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REGULATORY ORDER NUMBER R 16-04

APPROVAL WITH MODIFICATION OF THE 2017 WORKERS' COMPENSATION LOSS COST FILING AND ASSIGNED RISK RATE FILING

BACKGROUND:

On August 22, 2016, the Division of Insurance (division) received the 2017 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 5.5% decrease in voluntary loss costs and an overall 4.6% decrease in assigned risk rates from the current approved levels.

On July 18, 2016 the director issued Notice of Public Hearing H 16-02 notifying interested parties that, in accordance with AS 21.39.043, a hearing would be held on September 13, 2016. 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.

Alaska National Insurance Company (ANIC) requested information from NCCI on August 31, 2016. NCCI responded to ANIC's request on September 6, 2016. No other questions and no written testimony was received by the division prior to the hearing. At the hearing, ANIC provided testimony and supporting exhibits. No written comments were received after the hearing.

DISCUSSION OF FILING METHODOLOGY

1. Consistent with what was approved in the 2016 filing, NCCI again:

   - based the overall indication on three policy years (PY) of experience (2012, 2013, and 2014);
   - used limited losses and incorporated an excess provision to adjust the losses to an unlimited basis in accordance with their Large Loss Procedure (LLP);
   - used a combination of paid and paid-plus-case loss development factors;
   - used paid-plus-case experience to derive the tail loss development factors, adjusted to be on a limited basis (and further adjusted as necessary when applied to paid experience);
   - used a 10-year average to determine assigned risk administrative expenses (with adjustment to reflect a recent change in allocation of general expenses to products and services that carriers are responsible for paying).

2. NCCI proposed to increase the loss adjustment expense (LAE) provision from 16.8% to 17.0%. This change is due to a decrease, from 9.7% to 9.6%, in the defense and cost containment (DCC) portion of the LAE and an increase in the adjusting and other (AO) provision from 7.1% to 7.4%.

3. NCCI proposed using annual trends of -5.0% and -0.5% to adjust historical indemnity and medical loss ratios, respectively. These trend selections are within the range of the exponential trend fits presented within the filing, which range from 5-point to 15-point, and are based on experience data with losses limited by the LLP. The proposed loss ratio trends are the same as those utilized in the 2016 filing.

4. The assigned risk portion of the filing includes the following items:

    - servicing carrier allowance, based on the 2015 – 2017 servicing carrier bid process, updated to reflect the impact of changes in policy counts (increasing 0.3%[1]);
    - assigned risk plan commission rate (no change);
    - assigned risk plan administration expenses (increasing 0.1%);
    - excess of loss reinsurance expense (increasing 0.3%);
    - uncollectible premium provision (decreasing 0.2%);

5. NCCI included an adjustment to incorporate the expected impact due to the January 1, 2016 update to the Medicare fee schedules. The annual updates to the Medicare fee schedules are automatically incorporated in Alaska's medical fee schedule by reference.

6. The large loss limit threshold utilized in the LLP was updated to reflect changes in Alaska's premium levels.

7. Various values were revised within the Footnote and Advisory Miscellaneous Values loss cost and rate pages, the Experience Rating Plan Manual pages, and the Retrospective Rating Plan Manual State Special Rating Values pages based on previously approved standard formulas to reflect changes identified elsewhere within the filing, such as changes in the state average weekly wage, relative changes in state and federal benefits, and proposed loss cost level changes..

INTERESTED PARTY'S REQUESTED MODIFICATIONS AND COMMENTS

ANIC provided testimony at the hearing and requested the following modifications to the filing:

- The medical loss ratio trend should be 0.0%;
- The indemnity loss ratio trend should be less negative than -5.0%;
- The factor to adjust limited losses to an unlimited basis should not be reduced (versus the factor used last year).

The third modification was recommended as an interim solution only; long-term, ANIC suggested NCCI perform a more fundamental review of how they incorporate large losses to ensure the methodology is adequately responsive to apparent recent and continuing changes in

[1] Percentages are changes versus the corresponding component values approved in the 2016 filing and are expressed as a % of premium.

large loss emergence and is not over-smoothing and oversimplifying based on much older historical experience.

ANIC provided exhibits showing:

- that medical loss ratios have been relatively flat over recent historical time periods,
- that both medical and indemnity loss ratio exponential trend fits exhibit a generally increasing pattern as the historical timeframe decreases, and
- the relationship between the set of medical loss ratio trend fits that underlie the current filing's -0.5% trend selection compared to corresponding sets of trend fits underlying the 0.0% medical loss ratio trend selections in the prior two years' filings.

ANIC additionally provided comments related to the appropriateness of the DCC expense ratio assumption prospectively, considering the recent medical fee schedule change. Per ANIC, payments under the old medical fee schedule were relatively simpler to process and bill review costs were much lower. Accordingly, unadjusted historical DCC expense ratios are not accurate prospectively.

The division requested clarification on a few items within the filing and expressed concerns related to the appropriateness of the trend selections, the LLP, and using indications based on paid-plus-case loss development averages due to the potential distortions arising from uncertainty involved in setting case reserves during the recent precarious medical fee schedule change implementation timeline.

No other interested parties provided testimony or posed questions to NCCI during the hearing.

The hearing record remained open for 10 days after the hearing date, in accordance with AS 21.39.043(d)(7). No written testimony or proposed modifications to the filing were received by the division within that timeframe.

Questions and concerns raised during the hearing which were not, in the division's view, adequately addressed by the responses NCCI provided during the hearing, were incorporated by the division into an interrogatory letter sent to NCCI on September 26, 2016, which requested additional supporting information and required a rebuttal to the evidence provided in support of applicable proposed modifications, in accordance with AS 21.39.043(e) and (f). NCCI responded with the requested information and rebuttal on October 11, 2016.

NCCI REBUTTAL

NCCI explained that their selected trends consider both short- and long-term trend indications and are within the range of trend indications based on exponential annual fits over periods of between 5 and 15 PYs. NCCI believes trend indications based on fewer than 5 PYs are less predictive and noted that relying solely on a 3-point or 5-point fit would cause considerable volatility in Alaska's overall loss costs over time. Accordingly, their trend selections are made with the goal of balancing the predictiveness of short- and long-term indications and contributing to more stable loss cost indications.

NCCI noted that several external sources are consulted in the analysis of the final trend selection, and judgmentally incorporated in the selection. There were no explicit adjustments made to attempt to recognize trends in component drivers or trends or shifts within or among various segments of the experience base. NCCI noted that neither reinsurance data nor external econometric models were used in the trend analysis.

NCCI defended the appropriateness of this years' slightly reduced excess provision and their LLP in general by referring to the underlying theory of their LLP, which is not only based on loss experience from recent policy periods in Alaska, but also on countrywide data, statistical models, and curve-fitting. NCCI also provided a list of large claims in Alaska by PY from 1985 through 2015 showing that there was another period with a similar number of excess claims; accordingly, NCCI believes there is not enough data to conclude we are experiencing a fundamental shift in the frequency and severity of large claims.

Regarding the appropriateness of the DCC expense ratio after the recent medical fee schedule change, NCCI explained that bill review costs are one component of DCC expenses and its proportion is unknown. At this time, there is not enough information to estimate the impact of any changes in bill review costs on Alaska's DCC expense ratio; NCCI provided explanations why various estimation methods suggested by the division would be inappropriate or impractical.

NCCI provided exhibits summarizing the analyses they performed related to diagnostics from which they determined that both paid and paid-plus-case experience have merit in this filing, and discussed why the difference between indications based on paid and paid-plus-case development averages has diverged in this filing versus last year's filing.

FINDINGS

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

1. The use of a combination of paid and paid-plus-case loss development is acceptable.

    a. Paid-plus-case loss development factors can be volatile over time due to differing reserve philosophies and as insurers adjust the adequacy of their case reserves. Despite the difficulties adjusters may have experienced in the latter half of PY2014 in setting case reserves due to the uncertainty surrounding the implementation and impacts of the recent medical fee schedule change, which was ultimately made effective December 1, 2015, the use of paid-plus-case data takes into account adjusters' best estimates of ultimate claim amounts including expected impacts of any applicable benefit changes. Using a longer time period over which to average these loss development factors (e.g. 5 years) helps control the volatility and lessens the influence of short term anomalous reserving changes.

    b. Paid loss development factors are not as volatile as are the paid-plus-case loss development factors. Using a shorter time period over which to average these loss development factors (e.g. 3 years) strikes a reasonable balance between responsiveness and stability.

    NCCI's applicable supporting documentation and discussion adequately support the claim that both paid and paid-plus-case experience have merit in this filing.

2. The proposed LAE provision of 17.0% is acceptable. There is not enough information at this time to reliably estimate the potential impact of the recent medical fee schedule change on the DCC component of the LAE provision. Notably, NCCI does not collect LAE data at a more specific level of detail than DCC and the applicable hearing testimony was not accompanied by sufficiently comprehensive evidence. To the extent that carriers observe material differences in DCC subsequent to the medical fee schedule

change, the division encourages the applicable data and analyses to be submitted as evidence during next year's administrative hearing process. Otherwise, changes in DCC expenses will be reflected in future loss costs as DCC expense data emerges within the experience period utilized by NCCI.

3. NCCI's loss ratio trend selections are too aggressive.

    a. Using a one-step trending procedure is acceptable; however, since a one-step procedure does not explicitly allow for and consider different short-term and long-term trends, it is imperative that the single trend selection adequately reflect shorter-term information.

    b. Selecting trends at the loss ratio level (separately for indemnity and medical benefits) is acceptable. Measuring trends at the loss ratio level of aggregation avoids having to: accurately identify all of the component drivers that make up the observed changes in loss ratios over time or break the experience into homogenous segments (for example, by injury type); measure changes and make predictions for each component or segment; and study and model interactions among components or segments. Notably each step requires some amount of judgment and their combination potentially increases error. Utilizing loss ratios automatically reflects complex interaction effects and is expected to improve accuracy and promote stability when any of the component or segment trends or their expected interactions are not well understood or predictable or are difficult to model. Nevertheless, it may provide some reassuring context if the loss ratio trends were broken down such that their implicit components could be, to the extent possible, compared to external indices, econometric models, or observed trends by segment. NCCI's response noted that various sources were consulted and judgmentally incorporated in the trend selection, yet no documentation was provided linking the referenced information to NCCI's selected loss ratio trend selections to demonstrate how that information either aligned with or diverged from the corresponding component trends implicit in NCCI's loss ratio trend selections.

    c. NCCI's discussion related to considering and incorporating trend indications based on shorter-term time periods is unpersuasive. While 3-, 4-, or 5-point trend indications may not be fully reliable such that they should be relied upon solely without considering longer-term trends, they should also not be summarily dismissed as not providing useful information simply due to their year-to-year volatility. NCCI has not demonstrated that trend fits shorter than 5-point should be dismissed without consideration nor that considering only 5- through 15-point trend indications is optimal in terms of predictiveness. Also, it is an empirical issue as to whether selecting trends that more closely align with shorter-term indications actually result in instability in loss costs. Indeed, in this filing, selecting loss ratio trends that more closely align with shorter-term indications results in less change in loss costs.

Ultimately, while it is true that NCCI's loss ratio trend selections (-5.0% indemnity and -0.5% medical) are within the range of indications they provided, they do not adequately incorporate more recent data into the overall loss cost indication. Within the context of a one-step trending procedure, loss ratio trends of -4.5% and 0.0% for indemnity and medical, respectively, are more appropriate.

4. Order R11-05 expressed concerns related to the LLP adding subjective adjustments within the loss cost indications even though no losses were being removed from the experience, and ordered that the LLP not be utilized in Alaska. NCCI again included the LLP in the 2016 filing, and Order R15-07 found the LLP to be acceptable due to updates to the excess factor methodology and Alaska's excess ratios having been incorporated since R11-05. With this 2017 filing, a phenomena opposite to that identified in R11-05 is observed; specifically, more paid-plus-case excess losses are removed in the experience period than in 2016, yet the excess ratio is decreasing. While we recognize the soundness of the theory underlying the LLP and acknowledge NCCI may not have any clearly preferable and readily available alternatives, the results nevertheless are paradoxical and suggest that the LLP is not adequately accounting for the expected future costs of excess losses. Presumably some of this is due to the mismatch and lag between the data underlying the experience period (three PYs of data ending 12/31/2014) and the data used in calculating the excess ratio (five PYs of data ending 3/31/2013). Regardless, it is difficult to have full confidence in the LLP's results.

   Also, while there is no apparent conclusive evidence demonstrating that there has been a fundamental shift in the frequency or severity of the largest claims, there is likewise no apparent conclusive evidence demonstrating the opposite. NCCI provided a listing of claims in Alaska from the latest PYs 1985 through 2015 (at half report) to show that the current "flurry" of large claims is not obviously out of line with historical experience, but the sample is relatively small and subject to sufficient random variation such that it provides little evidence either way.

   Finally, the difference between the indications based on paid versus paid-plus-case loss development averages are much smaller using unlimited loss experience than using limited loss experience (i.e. utilizing the LLP), suggesting that there is more uncertainty in the loss cost change estimates using limited loss experience. The extent to which overall uncertainty is reduced by the LLP's expected reduction in process variance is unclear.

   Since there are reasons both for and against using the LLP, the loss cost level change should be revised to be based on a combination of the limited and unlimited indications, with equal weight given to each.

5. NCCI made an interim filing, effective May 1, 2016, to incorporate the effects of the December 1, 2015 adoption of a revised Alaska medical fee schedule. The loss cost and rate changes implemented in that filing were estimated using the Medicare fee schedule promulgated by the Centers for Medicare and Medicaid Services (CMS) effective January 1, 2015. The Alaska medical fee schedule automatically incorporates revisions to the Medicare fee schedules by reference.

   Accordingly, NCCI has included within this filing an adjustment to incorporate the estimated impact of updating from the January 1, 2015 Medicare fee schedules to the January 1, 2016 Medicare fee schedules. Notably, this creates a full year of lag between the time the fee schedule updates become effective and the effective date of the revised loss costs and rates. However, due to the timing of CMS' release of the annual fee schedule updates and considering both the practical difficulties involved in any alternative treatment and the expectation that the annual impacts will be small (for example, the estimated impact in this filing is +0.6% on medical costs), it is acceptable to adjust for the expected impact of the annual updates within the loss cost and rate filing that becomes effective the January 1 following CMS' release of the applicable "Final

Rule" Medical fee schedules. We may, in the future, revisit whether this approach remains the most appropriate.

Note that the above findings are specific to the subject filing and are not meant to apply generally to past or future filings or to provide guidance for future filings unless specifically noted.

ORDER

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

A. The following modifications should be made to the 2017 loss costs and assigned risk rates:

1. The indemnity loss ratio trend should be revised from -5.0% to -4.5%;
2. The medical loss ratio trend should be revised from -0.5% to 0.0%.
3. The limited and unlimited indications (based on an average of paid (3-year average) and paid-plus-case (5-year average)) should be combined using a 50/50 weighting.

Based on information provided within the filing, these modifications should result in approximately a -1.6% change in voluntary loss costs, and approximately a -0.7% change in assigned risk rates.

B. NCCI should continue to provide alternate indications in the 2018 filing. The alternative indications should include combinations of the following:

1. Losses: unlimited and limited;
2. Loss development averages: 2-year, 3-year, and 5-year paid; 3-year, 5-year, and 5-year xhilo paid-plus-case;
3. Trend assumptions: the assumptions approved in this 2017 filing, at least one alternative that is higher than the trend assumption selected for the 2018 filing and at least one alternative that is lower.

C. In the 2018 filing, NCCI should include additional supporting information related to whether, and to what extent, the frequency and severity of the largest claims are changing; such supporting information need not rely solely on Alaska data (see AS 21.39.030(a)(2)). NCCI should also provide an update on any research that is being performed related to this issue.

D. Revisions to values appearing within the Experience and Retrospective Rating Plan Manuals do not fall under AS 21.39.043. Future loss cost and assigned risk rate filings should not include these pages; rather such revisions should be filed separately in accordance with AS 21.39.041.

This order is effective November 4th, 2016.

Lori Wing-Heier
Director