level".

The WCIRB approach to determining the proposed advisory pure premium rate level, or claims cost benchmark, focuses narrowly on developing the indicated overall percentage change to the latest average approved advisory pure premium rate level. This overall change is then distributed to each of the approximately 500 individual rating classifications based on the analysis of the experience of each individual classification. These changes can and do differ substantially from the overall change; they are limited to a range of increases and decreases that do not exceed 25%, relative to the overall change.

The WCIRB filing displays the proposed pure premium rates by individual classification fairly prominently in the filing, but it does not provide a summary of the recommended changes to each individual classification's pure premium rate.

While the WCIRB's focus on the single overall percentage change number is necessary for the essential but narrow purpose of determining the indicated advisory pure premiums, it does not provide any insight into the broader context of how the advisory pure premium rates are being used in the marketplace. This lack of explanation of the broader context results in numerous misunderstandings on the part not only of the general public, but also on the part of various participants in the pure premium hearing process. For example, it is not well understood that under California's open rating law for workers compensation insurance, insurers are required to add on their own loadings for expenses and profit to the pure premium rates, despite the fact that explanations similar to the one we have made here have been given repeatedly over time.

It is also not well understood, despite repeated statements on the subject, that insurers are essentially free to adopt the WCIRB's proposed pure premium rates, whether or not the Commissioner approves them, or to modify either the proposed or approved pure premiums to whatever extent they see fit. In particular, many insurers have adopted the

proposed pure premiums each time a WCIRB filing is made, so their filed pure premiums are currently significantly higher than the latest approved pure premiums. There is a misperception that if the Commissioner was to approve the entire recommended increase of 27.7%, insurer rates would all increase by this percentage. Clearly, for those insurers who have routinely adopted the proposed pure premium rates rather than the approved ones, this should not be the case.

There is need for more information to be provided to place the WCIRB's recommended pure premium rate recommendations in the broader context of what is going on in the competitive marketplace.

The WCIRB provides the Department with the overall relationship of each insurer group's charged premium to the premium that it would have earned if it had charged the latest approved pure premiums without any loadings. This provides an overall look at each insurer's final pricing, after taking all rating modifications such as schedule rating and premium discount into effect. This relationship is presented on an industrywide average basis within each WCIRB filing. As shown in the current filing, the industry charged 146.8% of the then current approved pure premium rates, on average, during 2005; 144.7% in 2006; 149.3% in 2007; 143.4% in 2008; and 135.4% in 2009. For policies issued in the first half of 2010, based on data provided by the WCIRB to the Department, the industry average ratio has increased to 141.3%. In keeping with the definitions set forth previously, we define this as the "industry final price level".

While this statistic provides an indication of the overall level of insurance industry pricing levels, it does not provide information on either the average level of pure premium rates or manual rates filed by insurers. We have defined the former as the "industry filed pure premium level" and the latter as the "industry filed manual rate level". Despite these limitations, Department staff has attempted to calculate what approximate average industry filed pure premium rate levels and industry filed manual rate levels would be using information taken from individual insurer rate filings and a combination of WCIRB and Annual Statement premium data. As best we can tell, the average filed pure premium rate level is 36% higher than the Commissioner's latest approved pure premium rate level. It appears that the average filed pure premium rate level is actually higher than the pure premium rate level proposed by the WCIRB in its current filing. This finding implies that there is no need for insurers to increase their rates at all in response to the WCIRB filing.

Based on similar calculations, it appears that the average industry Loss Cost Multiplier is about 1.393, indicating an average loading for underwriting expenses and underwriting profit (including investment income offset) of 39% of the pure premium or 28% of manual premium. Combining this with the estimated average industry filed pure premium rate level of 136% of the latest approved pure premium rate level, it appears that the average industry filed manual rate level is 189% of the latest approved pure premium rate level.

Finally, comparing the apparent average industry filed manual rate level of 189% of the approved pure premium rate level to the average industry final price level of 141% of the same level, it appears that the average combined effect of all rating plan discounts is an average discount of about 25%. This appears to be a high level of discounting of insurers' manual rates; however, it should be noted that this average credit includes premium discount for at least one major insurer, and that insurer's average premium discount is about 10% of manual premium. Therefore, it is reasonable to conclude that the industrywide average rating plan discount excluding premium discount is probably somewhat less than 25%.

It would be very instructive to see how each of these statistics has changed over time in response to the WCIRB filings and the Commissioner's Decisions. We do have information on average filed rate increases in each semiannual filing cycle since January 2004. It is interesting to note that for the period January 2004 to July 2008, the approved pure premium rates declined by approximately 65%, while the insurers' filed manual rates declined by approximately 56%. Since July 2008, insurers' filed manual rates have increased by approximately 21%, while the approved pure premium rates have increased by 5%.

This implies that insurers never filed the full amount of the decreases that were made to the approved pure premium rates as a result of the reforms, and that insurers have also adopted most of the increases recommended by the WCIRB but denied by the Commissioner.

It is also noteworthy that the average industry final price level ratio, which was 141.3% for the first half of 2010, has not increased relative to the 2008 level of 143.4%. Since the approved pure premium rate level has only increased by 5% over this time period, it is clear that average industry prices have not increased much, despite the 21% average increase in insurers' filed manual rates in that time period. It is clear from this information that insurers' filed manual rate increases have been largely made ineffective by the increased application of schedule credits and other rating plan modifications.

Finally, even if reasonably complete information was available regarding industry average filed pure premium rate levels, manual rate levels, and average price levels after rating plan discounts, credible information on past and prospective profitability is missing from the general discussion. Again, while this information is not part of the WCIRB's narrow charge to develop recommended advisory pure premium rates, it is a key component to understanding how the advisory pure premium rates are being used and how well the system is working overall. The WCIRB periodically provides information on industry underwriting results on both a calendar year and accident year basis, but the crucial element of investment income is missing from the presentation.

OTHER MATTERS

Amendments to the California Workers' Compensation Uniform Statistical Reporting Plan—1995 (USRP)

The WCIRB has proposed amendments to the USRP to be effective on January 1, 2011 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2011 and additional amendments to be effective on January 1, 2012 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2012. Those amendments are contained in the WCIRB's filing and summarized in the Notice of Proposed Action and the Initial Statement of Reasons.

It should be noted that the following amendments were withdrawn by the WCIRB on September 27, 2010:

- The establishment of Classification 8602(1), *Land Surveyors – consulting – not engaged in actual construction or operation,* to encompass land surveying and timber cruising operations, Classification 8602(2), *Oil or Gas Geologists or Scouts*, and Classification 8602(3), *Geophysical Exploration – including mapping of subsurface areas.*

- The elimination of Classifications 8601(2), *Oil or Gas Geologists or Scouts,* and 8601(3), *Geophysical Exploration,* listed under the *Petroleum Industry* Group, and establish Classifications 8602(2), *Oil or Gas Geologists or Scouts,* and 8602(3), *Geophysical Exploration – including mapping of subsurface areas,* as alternate wording to proposed Classification 8602(1), *Land Surveyors – consulting – not engaged in actual construction or operation.*

The WCIRB's September 27, 2010 letter proposes to amend Classifications 8601(2) and 8601(3) to add Outside Salespersons and Clerical Office Employees, a change that was included in the original amendment to Classification 8601(1). Based upon the trade group notices and for consistency for this group of classifications, these amendments are accepted.

Amendments to the USRP contained in the filing and as modified, as noted above, have been reviewed, along with the trade group notices and other materials provided by the WCIRB, and, having received no objections to them, are approved as being reasonable and consistent with the purpose of the USRP.

Amendments to the Miscellaneous Regulations for the Recording and Reporting of Data

The WCIRB has proposed amendment to the Miscellaneous Regulations for the Recording and Reporting of Data to be effective on January 1, 2011 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2011. That amendment is contained in the WCIRB's filing and summarized in the Notice

of Proposed Action and the Initial Statement of Reasons. The amendment, having been reviewed and having received no objections regarding it, is approved as being reasonable and consistent with the purpose of these Miscellaneous Regulations for the Recording and Reporting of Data.

Amendments to the California Workers' Compensation Experience Rating Plan—1995 (ERP)

The WCIRB has proposed amendments to the ERP to be effective on January 1, 2011 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2011 and additional amendments to be effective on January 1, 2012 with respect to new and renewal policies as of the first anniversary rating date of a risk on or after January 1, 2012. Those amendments are contained in the WCIRB's filing and summarized in the Notice of Proposed Action and the Initial Statement of Reasons.

The amendments to the ERP have been reviewed, and two objections to the proposed changes were received.

The first objection is to the amended expected loss rates. Specifically, an employer, whose experience modification for the 2011 would increase based upon the amended expected loss rates, stated that the expected loss rates were inflating experience modifications because the expected loss rates are based upon projected decreases for 2011. This is not correct.

Upon review of the filing, the WCIRB has spent considerable effort in explaining that the expected loss rates are based upon the expected losses that occur or are expected to occur during the same period for which experience modifications are to be calculated. In the case of the 2011 policy year expected loss rates, the expected losses for policy year 2007 at the third unit statistical report level, policy year 2008 at the second unit statistical report level, and policy year 2009 at the first unit statistical report level will be used. The increase that this employer may experience is recognized by the WCIRB in past filings and testimony and is attributable, in large part, to the drop in claims experience overall as a result of the reforms and the economic situation where fewer claims are being filed or the claims filed are less costly due to the reforms. Based upon the analysis provided by the WCIRB in this filing, the amendments to the expected loss rates are reasonable and appropriately calculated.

The second objection received is to the WCIRB's proposal to offer employers a copy of the employer's Experience Rating Form upon request and free of charge. It is alleged in the objection that there is opposition to this and that it will create stress between insurance brokers and their client employers. It is further alleged that the broker has a right to explain this information to its client in its own way without interference from a separate private company with a different agenda.

The WCIRB was directed by the Commissioner to establish a process to provide experience modification information, including the estimated experience modification for a loss-free rating, directly to employers. The WCIRB's proposal is required by the Insurance Code. California Insurance Code Section 11752.6 states in part that a licensed rating organization shall make available in writing to an employer all policyholder information contained in its records upon request of the employer. The objection to this change must be rejected. The proposed rule change from the WCIRB should be approved since it does comply with Section 11752.6.

The amendments to the ERP are reasonable and consistent with the Plan and are approved; however, the WCIRB is directed to adjust the eligibility threshold to reflect the Insurance Commissioner's adopted Claims Cost Benchmark in order to maintain approximately the same volume of experience rated employers.

REVIEW OF AMENDMENTS TO THE CALIFORNIA RETROSPECTIVE RATING PLAN AND CALIFORNIA LARGE RISK DEDUCTIBLE PLAN

Amendments to the advisory California Retrospective Rating Plan and advisory California Large Risk Deductible Plan were adopted by the WCIRB to be effective January 1, 2011 and submitted in the WCIRB's filing for review only. These amendments do not require approval by the Insurance Commissioner and are only noted in the record.

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

It is the determination of this Hearing Officer, based upon the current filing, that the Insurance Commissioner adopt a 20.4% increase (+20.4%) to the current level of the Workers' Compensation Claims Cost Benchmark in effect since January 1, 2010, which is a measure of the projected costs in the workers' compensation system to be effective on or after January 1, 2011. The change in the Benchmark determined herein 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 Department of Insurance Financial Surveillance Chief Actuary Ron Dahlquist.

It is important to note that if this analysis were based upon the industry average of pure premium rates currently filed, we would direct the WCIRB to use advisory pure premium rates that are 11% less than what the industry has currently filed.

Therefore, it is also the determination of this Hearing Officer that future filings and proceedings concerning advisory pure premium rates be based upon insurers' actual filed pure premium rates and include a review and analysis of the current rates, pricing level, and profitability of the industry.

DIRECTIONS TO WCIRB TO MODIFY BENCHMARK AND PURE PREMIUM RATES FILING

We therefore direct the WCIRB to implement the following changes to better review, analyze, and inform the public and insurers regarding workers' compensation costs and rates:

- The WCIRB shall include in each future advisory pure premium rate filing a table showing its proposed change for each individual classification pure premium rate.

- The WCIRB shall obtain from the Department filing information and formulate rules for data collection necessary to enable accurate calculation of individual insurer and industry average filed pure premium rate levels and individual insurer and industry average filed manual rate levels on an ongoing basis. With this information, the WCIRB shall provide the industry average filed pure premium rate level and industry average filed manual rate level on an ongoing basis as part of each future advisory pure premium rate filing.

- The WCIRB shall provide as part of each future advisory pure premium rate filing its proposed overall pure premium rate change relative to the latest industry average filed pure premium rate level in addition to the latest WCIRB recommended advisory pure premium rate level and the latest approved advisory pure premium rate level.

- Finally, we direct that the WCIRB to work with the Department to assist in evaluating profitability of the California workers' compensation insurance industry and to collect and analyze necessary information as further directed.

PROPOSED ORDER

WHEREFORE, 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 advisory workers' compensation pure premium rates filed by the WCIRB and Sections 2318.6, 2353.1 and 2354 of Title 10 of the California Code of Regulations are hereby amended and modified in the respects specified herein;

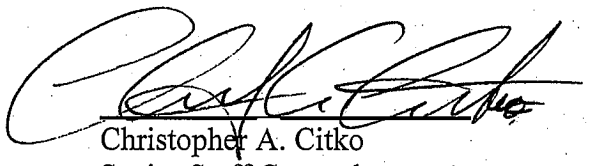
IT IS FURTHER ORDERED that pure premium rates for individual classifications shall change based upon the classification relativities reflected in the WCIRB's filing to reflect the adjustment of the Workers' Compensation Claims Cost Benchmark;

IT IS FURTHER ORDERED that the experience rating threshold be calculated to reflect the adjustment of the Workers' Compensation Claims Cost Benchmark; and

IT IS FURTHER ORDERED that these regulations shall be effective January 1, 2011 for all new and renewal policies with anniversary rating dates on or after that date, except where another effective date is specified.

I HEREBY CERTIFY that the foregoing constitutes my Proposed Decision and Proposed Order in the above entitled matter as a result of the hearing held before me as a Senior Staff Counsel of the Department of Insurance on October 12, 2010, and I hereby recommend its adoption as the Decision and Order of the Insurance Commissioner of the State of California.

November 18, 2010



Christopher A. Citko
Senior Staff Counsel