ORDER NUMBER R 11-05 **November 23, 2011**

APPROVAL WITH MODIFICATIONS OF THE 2012 WORKERS' COMPENSATION LOSS COST FILING AND ASSIGNED RISK RATE FILING

BACKGROUND:

On August 24, 2011, the Division of Insurance (division) received the *2012 Alaska Workers' Compensation Filing for Voluntary Loss Costs and Assigned Risk Rates from the National Council on Compensation Insurance, Inc.* (NCCI). This filing proposed an overall 2.7 percent increase in voluntary loss costs and an overall 2.9 percent increase in assigned risk rates from the current approved levels.

On July 11, 2011, the director issued Notice of Public Hearing H 11-02 notifying interested parties that, in accordance with AS 21.39.043, a hearing would be held on September 13, 2011. The purpose of the hearing was to allow interested parties to provide testimony or evidence as to whether the filing's prospective loss costs meet the requirements of AS 21.39. Interested parties were also invited to include a recommendation for approval, disapproval, or modification of the filing.

On September 1, 2011, Alaska National Insurance Company (ANIC) provided the division with written testimony and questions on the filing. NCCI responded to ANIC's written testimony on September 9, 2011. NCCI presented the components and discussed the methodology included in the filing at the hearing. Testimony was received at the hearing on behalf of ANIC and Alaska Public Entity Insurance (APEI). ANIC provided several exhibits to support its testimony at the hearing. No other additional written comments were received after the hearing.

The division asked for and received additional supporting information from NCCI. On September 28, 2011, the division asked for an extension as provided for in AS 21.39.043(e) and, on September 30, 2011, the division asked for additional supporting information as allowed under AS 21.39.043(e). NCCI responded to the division's interrogatories on October 25, 2011. On November 9, 2011, the division asked for an extension as provided for in AS 21.39.043(e).

DISCUSSION OF FILING METHODOLOGY

1. Consistent with the 2011 filing, NCCI again

    - based the overall indication on three policy years of experience;
    - used limited losses in the loss development factor selection and incorporated an excess provision to adjust the losses to an unlimited basis; and
    - used a five-year average of paid-plus-case loss development factors.

2. NCCI proposed to decrease the loss adjustment expense (LAE) provision from 19.5 percent to 18.5 percent. This change is due to a decrease from 11.7 percent to 11.0 percent in the defense and cost containment portion of the LAE and a decrease in the adjusting and other expense provision from 7.8 percent to 7.5 percent. NCCI based the selection of LAE on experience obtained through a special data call. Consistent with the change first made in the 2010 filing, NCCI included only private carrier data, and excluded state-fund data.

3. For the tail loss development factors, NCCI used a seven-year average, rather than the eight-year average used in 2011, the six-year average used in 2010 and 2009, or the five-year average that had been used in filings before 2009. The change in the number of years used was to smooth the impact of one unusually large indemnity tail factor and two unusually large medical tail factors. Decreasing the number of years for 2012 allowed one of the older volatile factors to be removed from the calculation.

4. NCCI selected a minus 5.5 percent indemnity loss ratio trend and a 0.0 percent medical loss ratio trend. These are the same trend factors as selected for the 2010 filing. NCCI stated that the annual frequency trend for policy year 2009 continued to decrease from policy year 2008; however, the accident year 2010 frequency shows an increase over accident year 2009. Indemnity loss ratio trends continue to decline, but NCCI selected the same indemnity trend factor used in the 2011 filing due to fluctuations in the underlying severity trends and the flattening of the frequency trend. Large trend factors have an increasing amount of leverage on the overall indication as they move further away from unity, so maintaining the same trend as in the 2011 filing promotes stability. Medical severity continues to increase at about 3.5 percent annually, which is largely offset by the decline in frequency. The selected medical trend factor is in the middle of the various trend fits.

5. Under AS 23.30.097, the fee schedule for medical treatment or service based upon the December 1, 2004 fee schedule and adjusted for changes from 2004 to 2008 in the medical care component of the Consumer Price Index for all urban consumers compiled by the United States Department of Labor, Bureau of Labor Statistics was not applicable after December 31, 2010. At the time of the 2011 filing, there was no replacement fee schedule. Therefore, NCCI included an increase in benefit costs of 3.3 percent into the 2011 filing to account for the sunset of the medical fee schedule. On October 7, 2011, the governor signed House Bill 13, which established a fee schedule to be effective on or after December 31, 2010. Since the legislation was not in effect at the time NCCI

submitted the 2012 filing, no adjustment in the loss costs was proposed for this new fee schedule. The 3.3 percent increase contained in the 2011 loss costs remained in the proposed 2012 loss costs.

6. NCCI revised the experience rating off-balance procedure to reduce the intrastate off-balance in the aggregate ratemaking to help better align the loss experience and premium adequacy for small risks.

7. As in the 2011 filing, the large loss base year threshold was determined by applying the change in average weekly wage for 2009 – 2013 to the 2009 large loss threshold taken from the 2011 filing. A wage index is assumed to reflect the impacts of inflation on claim values. The 2012 threshold is $4,891,856 compared to $4,597,429 in 2011.

8. In the 2011 filing, NCCI addressed Alaska's unique combination of a high tail factor and a low excess ratio by using Alaska-specific excess ratios instead of countrywide ratios in the tail factor adjustment calculation. This same procedure was used in the 2012 filing.

9. NCCI proposed to use the Alaska state average weekly wage in determining the payroll for partners and sole proprietors. Previous filings have used an NCCI calculated value based on the Alaska current population survey (CPS) wage data. This change was made since NCCI no longer calculates the CPS average weekly wage for any other purpose; the state average weekly wage is calculated by the state as well as already being used to establish the minimum payroll of executive officers and it is the basis for determining benefits.

10. NCCI proposed to increase the USL&H factor by 5.7 percent to recognize the difference between state and federal loss-based expenses.

11. The assigned risk portion of the filing includes

    - an excess of loss reinsurance expense;
    - an uncollectible premium provision; and
    - the assigned risk plan administration expenses.

    NCCI proposed a small decrease of 0.45 percent in assigned risk expenses. This change is due to several factors:

    a) the excess of loss reinsurance provision is a higher percentage of the premium;
    b) the uncollectible premium provision is increased by 0.2 percent;
    c) the cost of D&O and E&O insurance that was in the 2011 filing was excluded;
    d) NCCI used 10 years of experience instead of five years to calculate the administrative expenses.

12. A servicing carrier RFP was published in May 2011 to select servicing carriers for the Alaska assigned risk market for 2012 – 2014. When NCCI submitted the filing to the

division, the servicing carrier selection process was not complete. Therefore, NCCI included the 2011 servicing carrier allowance in the expenses for 2012 until the actual servicing carrier allowance is known.

13. In the past, NCCI applied the same swing limits to the F-classes as to the industrial classes. In 2010 NCCI changed the swing limits from +/-25 percent to +/-15 percent for the F-classes due to relatively low exposure and the potential for large swings in loss costs for these classes. NCCI proposes to continue to use +/-15 percent for the F-classes to mitigate large swings in the class loss costs due to low exposure.

INTERESTED PARTIES' REQUESTED MODIFICATIONS AND COMMENTS

ANIC provided testimony at the hearing and raised four general concerns with the filing:

- the adjusting and other expense provision volatility from year-to-year;
- the large loss factor that is consistently lower than other states;
- the year-to-year volatility in loss development;
- the unexplained reduction in experience used to calculate the tail factor.

The following rationale for these concerns was provided.

ANIC commented that reasonableness should be added to the stability and responsiveness criteria for evaluating a change. ANIC specifically commented on year-to-year volatility in the adjusting and other expense (AOE) provision and the tail factors, and that the methodology for making these selections may be causing some of the fluctuation rather than actual changes in cost. For example, when comparing the developed adjusting and other expense provisions between the 2011 filing and the proposed 2012 filing, the 2012 filing has lower AOE ratios than the 2011 filing. For accident year 2008 and earlier the differences are small, about 0.1 point, but for accident year 2009 the difference is 0.5 points.

ANIC commented that, because Alaska's large loss threshold is lower than that of other western states, it seems unreasonable that the large loss factor to adjust limited losses to unlimited losses would also be lower than the large loss factors of other western states, particularly because Alaska has a higher catastrophe exposure than other western states. ANIC provided the following comparison between Alaska, Montana, Idaho, and Oregon from the 2011 NCCI filings for these states:

State	Threshold	Large Loss Factor
Alaska	4,597,429	1.016
Montana	7,770,839	1.025
Idaho	6,364,882	1.033
Oregon	12,323,284	1.024

ANIC questioned the selection of the loss development factors and whether the selected factors meets NCCI's goal of responsiveness. ANIC commented that the most recent paid-plus-case loss development factors are the highest in the last five years. Therefore, using a five-year average results in loss development factors that are too low.

ANIC also commented that NCCI appears to be struggling with the methodology used to select the tail factor since they have varied the number of years in the calculation (five – eight years) in the filings since 2008, and that changing the tail factors from year-to-year defeats NCCI's stated goal of stability.

APEI provided testimony at the hearing and raised the following concerns with the filing:

- the frequency, severity, and loss ratio graphs did not include the most recent accident year as they have in the past;
- alternate indications that include alternate trend assumptions would be more useful than some of the alternatives currently provided;
- the large loss threshold should be a function of exposure rather than loss costs as it is not intuitive that the threshold should go up and down as the loss costs fluctuate;
- the large loss procedure understates the actual large losses because it relies on actual loss experience rather than potential exposure.

NCCI REBUTTAL

The total LAE percentage decreased between the 2011 filing and the proposed 2012 filing. The decrease occurred in both the AOE percentage as well as the defense and cost containment expense (DCCE) percentage. NCCI identified two main factors contributing to these decreases. Since the LAE provisions are calculated as a percentage of the paid losses, changes in loss development for paid losses and LAE lowered the DCCE-to-loss ratio and the AOE-to-loss ratio; specifically, paid loss development factors increased while paid DCCE and AOE development factors decreased. Incurred development factors for losses, DCCE and AOE all decreased. In addition to the changes in loss development factors, actual paid losses were greater than expected, while paid DCCE and paid AOE emergence was less than expected. This also resulted in lower LAE-to-loss ratios. NCCI continued to use the two most recent accident year experience periods to select the LAE percentages.

NCCI stated that, when the large loss procedure was introduced, the countrywide excess curves were credibility weighted with Alaska data. From these curves, Alaska shows small permanent total and permanent partial injury tails compared to other states, which result in a smaller excess ratio for Alaska. NCCI also stated that, while comparisons between Alaska's excess ratio and other western states was provided at the hearing, no analysis was provided to illustrate how Alaska's individual large claim risk is better or worse than that of other states and that each state's individual experience influences the excess ratio.

NCCI stated that, since premium is defined as payroll multiplied by loss costs, calculating the threshold based on premium does reflect exposure and if payroll was the sole basis for determining the threshold, two states with the same payroll but different large loss exposure would have the same threshold. When the large loss procedure was implemented in 2005, NCCI explored several alternatives and determined that the threshold was most appropriate at an amount where a claim of that amount would impact the overall aggregate indication by one percent or more, so the threshold was calculated as one percent of the experience period ultimate on-leveled loss costs. Since a one percent premium change is one of the goals of the large loss procedure, basing the threshold on premium is appropriate. In addition, aggregate payroll is not collected in NCCI's data calls.

NCCI addressed the volatility in loss development factors (LDF) by continuing to use paid-plus-case data to "balance stability and responsiveness by smoothing the effect of reserve fluctuations on LDFs while reflecting the impact of changing LDFs." Alaska's loss development does fluctuate from year to year and, since the high factors in the most recent evaluation may or may not indicate a trend, the use of a shorter term average would reduce the stability of the factors. Using a shorter term average may also result in an overreaction to the more recent data and an overestimation of the ultimate value of the losses.

The number of years used in selecting the tail factor has ranged from five years in 2008 and prior filings to eight years in 2011. The additional years were added to smooth the volatility in the factors. Decreasing the number of years from eight to seven in 2012 allows the high tail factor to be removed from the experience.

FINDINGS

After fully reviewing and considering the supporting documentation and testimony, both written and oral, the director finds:

1. The use of paid-plus-case loss development is acceptable. The order adopting the 2011 loss costs requested NCCI to include documentation related to the selection of paid or paid-plus-case data in the 2012 filing. NCCI stated that the differences between the indications based on paid vs. paid-plus-case show that paid experience appears to be lagging and the paid-plus-case is expected to be more predictive.

2. The proposed LAE of 18.5 percent has been adequately supported. The use of a two-year average for calculating the adjusting and other expense portion of the LAE is acceptable.

3. The use of a seven-year average rather than eight to calculate the loss development tail factors is acceptable. In the order adopting the 2011 filing, NCCI was requested to demonstrate why it is appropriate to continue use of the unusually large tail factors instead of letting the older years drop out of the experience period used in the calculation. The large medical tail factor that falls out of the experience by reducing the number of years from eight to seven appears to be an anomaly and removing it allows the tail factor to be based on the more recent data valuations. As ANIC noted in its testimony, the data used to predict tail factors is old and changes from year to year have little or no

credibility. While removing the eighth year does result in a lowering of the tail factor, relying on more recent data is acceptable.

4. The NCCI selected indemnity trend factor of minus 5.5 percent and the selected medical trend factor of 0.0 percent are acceptable. The decreasing trend in medical loss ratios beginning in 2006 appears to be flattening out and the 2010 accident year indication is a slight increase. In spite of the leveling-off of the medical loss ratios, the medical severity continues to be a fairly steady upward trend. The indemnity loss ratio trend shows a similar pattern of decreases since 2000 with a small increase in the 2010 accident year loss ratio.

5. The inclusion of a provision to account for the sunset of the medical fee schedule on December 31, 2010, was acceptable at the time the filing was submitted to the division on August 24, 2011. However, on October 7, 2011, the governor signed HB 13 that provides for a fee schedule based on the 90th percentile of billed charges to be applied to workers compensation claims. NCCI analyzed the fee schedule and proposed to remove the 3.3 percent increase related to the sunset filed in 2011 and replace it with a 2.0 percent increase based on the newly adopted fee schedule that is effective for service provided beginning December 31, 2010. This change to the overall indication is acceptable.

6. The revision to the calculation of the experience rating off-balance factors is acceptable.

7. In the order adopting the 2011 filing, NCCI was requested to demonstrate that the continued use of the large loss procedure in Alaska is appropriate. NCCI was specifically ordered to provide justification for the continued use of the large loss procedure, which must be more than just general statements related to the rationale for using a large loss procedure or that it is NCCI's standard countrywide procedure and must specifically address how and why it benefits Alaska to continue to use limited losses rather than unlimited losses. NCCI's response was a hypothetical example of why a large loss procedure is appropriate and did not really address the actual impact of the procedure on Alaska loss costs. On a follow-up question from the division, NCCI responded that it again adjusted the tail factor to account for Alaska's unique combination of a relatively high tail factor and relatively low loss ratio. NCCI also stated that, without the large loss procedure, instability would be introduced into the ratemaking process. Since Alaska has so few capped individual large claims (only nine claims have been capped from the most recent 19 policy year history of large claims), it is difficult for NCCI to illustrate how the large loss procedure stabilizes the loss cost changes in Alaska.

   Prior to the 2005 loss cost filing, NCCI did not include a large loss procedure and no evidence has been provided to show that the indications before 2005 are more unstable than the indications since 2005. With so few large losses that are actually being removed from the experience and the tail factor adjustments that are needed to reflect Alaska's experience, the large loss procedure replaces actual experience with subjective adjustments to the data. While stability is one consideration in selecting an appropriate methodology, AS 21.39.030 requires that rates not be excessive, inadequate, or unfairly discriminatory. The use of actual data, rather than subjective adjustments, can better meet the statutory requirements. The 2012 filing and future filings should use unlimited data. In the event that a truly large claim does emerge in future years, there are alternate actuarial techniques that can be used to mitigate its impact.

8. The use of the state average weekly wage for determining the basis of premium for partners and sole proprietors is acceptable.

9. The division does not agree that the current 30 percent USL&H percentage reflects the difference in state and federal benefits only. Since no other USL&H factor has been approved, the 30 percent must cover all costs related to USL&H coverage, including the difference in benefits as well as loss based expenses. NCCI has not provided any support to demonstrate that the current 30 percent surcharge results in rates that are inadequate. The change in methodology to incorporate a loss based expense provision has not been adequately justified.

10. NCCI's proposal to increase the number of years, from five to 10, used in the calculation of the assigned risk market administrative expenses was proposed simply to smooth the expense ratios. AS 21.39.030 states that rates shall not be excessive, inadequate, or unfairly discriminatory. 3 AAC 30.030(d)(3) states that "to the extent practical, rates shall be established and maintained at a level that permits the assigned risk pool to operate as a self-funded mechanism based upon . . . administrative expenses incurred to operate the assigned risk pool . . . ." Adding additional older years of data to determine the administrative expense provision does not comply with these standards. The administrative expense provision should be based on the most recent five years of data as in past filings.

11. The provisional 2011 servicing carrier provision of 30.29 percent should be replaced by the actual 2012 servicing carrier allowance of 29.51 percent.

12. The +/-15 percent swing limits for the F-classes are acceptable.

ORDER

For the reasons set forth above and in accordance with AS 21.39.043, the director orders that

A. The following modifications should be made to the 2012 loss costs and assigned risk rates:

    1. The medical fee schedule impact of HB 13 of 2.0 percent should replace the 3.3 percent impact of the medical fee schedule sunset.
    2. The actual 2012 servicing carrier allowance of 29.51 percent should be used in the assigned risk expense calculation.

3. The administrative expenses for the assigned risk rates should be calculated using the most recent five years of data, increasing the administrative expense provision from 3.56 percent to 3.97 percent.
4. The indicated change based on experience should use unlimited paid-plus-case losses with a five-year development resulting in a 5.0 percent experience and trend indication instead of the 3.5 percent filed indication.

These modifications result in a 2.9 percent change to the voluntary loss costs and a 2.5 percent change to the assigned risk rates. Since the modified overall indications are similar to the NCCI filed indications and, in the interest of having 2012 loss costs and assigned risk rates available in a timely manner for policy renewals on January 1, 2012, the voluntary loss cost increase of 2.7 percent and the assigned risk rate increase of 2.9 percent are approved as filed.

B. The USL&H loss based assessment of 1.057 is disapproved.

C. In the 2013 filing NCCI will use unlimited losses.

D. The alternative indications NCCI provides in the 2013 filing should include unlimited losses with a three-year average, a five-year average, and a five-year xhilo average using both paid and paid-plus-case loss development. NCCI may include any other alternative indications that it feels are needed and are justifiable to support the filing.

This order is effective November 23, 2011.

Linda S. Hall
Linda S. Hall
Director