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NOV 05 2014

OFFICE OF INSURANCE REGULATION

OFFICE OF INSURANCE REGULATION
Docketed by: NWO

KEVIN M. MCCARTY
COMMISSIONER

REVISED WORKERS' COMPENSATION RATES AND RATING VALUES AS CONTAINED IN THE FILING SUBMITTED BY: NATIONAL COUNCIL ON COMPENSATION INSURANCE, INC

Case No. 159541-14

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ORDER ON RATE FILING

On August 22, 2014, the **NATIONAL COUNCIL ON COMPENSATION INSURANCE, INC** ("**NCCI**") filed, pursuant to Section 627.091, Florida Statutes, revised Workers' Compensation Rates and Rating Values for consideration and review by the **FLORIDA OFFICE OF INSURANCE REGULATION ("OFFICE")**. The filing proposed a 2.5% (2.5 percent) decrease in the overall rate level, to be effective January 1, 2015, on new and renewal policies. On September 22, 2014, **NCCI** filed an amended filing (hereinafter the "Filing") which proposed a 3.3% (3.3 percent) decrease in the overall rate level to become effective January 1, 2015, on all new and renewal policies.

The **OFFICE**, having concluded that it would be in the public interest to hold a public hearing pursuant to Section 627.101, Florida Statutes, for the purpose of allowing the public an opportunity to speak or present evidence regarding the matters contained in the Filing, and by doing so assist the **OFFICE** in determining whether the Filing meets the applicable requirements of law, held a public hearing ("Hearing") on October 14, 2014, in room 401 of the Senate Office Building in Tallahassee, Florida.

The Commissioner of the Office of Insurance Regulation, having considered the Filing and additional information submitted by **NCCI**, the supporting data, oral and written statements presented at the Hearing, the analysis by the staff of the **OFFICE**, and being otherwise fully advised in the premises finds:

1. The Commissioner of the Office of Insurance Regulation has jurisdiction over the parties and the subject matter of these proceedings.

2. Notice of the Hearing was published in Vol. 40, No. 181, of The Florida Administrative Register on September 17, 2014, on page 4017. Notice was also sent directly to **NCCI** and to other persons requesting to be notified of such events.

3. Some of the proposed changes in the Filing have not been justified.

4. Since **NCCI** began including trend in its workers' compensation filings, it has displayed the on-level developed loss ratio trends based on fitting the data to either a linear or exponential curve. This loss ratio trend was the primary basis and for many years the only basis for **NCCI's** trend selection. In the more recent filings, **NCCI** expanded the trend section of the filings by including not only the loss ratio data, but also data showing frequency and severity. The loss ratio trend data in the Filing shows a long term downward trend in loss ratios for indemnity of -6.4% and for medical of -4.0%, using an exponential trend fit to the policy year data for the latest 15 years for Standard Coverage. However, the shorter term loss ratio trend data in the Filing shows a decreasing trend for indemnity equal to approximately one-third of the long term indemnity trend and an upward trend for medical. The trend data in the Filing reflects losses that have been adjusted to the current level using the **NCCI** initial estimate of the effect of the 2003 reforms. If the actual impact of the 2003 reforms is greater than the initial estimate (as is commonly believed), then the use of the longer term data in the

Filing would produce trends that are too low. Recognizing that the 2003 reforms have affected the data in ways that will not be repeated in the future and the more recent, shorter term trends, the **NCCI** selected indemnity trend of -2.0% appears to be reasonable, while the selected medical trend of 0.0% has not been justified.

5. In this Filing, the internal rate of return model used by **NCCI** in selecting the profit and contingencies factor of +4.5% does not include anticipated policyholder dividends. **NCCI** indicated at the hearing that they would have chosen the same profit and contingencies factor of +4.5% even if policyholder dividends were considered. Florida workers' compensation rates have not previously included an explicit policyholder dividends provision greater than zero. Further, the failure to explicitly load an amount for policyholder dividends into the rates has not precluded insurers from paying policyholder dividends in Florida. Thus, policyholders in Florida have received substantial dividends without the explicit inclusion of a provision for policyholder dividends greater than zero.

6. Policyholder dividends are, by definition, a non-guaranteed return of profits, which means the payment of policyholder dividends is left strictly to the discretion of the insurers. In order for a policyholder to be eligible for a policyholder dividend, the insurance carrier files a participating endorsement that is attached to and becomes part of the policy. Many insurance carriers do not intend to pay policyholder dividends and have not filed such endorsements. Of the 256 insurance carriers actively writing workers' compensation in Florida in calendar year 2013, only 92 carriers paid policyholder dividends. Thus, if the rates are explicitly loaded for policyholder dividends, some employers will pay higher rates without any possibility of receiving a dividend, so

that other employers can receive a policyholder dividend. This loading would likely result in unfairly discriminatory rates.

7. Pursuant to Actuarial Standards of Practice 29, "[w]hen the actuary determines that policyholder dividends are a reasonably expected expense and are associated with the risk transfer, the actuary may include a provision in the rate for the expected amount of policyholder dividends." **NCCI** has not demonstrated that for Florida workers' compensation, policyholder dividends are a reasonably expected expense and are associated with the risk transfer. Nor has **NCCI** demonstrated that in accordance with Actuarial Standards of Practice 29, they have considered the following: the companies' dividend payment history, the current dividend policy or practice, whether dividends are related to loss experience, the capitalization of the companies, and other considerations affecting the payment of dividends. Further, **NCCI** did not address these factors at the Hearing or in the Filing.

8. **NCCI** has estimated the investment yield at +2.676%, a yield near historic long term lows. This estimate is significantly below the average representative portfolio yields over the recent past and below expected yields in the near future as economic performance continues to improve.

9. The basis of **NCCI**'s Discounted Cash Flow (DCF) model is the Gordon dividend growth model. The Gordon dividend growth model is best suited for firms growing at a stable rate and is generally used to estimate the cost of capital for regulated entities. **NCCI** uses an extremely long term average (1929-2013) of nominal Gross Domestic Product (GDP) growth in the DCF model to determine the long-term dividend growth rate of +6.23% and applies the assumption that the growth in economic activity mean-reverts to a long-term average in the long run. While the **OFFICE** agrees

with **NCCI** regarding some degree of intertemporal mean reversion, it is not apparent from the information provided in the Filing or at the Hearing that an 85-year average is necessarily the most appropriate timeframe to develop an appropriate mean reversion framework. The growth in GDP has been lower than **NCCI**'s estimate of +6.23% for approximately 40 years. In addition, **NCCI** has not provided economic justification for using the two-stage model. If a shorter-term average of GDP growth is used as the dividend growth rate, a lower cost of capital results.

10. **NCCI** changed their methodology for determining the selected profit and contingencies provision. **NCCI**'s expert witness testified at the Hearing that the change in the methodology is due to unprecedented economic conditions that have caused interest rates to remain near historic lows for an extended period. He also testified that low interest rates negatively impact the industry's ability to earn investment income and that this situation is expected to continue for the foreseeable future. **NCCI** presented no evidence in the Filing or at the Hearing regarding the actual investment income realized by property and casualty insurers in the recent past.

11. The analysis and data underlying the 2013 Office of Insurance Regulation Workers' Compensation Annual Report (hereinafter the "Report") finds the Florida workers' compensation market to be stable, competitive, and robust. Based on data from 2012, the Report indicates that the market is served by a large number of independent insurers with no significant barriers to entry or exit. The number of companies writing workers' compensation in the state has remained stable, and the residual market remains one of the smallest in the country as a percentage of premium. Additionally, the Report specifies that the 2012 Herfindahl-Hirschman Index (HHI), a measure of market concentration, for Florida is 330.93, which suggests a competitive

market. Moreover, the Florida workers' compensation market has become progressively more competitive following the 2003 legislative reforms as indicated by a declining HHI from 404 in 2005 to 330.93 in 2012. Also noted in the report is the fact that the 2012 Florida aggregate loss ratios are the second lowest among the six most populous states. Nothing presented in the Report suggests any market wide or systemic issues in the Florida workers' compensation market.

12. Based on Paragraphs 5. through 11. above, the +4.5% profit and contingencies provision is excessive. The use of a +4.5% profit and contingencies provision in the Filing does not adequately reflect investment income on unearned premium and loss reserves as required by Section 627.072, Florida Statutes. Significantly, **NCCI** just only last year requested and had approved a profit and contingency provision of +2.5%. The record does not reflect any appreciable change in economic conditions that would justify a near doubling of such provision. As discussed above, the Florida workers' compensation market is functioning very well while taking into account current economic conditions. Therefore, a +4.5% profit and contingency provision has not been justified.

13. **NCCI** is proposing an increase in the percentage of the premium dollar that is allocated to production expenses. **NCCI** has not provided evidence that production expenses need to be increased by the magnitude proposed in the Filing. Thus, **NCCI** has not justified the increase in production expenses.

14. **NCCI** is proposing an increase in minimum premiums by increasing the multiplier by 17.6% and increasing maximum minimum premiums by 9.1%. It is not clear from the data provided in the Filing that an increase to both the minimum premium multiplier and maximum minimum premium are justified.

15. Classification code 8728 for Outside Insurance Claim Adjusters was established as a Florida state special classification code as a result of **NCCI** item filing B-1419, effective 1/1/2011. Prior to this Filing, the rate and rating values for this classification code were based on classification code 8742 for Outside Salespersons or Collectors because insurance claims adjusters were previously assigned to classification code 8742 prior to establishing classification code 8728. Classification code 8742 is assigned to the Office and Clerical industry group. With this Filing, classification code 8728 has approximately one year of actual experience to utilize as the basis for the rate. **NCCI** has assigned classification code 8728 to the Goods and Services industry group and based the proposed rate on this industry group. The Goods and Services industry group assignment was based on a national analysis for classification code 8720 (Inspection of Risks for Insurance or Valuation Purposes) which was not provided in the Filing and does not apply to Florida state special classification code 8728. Therefore, the industry group assignment and the proposed rate for classification code 8728 have not been justified.

16. **NCCI** introduced a new methodology used to the develop the Excess Loss Factors (ELF) and Excess Loss and Allocated Expense Factors (ELAEF) as well as the Hazard Group Differentials used in the NCCI Retrospective Rating Plan. These excess factors are also used in class ratemaking to bring the limited losses to an unlimited level. The methodology change is a significant departure from the methodology used in prior filings. The proposed methodology for Permanent Total Disability differs from the methodology for the other injury types; therefore, the additional trend is not necessary. **NCCI** stated in an interrogatory response that removing the additional trend has no impact on six of the seven Hazard Groups.

17. **NCCI** revised the methodology used to calculate the rates for Maritime and Federal Employers' Liability Act (FELA) classification codes. The revised methodology relies on maritime loss experience data reported to **NCCI** as the basis of the maritime rate calculation rather than relying on the experience of related federal or state classification codes. While the methodology represents an improvement over the current methodology, it is appropriate to monitor the impact of the new method on these classifications and limit the impact of the new methodology in the first year of implementation.

WHEREFORE, in consideration of the foregoing and being otherwise duly advised in the premises, it is hereby ORDERED:

The Filing of **NCCI** is hereby DISAPPROVED. The Filing will be approved provided the Filing is amended to comply with all of the following and such amendments to the Filing are filed as soon as practicable.

A. The statewide overall rate level change for the Filing for new and renewal policies for other than the "F" classifications shall be -5.2% (-5.2 percent), effective January 1, 2015, which includes a -2.0% annual trend for indemnity and a +0.5% annual trend for medical.

B. The +4.5% (+4.5 percent) allowance for profit and contingencies for the proposed rates in the Filing and identified in Exhibit II of the Filing is disapproved. Exhibit II of the Filing shall be re-filed containing a profit and contingencies provision no greater than +2.5% (+2.5 percent). The +2.5% (+2.5 percent) profit and contingencies provision shall also apply to the "F" classifications.

C. The +17.60% (+17.60 percent) allowance for production expense for the proposed rates in the Filing and identified in Exhibit II of the Filing is disapproved.

Exhibit II of the Filing shall be re-filed containing a production expense provision no greater than +17.40% (+17.40 percent). The +17.40% (+17.40 percent) production expense provision shall also apply to the "F" classifications.

D. The statewide overall rate level change in the Filing for "F" classifications for new and renewal policies shall be adjusted to reflect the +17.40% (+17.40 percent) production expense provision, the +2.5% (+2.5 percent) profit and contingencies provision, a -2.0% annual trend for indemnity, and a +0.5% annual trend for medical effective January 1, 2015.

E. The proposed change in the minimum premium multiplier is disapproved, and the maximum minimum premium shall be $1,200.

F. Classification code 8728 shall be assigned to the Office and Clerical industry group and the rate and rating values shall be based on the Office and Clerical industry group.

G. The Hazard Group Differential for Hazard Group F shall be 0.90.

H. For Maritime and FELA classification codes, the swing limits shall be no greater than the rate level change for the Miscellaneous Industry Group plus or minus 10% (10 percent) rounded to the nearest 1% (1 percent).

I. **NCCI** shall list and explain each and every change in the proposed manual pages, including the experience rating plan manual and the retrospective rating plan manual. These shall be shown in the summary exhibit and described by an explanatory memorandum.

J. **NCCI** shall provide to the **OFFICE** a report for each quarter of calendar year 2015 showing the average intrastate experience modification factor for policies with effective dates in the year 2015 and for the same policies with effective dates for a comparable period in calendar year 2014. The report for each quarter shall be filed within 30 days of the end of the quarter. Thus, the first report will be due no later than May 1, 2015 for the first quarter of calendar year 2015. In addition to the quarterly report, **NCCI** shall provide a monthly report to the **OFFICE** of the average intrastate mod for the policies effective during the month. This monthly report shall be filed with the **OFFICE** within 7 days of the end of the month. Thus, the January 2015 report will be due no later than February 7th.

To meet statutory timeframes for a January 1, 2015 effective date, **NCCI** shall file the necessary amendments to the Filing as may be required to implement the terms of this Order as soon as practicable but no later than November 11, 2014. No rate change shall be implemented until such amendments are properly filed and final approval is issued by the **OFFICE**.

By making a filing to comply with this order, **NCCI** waives any right to any further proceedings and authorizes the **OFFICE** to enter a final order on the Filing.

DONE and ORDERED this 5th day of November, 2014.

Kevin M. McCarty, Commissioner
Office of Insurance Regulation

Copies furnished to:

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NOTICE OF RIGHTS

Pursuant to Sections 120.569 and 120.57, Florida Statutes and Rule Chapter 28-106, Florida Administrative Code (F.A.C.), you may have a right to request a proceeding to contest this action by the Office of Insurance Regulation (hereinafter the "Office"). You may request a proceeding by filing a Petition. Your Petition for a proceeding must be in writing and must be filed with the General Counsel acting as the Agency Clerk, Office of Insurance Regulation. If served by U.S. Mail the Petition should be addressed to the Florida Office of Insurance Regulation at 612 Larson Building, Tallahassee, Florida 32399-4206. If Express Mail or hand-delivery is utilized, the Petition should be delivered to 612 Larson Building, 200 East Gaines Street, Tallahassee, Florida 32399-0300. The written Petition must be received by, and filed in the Office no later than 5:00 p.m. on the twenty-first (21) day after your receipt of this notice. Unless your Petition challenging this action is received by the Office within twenty-one (21) days from the date of the receipt of this notice, the right to a proceeding shall be deemed waived. Mailing the response on the twenty-first day will not preserve your right to a hearing.

If a proceeding is requested and there is no dispute of material fact the provisions of Section 120.57(2), Florida Statutes may apply. In this regard you may submit oral or written evidence in opposition to the action taken by this agency or a written statement challenging the grounds upon which the agency has relied. While a hearing is normally not required in the absence of a dispute of fact, if you feel that a hearing is necessary one may be conducted in Tallahassee, Florida or by telephonic conference call upon your request.

If you dispute material facts which are the basis for this agency's action you may request a formal adversarial proceeding pursuant to Sections 120.569 and 120.57(1), Florida Statutes. If you request this type of proceeding, the request must comply with all of the requirements of Rule Chapter 28-106.201, F.A.C., must demonstrate that your substantial interests have been affected by this agency's action, and contain:

a) A statement of all disputed issues of material fact. If there are none, the petition must so indicate;

b) A concise statement of the ultimate facts alleged, including the specific facts the petitioner contends warrant reversal or modification of the agency's proposed action;

c) A statement of the specific rules or statutes the petitioner contends require reversal or modification of the agency's proposed action; and

d) A statement of the relief sought by the petitioner, stating precisely the action petitioner wishes the agency to take with respect to the agency's proposed action.

These proceedings are held before a State Administrative Law Judge of the Division of Administrative Hearings. Unless the majority of witnesses are located elsewhere, the Office will request that the hearing be conducted in Tallahassee.

In some instances, you may have additional statutory rights than the ones described herein.

Failure to follow the procedure outlined with regard to your response to this notice may result in the request being denied. Any request for administrative proceeding received prior to the date of this notice shall be deemed abandoned unless timely renewed in compliance with the guidelines as set out above.

Revised 02/04/2008