
Private Passenger Automobile Insurance Rates for 2006
Safe Driver Insurance Plan
Docket No. R2005-01

Decision and Order

I. Introduction and Procedural History

Incorporated into the procedure for fixing-and-establishing risk classifications and premium charges for private passenger automobile insurance, contained in G.L. c. 175, §113B, is the annual requirement that the Commissioner, as part of classifying risks, incorporate a safe driver insurance plan (“SDIP”) to equitably reflect the driving records of insureds. Because the SDIP is a part of the process for fixing and establishing private passenger automobile insurance rates, it is reviewed periodically. The current proceeding is the second to consider changes to the SDIP first proposed by the State Rating Bureau (“SRB”) in 2004. That year, the SRB submitted a filing that proposed two sets of changes to the SDIP, some to take effect on January 1, 2005 and others with an effective date of January 1, 2006. In October 2004, the Automobile Insurers Bureau (“AIB”), the Attorney General (“AG”) and the SRB submitted a Stipulation and an Addendum to that Stipulation adopting three changes to the SDIP for 2005. The Commissioner and Presiding Officer approved those changes.

On January 3, 2005, a hearing notice issued, initiating a proceeding to address the structure and operation of the SDIP on and after January 1, 2006. In response to that

notice, the SRB filed its specific recommendations for changes. The AG, a statutory intervenor, gave notice of his intent to intervene; the AIB moved to intervene. A prehearing conference took place on January 21, and a public comment hearing was held on January 26. At the evidentiary hearing that began on that same date, the AIB's motion to intervene was allowed and the SRB's witness, Cara Blank, FCAS, MAAA, was cross-examined. The AG made his filing on February 11, and his witness, Stacey Gotham, FCAS, MAAA, was cross-examined on February 17. The SRB and the AG submitted briefs on March 9. The AIB did not make a filing or submit a brief, but made a post-hearing commentary in letter form.

II. Summary of the Recommendations

The SRB's filing is in two parts, its January 2005 submission (the 2005 Filing") (Exhibit 2) and a copy of its June 2004 filing (Exhibit 3). The 2005 Filing recommends five changes to the SDIP for 2006: 1) replacing the step component of the current SDIP with a statistical coding system, that applies accident and violation surcharges as a linear function of the total number of surchargeable points applicable to the driver over the past five years; 2) application of separate credit factors to drivers with exactly 5 and 6 years of incident-free driving experience; 3) aging of surchargeable incidents for drivers with up to three surchargeable incidents in the past five years by reducing the number of surcharge points applicable to incidents within the experience period when all such incidents are more than three years old; 4) inclusion of bodily injury claims as a basis for a surcharge; and 5) revision of the rules for assigning drivers to vehicles.¹

The AG does not object to the inclusion of bodily injury claims with other surchargeable events or to the SRB's proposal to age surchargeable incidents. Ms. Gotham testified that it is reasonable to surcharge a driver who hits a pedestrian, and that she had no problem with the concept of aging incidents. The AG opposes the SRB's proposal to replace the current step-based SDIP, and recommends its retention with step differentials updated "in the usual way." His filing (Exhibit 9) principally addresses the issue of the SRB's proposal to substitute a point-based SDIP for the current step-based system.

¹ For purposes of aging incidents, the driver must have a clean driving record for the three years (thirty-six months) immediately preceding the effective, or renewal, date of the policy.

The AIB's post-hearing letter states that it takes no position on the merits of the proposed changes, but requests that, because of the time that would be required to implement a point-based system, any decision adopting the SRB's proposal be issued by March 31, 2005. It asserts, as well, that the issue of driver class/territory subsidies should not be adjudicated in this proceeding, but should be considered in the proceedings to fix and establish private passenger automobile rates, as part of the main rate case.

The SRB's recommendation for aging incidents for operators with no more than three incidents during the experience period and its recommendation for adding bodily injury claims to surchargeable incidents are hereby approved. The parties are directed to submit promptly the regulatory changes needed to implement these recommendations.

The SRB's fifth recommendation relates to amending Rule 29 of the Manual to address the assignment of inexperienced occasional operators to insured automobiles. No objection was made to those changes. However, in 2004 the parties agreed to make recommended changes to the Manual independently from the proceeding on the SDIP. Consistent with that approach, the parties are directed to follow the customary procedures to ensure that the recommended change is timely incorporated in the Manual.

III. Background

Proceedings to fix-and establish private passenger automobile insurance rates result in setting a statewide average rate that represents a composite of rates for all driver classes in all territories.² In that same proceeding, rates are also developed for various driver class and territory combinations by applying formulas that are based on claims data for operators, including their years of driving experience and the place where the vehicle is garaged. The SDIP is an overlay to the driver class and territory rates that, by examining an individual operator's driving record, identifies whether that person presents a higher or lower risk of future claims. The relevant driving record consists of reported accidents in which the operator was found to be at fault and convictions for violations of the motor vehicle laws. As implemented, the SDIP develops for groups of operators with similar driving records differentials that, when applied to otherwise calculated premiums, are

² Driver classes are based on years of experience and other factors. For inexperienced operators, classes reflect the length of time the individual has been licensed, whether he or she is a principal or occasional driver of a particular vehicle, and completion of driver training. For experienced operators, those with six years of driving experience, the only other factor is whether the individual is age sixty-five or more. By statute, the Commissioner approves territories for use in automobile insurance ratemaking.

expected to result in premiums that reasonably reflect the anticipated costs of covering that group.³

Over time, Massachusetts has enacted a series of statutory procedures that are intended to ensure that private passenger automobile rates and premiums reflect the insured's driving record, including at-fault accident frequency and infractions of the motor vehicle laws. The current SDIP is, in large measure, a plan created in 1990 in a joint filing made by the SRB, the AG and the AIB in response to the requirements of c. 273 of the Acts and Resolves of 1988, and amended in a 1991 joint filing that addressed issues resulting from legislative changes. The statutes set the parameters for the plan, including downward premium adjustments for drivers with no surchargeable incidents and upward premium adjustments for drivers with surchargeable incidents, within specified time periods. The operational aspects of the SDIP are established, in large measure, by regulation. 211 CMR 134.00 addresses the mechanics of the plan, while 211 CMR 74.00 incorporates standards of fault to be used in determining when an operator is at fault for purposes of determining the application of surcharges.

Under the current plan, drivers are assigned to steps according to their driving record. The steps are numbered 9 through 35; upon entrance into the SDIP, all drivers are assigned to Step 15 and, for each year of incident-free driving move down a step until they reach Step 9.⁴ A driver at any step who is surcharged moves up one or more steps; the ultimate step depends on the number of points the driver accumulates over a five-year period. A step differential, expressed as a percentage and established as part of the ratesetting process, is applied to calculate the downward or upward premium adjustment for each individual driver relative to the Step 15 starting point. Separate step differentials are calculated for liability and for physical damage coverages.

Until 2005, the general structure of the SDIP remained unchanged.⁵ The stipulation and addendum that the parties executed in October 2004 made three changes to the SDIP for 2005. Those changes allowed experienced drivers rated at SDIP steps 10 through 15, with exactly one incident in their driving record that is more than three years

³ The anticipated costs include the pure premium (the amount needed to cover losses and loss adjustment expenses) and the company expenses associated with writing the policy.

⁴ A driver new to Massachusetts who has a driving record from another jurisdiction may, based on that record, be rated at a step lower than 15.

⁵ Changes in the step differentials were approved.

old, to receive an additional credit to their otherwise applicable step rating, increased the surcharge for experienced operators rated at Step 20 or higher to ten percent for each step higher than 19, for both liability and physical damage coverages; and phased out the Clean Slate Rule.⁶

The principal controversy in this proceeding focuses on the SRB's recommendation to change from a step-based system to a point-based system, a recommendation that incorporates, among other things, a new approach to rating inexperienced drivers. Rather than start drivers at the Step 15 rate and assign them to a new step for each incident-free year, all incident-free drivers within a driver class will start at a base rate calculated for that driver class and territory. As in the current system, over a six-year period an inexperienced driver will be assigned to one of four classes, depending on the length of experience and whether the individual is a principal or occasional operator of the insured vehicle. The proposal also provides specific credits to two classes of drivers, those whose driving records have been incident-free for five and six years, respectively. In addition, the SRB changes the approach to developing step differentials, and recommends calculating separate differentials for experienced and inexperienced drivers.

IV. The Parties' Arguments

A. The SRB

The SRB asserts that its recommendations are designed to meet three objectives: 1) to increase premium equity among drivers based on accident and violation history; 2) to improve consumer understanding of the effect of accidents and violations on their final insurance premiums; and 3) to encourage safe driving by providing explicit financial incentives. It argues that it is necessary to eliminate the practice of rating by driver step because information by driver step is not meaningful without additional detail about a particular driver's history of accidents or traffic violations. Steps, the SRB asserts, do not reflect specific driving histories. Further, the SRB argues, the rate effect of the current step

⁶ The Clean Slate Rule was developed in the 1990 filing to soften the effect of the transition from the prior plan. It allowed drivers who had been incident-free for five years, but were at a step higher than 15, to be moved down to step 15. It was adopted for the specific purpose of encouraging safer driving by drivers with prior surcharges.

system depends on the SDIP off-balance factor in the rates, a factor that corresponds to the driver's class rating and the vehicle's garaging territory.

Under the SRB's point-based system, premium surcharges are a direct function of the total number of surcharge points incurred by the driver over the past five years.⁷ Surcharges would be calculated from a base formula of 1.0; the additional premium that is added to the base premium is the result of multiplying the number of surchargeable points times the point differential. The SRB asserts that its proposal presents a more direct process for calculating surcharges, and will improve data quality by replacing step coding with a system based on the number of surchargeable points. Its methodology, the SRB argues, therefore constitutes a substantial improvement over the existing SDIP.

Except for adding bodily injury claims to the list of surchargeable incidents, the SRB proposes no changes to the current definitions of surchargeable accidents or violations, nor does it propose to alter the point values initially assigned to each type of incident. However, the SRB recommends reducing the surcharge points associated with an accident or violation when an individual has satisfied two conditions: 1) three or fewer surchargeable incidents during the five-year experience period; and 2) all points are more than three years old. In addition, the SRB recommends that drivers who have exactly five, or six or more, years of incident-free driving experience receive a rate credit. The SRB proposal continues to off-balance the driver class/territory rates based on the average SDIP experience of each driver class/territory combination.

The SRB argues that, overall, its proposal is similar to the current step system, without the complexity of calculating steps. It asserts that a point-based system is simpler and easier to explain to policyholders, because the surcharge is based on the number of points the insured has accumulated in a particular time period. It also ensures that, within a given three-year period, the same incidents, regardless of when they occurred, will receive the same surcharge. The SRB argues that the point-based system translates to the types of systems that exist in other states, and therefore represents a substantial improvement over the existing SDIP.

The SRB proposal changes the methodology for calculating the SDIP step differentials and the rate credit for drivers with no incidents in the past five years or more.

⁷ Like the current step system, it looks at a five year period.

The SRB argues that regression models work well for calculating pure premiums for drivers with a history of accidents or violations in the experience period, but that such models either over- or understate pure premiums for drivers with no incidents in at least the past five years. The SRB proposes to use a linear regression to describe the relationships among drivers with varying numbers of incidents in their driving records, and a direct data analysis to determine the rate credits for drivers who are incident-free for five years or more. In performing its calculations, it incorporates the residual market load on a variable basis as a part of pure premium, rather than as an expense.

The SRB proposes that the surcharge point differentials be calculated separately for inexperienced and experienced operators, *i.e.*, those with six or more years of driving experience. For the latter, the SRB recommends a 13.5 percent surcharge on both collision and liability coverages. It states that the indicated pure premium differentials for this class were 13.5 percent for liability and 16.5 percent for collision, and that its recommendation is intended to temper the increase from the differentials in the 2005 SDIP. The SRB also recommends that experienced operators with no incidents in the past five years receive a six percent credit, and that operators with six or more years of incident-free driving receive a discount of 17 percent. The SRB notes that the fully indicated rate differentials for this group of operators are 26 percent for liability and 30 percent for collision. However, because of the possible influence of factors that cannot be normalized, the SRB considers it reasonable to take only two-thirds of the indicated differential. For inexperienced operators, the SRB recommends a surcharge of 7.5 percent for both liability and collision coverages, and a credit of six percent for such operators with no incidents in the past five years. It asserts that its recommendations are reasonable and actuarially sound.

The SRB argues that its proposal, unlike the current SDIP, avoids *de facto* rating by driver age. It asserts that the majority of operators assigned to the inexperienced classes are young drivers, who are rated at Step 15, receive credit for each additional year of driving experience, and may receive credit for incident-free driving experience once they are classified as experienced operators. The SRB characterizes granting inexperienced operators an SDIP credit for each incident-free year as, essentially, a proxy for age rating, noting that experienced operators do not receive additional SDIP credits for years beyond six in which they have incident-free records. It notes that, as initially structured, the SDIP

contemplated that drivers would receive a maximum credit based on approximately ten incident-free years, an objective that was nullified when the legislature determined that upward rate adjustments must be determined based on incidents occurring during the five years immediately preceding the effective date of the policy. In contrast to the current plan, the SRB argues, its proposal does not rate by driver age and will more accurately recognize the effect of driving history on prospective rates for all operators.

Addressing the implementation of its plan, the SRB asserts that the algorithms for computing surcharges are almost identical to those used in the current step system, and that the costs of converting to a point system would not be excessive or prohibitive. It estimates that it could take up to a year to implement the new plan, and that the parties could work with the Merit Rating Bureau to expedite the process. The SRB notes as well that it is a relatively simple matter to develop an informational brochure that the industry could use to explain the new system. It argues that implementation issues are not a factor that requires rejection of its proposal.

B. The AG

The AG asserts that merit rating has two goals: providing cost reduction incentives through price and fairly apportioning costs that cannot be reduced or eliminated. Therefore, he contends, the single most important factor in any merit rating plan is the accuracy of pricing for each rating group. The AG argues that the SRB's plan does not satisfy the criterion of price accuracy, claiming that pricing under its proposal is less accurate, for both experienced and inexperienced operators, than the current step plan updated in the usual fashion. In addition, the AG argues that the SRB's plan raises difficult, and unresolved, issues of fairness to urban drivers because it will eliminate territorial subsidies in some urban areas. He asserts, as well that its plan has not been tested to determine its impact on Massachusetts drivers, and will result in consumer confusion and market disruption.

The AG argues that a point-based system is not intrinsically simpler than the step-based system and that both, while easy to understand in concept, are complex in detail and difficult to implement. He observes that, when the current SDIP was adopted, the step was considered to be accessible nomenclature and consistent with the statutory references to classes of drivers. Nothing has happened since then, the AG argues, that makes that

terminology less understandable, and consumers have become accustomed to the step system.

The AG disputes the SRB's contention that under the current SDIP step level and rate effect depend on driving experience, arguing that such a statement is correct only for inexperienced drivers, not for experienced drivers. The AG argues that, although the SRB criticizes the current SDIP on the ground that the same step can be assigned for different incident records, its plan has the same failing. He notes that a given number of incidents may produce a wide variation in points, and that points may be the result of a range of incidents.

The AG argues that his comparison of the SRB proposal to the step plan, as updated using a step differential analysis prepared by the AIB in 2004, shows that the current SDIP more accurately rates Step 9 experienced (*i.e.*, Class 10 and 15) drivers. He states that a direct comparison using data from the same policy year and using the same flattening procedure shows that the SRB plan will raise rates for Step 9 drivers by 8.9 percent or 5.8 percent, depending on the set of data used in the analysis. The lower anticipated increase is based on an analysis of Merit Rating Board data that were adjusted to remove inexperienced drivers who were erroneously assigned to Class 10. The AG argues that inclusion of inexperienced operators in Class 10 raises questions about the SRB's calculations, asserting that the SRB calculated its proposed differentials from data that included misclassified operators, but compared its proposal to the Step plan based on data that removed those operators. The SRB, the AG argues, draws its conclusions from calculations that made on inconsistent data.

The AG recommends retention of the current SDIP, with the step differentials updated once the AIB has processed 2003 data.⁸ Although the AG's analysis calculates the step differentials, as does the SRB, by loading the residual market deficit as a variable component of pure premium, he notes that in the past the deficit has been loaded as a fixed component, because of the statutory requirement that the deficit should not be distributed to risks based on classification or territory. The AG asserts that the current practice is appropriate and argues that the SRB has not offered a reason to change this long-standing interpretation of the statute. He asserts that variable loading of the residual market deficit

⁸ He recommends that this proceeding remain open for the purpose of revising the step differentials.

will distribute it unequally among different driver classes in violation of the statute. He further notes, however, that residual market loading is not specific to either plan, and that should the Commissioner adopt variable loading, it could be applied within the existing SDIP.

The AG argues that, for inexperienced operators, the SRB's proposal is inferior to the Step plan. Under the current SDIP, inexperienced drivers enter the system at Step 15 and, for each year of a clean driving record, move down a step and therefore receive a credit. The SRB proposal, according to the AG, starts an inexperienced driver with zero points at a level roughly comparable to Step 10; a driver who maintains a clean record stays at that rate level until he or she becomes eligible for the "clean in five" discount. It thus eliminates the rate reduction, in the form of step credits, for inexperienced drivers who do not incur surcharge points. The AG argues that the SRB's proposal is inconsistent with data that show that for inexperienced drivers without incidents on their records, driving experience improves substantially as they gain experience. He states that pure premiums for drivers in the inexperienced classes show reductions each year, commenting that the reductions are actuarially proper, though mostly inadequate. A plan that offers no reductions to inexperienced drivers, the AG argues, is inconsistent with the data.

The AG also questions the treatment of inexperienced operators who have been erroneously assigned to Class 10 under the SRB proposal. He asserts that any who remain misclassified will be considered to have "one minor" incident on their records, a status comparable to Step 10, and will receive significant rate reductions. The AG argues that these drivers are already substantially underpriced and that it is inconsistent with merit rating to further lower their rates. In addition, the AG asserts, the SRB proposal, rather than provide incentives to inexperienced drivers for each year of clean driving, lowers the rates for the worst drivers in the inexperienced classes, those with zero years of experience, and raises the rates for clean drivers with more experience. He notes that the highest rate increases will be given to drivers with three to six years experience who are clean in five and to drivers with zero to three years experience who have two clean years. The AG argues that the SRB's position that the SDIP should provide no reward for inexperienced drivers with clean records is shortsighted, even if experienced drivers receive no

comparable rewards, and will likely result in more accidents and higher costs for all drivers.

The AG further argues that the data do not justify the discount that the SRB proposal offers drivers who are clean in five. He points out that under the current SDIP all drivers, both experienced and inexperienced, who are clean in five years are placed in Step 10; that step also includes drivers with one minor violation. The AG argues that the pure premium of experienced “clean in five” drivers is almost identical to the pure premium of drivers with one minor violation, and that clean in five drivers should not receive an additional six percent discount. He asserts again that the SRB’s recommendation is incorrect because the calculations underlying the proposed discount utilize data that includes inexperienced operators who are misclassified as experienced and then applies the result to experienced operators. Therefore, the AG argues, there is an inconsistency between the calculation and the application. Further, he asserts, providing one class of drivers with an unjustified discount means that the rates for other drivers are unjustifiably increased. In the SRB’s plan, he contends, the “clean in five” discount is primarily subsidized by operators with six clean years of experience.

The AG asserts that, unless the method for determining subsidies in the rates is changed, policyholders in urban areas will receive significant premium increases under the SRB plan. He notes that rates for urban areas are currently tempered by mechanisms that cap rates when they rise above certain constraints, and that no alternative is now in place. The AG states that such tempering is an important public policy, but that the SRB Plan, as outlined in its January 10 submission, does not provide for the continuation of subsidies at their current level. He asserts that the SRB’s reference to the application of an additional off-balance factor does not address the problem of specific territorial subsidies and does not ensure that urban rates will not rise. Because the SRB plan does not provide specific recommendations for alternative approaches to preserving subsidies it does not, the AG argues, satisfy the regulatory requirement for filings that propose to change methodologies.

Addressing the effect of changes to the SDIP on consumers, the AG argues that, although a stated goal of the SRB’s plan is to improve consumer understanding of the relationship between accidents, violations and their final premiums, its filing does not demonstrate or explain how its plan will achieve that goal. Therefore, he asserts, the SRB

has not met its burden of showing that its plan is an improvement on the current system. The AG argues that the SRB's plan differs substantively from the SDIP that has been in place for 15 years and is at least as complex. He further contends that, based on the novelty of the SRB's plan and the absence of consumer education materials in the SRB filing, it is likely that its adoption would produce consumer confusion rather than understanding.

Further, the AG asserts, the SRB's claim that its proposed system "translates" to the merit rating systems that are in place in other jurisdictions does not represent an advantage, because no other state has established a merit rating plan or mandates that companies use a single plan. Therefore, no plan adopted in Massachusetts can be compared to another state's plan. The AG notes that the record includes no information on the merit rating plans of individual companies, and therefore no comparison is possible among either the current or proposed SDIP plan and those that companies employ elsewhere. Further, the AG argues, the SDIP is not a barrier to the entry of new companies into Massachusetts and thus the SRB plan will not be an incentive to do business here. Therefore, he asserts, conforming the Massachusetts SDIP to plans in effect in other states would not justify adoption of the SRB's proposal.

IV. Analysis and Discussion

The SRB has identified three goals that its proposal will achieve: 1) increased premium equity among drivers based on accident and violation history; 2) improved consumer understanding of the effect of accidents and violations on their insurance premiums; and 3) encouragement of safe driving through explicit financial incentives. The AG argues, in opposition, in part that the record does not include evidence that the SRB's proposal will achieve its stated goals and, in part, that it less accurately reflects appropriate premiums for experienced and inexperienced operators. That inaccuracy, he asserts, is in part the result of using inconsistent data. The AG also questions whether the SRB's methodology for calculating rating differentials is based on a permissible interpretation of the SDIP statute. The parties' arguments will be addressed sequentially.

1. Consumer Issues.

The AG argues that the SRB's proposed merit band rating is as complex as step rating and is likely to create confusion rather than understanding among consumers. He

asserts that the SRB's filing is inadequate because it does not include any information on the process for educating consumers about the changes resulting from adoption of a point system. His argument is not persuasive. The SRB acknowledges that its filing is based, in part, on data that is expected to be updated in the Spring of 2005. Preparation of specific educational materials before the filing has been approved and before the final data are available might well require a substantial investment of time into preparing documentation that would almost certainly require revision. Furthermore, all changes to the SDIP, including those about which there is agreement, will require revisions to information systems and education for consumers, producers and industry personnel.

The AG and the SRB disagree on whether the SRB's proposal improves the simplicity of the SDIP. Under a point-based system, for example, the premium for any operator who receives three points as a result of a single incident would increase by applying, to the otherwise determined premiums for the relevant coverages, a factor that is three times the step differential. In contrast, because step-based rating provides a credit for all drivers rated below Step 15, the bill for an experienced operator at Step 9 who receives points for a single incident and moves, for example, to Step 12 will still show a credit, even though the operator has been surcharged. The AG argues that under the SRB system operators with similar driving histories might still have different numbers of points. The parties agree that under the step system, a single incident will move all experienced operators rated at Step 9 to a uniform step depending on the number of points associated with the incident. For operators with multiple incidents in their driving records, the SDIP rating will differ because different numbers of points may be associated with each incident. For experienced operators with multiple incidents, neither the step system nor point-based rating will precisely reflect their driving history; for inexperienced operators, step rating is less indicative of the relationship between their driving experience and their driving history. Further, any rating system, whether step-based or point-based, will be affected by the adoption of SDIP adjustments to reflect the aging of incidents. Both systems must be explained to consumers, and I am not persuaded that, at least for consumers with multiple violations and inexperienced drivers, either is significantly more or less complex.

Neither the SRB nor the AG offers any evidence on the degree of consumer confusion that exists under the step-based system, or would be created by the adoption of a

point-based system. Their respective positions are therefore somewhat speculative. That step-based rating has, as the AG notes, been in place for 15 years, does not alone demonstrate that consumers find it readily understandable.⁹ The SRB identifies many similarities between step rating and merit rating, but also recognizes that implementation of merit rating in Massachusetts would require public education for consumers, as well as for the industry. To the extent that the SRB's proposal incorporates procedures for determining fault and the assignment of points from the current step rating, it may moderate consumer confusion. I note as well Ms. Gotham's testimony that the SRB proposal and the step system are, apart from the treatment of incident-free years of experience, "pretty comparable," and that consumer confusion would occur only for a certain time period. In any event, if a point-based system rating permits consumers to understand more directly the relationship between their driving records and their insurance premiums, dedicating time and effort to educate them during the transition period may be a reasonable investment. I am not persuaded that the SRB's proposal should be rejected because adoption will require consumer education. I find, further, that it is reasonable to adopt an SDIP that shows the direct upward effect of surcharge points and the downward effect of credits on a base rate, without translation into steps. Further, a system for aging violations that is based on easily quantifiable concepts should improve consumer understanding of the value of avoiding additional surchargeable incidents.¹⁰

2. Consistency with Merit Rating in Other Jurisdictions

As a reason for adopting a point-based SDIP, the SRB asserts that it would create a system that "translates" to the types of systems in place in other jurisdictions. The AG argues that the record does not support that argument, because no other state requires a particular merit rating plan and individual company plans may vary; he further asserts that changes to the SDIP are not necessary because it is not viewed as a barrier to participation

⁹ The AG argues that the use of the term Step was acceptable in 1990 and that nothing has occurred to make it less suitable. I note, however, that the joint Filing on the 1990 SDIP also refers to the recommended plan as a Point plan. Further, the term Step was to refer to groups of drivers with a similar status under the SDIP. Because one can reach an SDIP step by various means (acquiring experience, incurring points for incidents, receiving credits for clean years) the step designation addresses status but not the reasons for assignment to a particular step.

¹⁰ Under the SRB's proposal, statistical coding for surchargeable incidents will provide more specific information on individual drivers. Such information may prove helpful to insurers and enable them better to analyze the characteristics of their books of business.

in the Massachusetts market. Because G.L. c. 175, §113B mandates development of an SDIP as part of ratesetting, that no other state has established a particular merit rating plan provides no basis for adoption or rejection of an SDIP for Massachusetts. No party denies that companies utilize merit rating in other states, but the record contains no description of the precise nature of their plans. Ms. Gotham's testimony that she knows of no company that uses a plan similar to that recommended by the SRB does not provide a persuasive basis for rejecting its proposal; any merit rating plan in Massachusetts must conform to specific statutory requirements that are absent in other states.

3. Territorial Subsidies

The AG expresses concern about the effect of the SRB's recommendation on existing territorial subsidies. The SRB asserts that it does not intend to eliminate the territorial subsidies that are put in place through the application of interclass constraints, noting that it was unable to measure the effect of its proposal on subsidies because appropriate data were not available from the Merit Rating Board.¹¹ It acknowledges that its proposed changes to the SDIP can be expected to change the overall difference between credits and surcharges for each driver class/territory combination and states that, to maintain the current level of territorial subsidy, it will evaluate the effect of its proposal on the off-balance factor that would have been applied had the proposal been in effect for 2005. Further, the SRB explains, the measured change in the overall difference between credits and surcharges resulting from interclass constraints under the new proposal will then be carried forward into the calculation of 2006 rates as an additional off-balance factor in the final manual rate calculation. Ms. Blank affirmed that the SRB's proposal intends that the SDIP will remain revenue-neutral in each driver class/territory cell, but that the off-balance factor will be different for drivers at all experience levels than it is under the current system.¹² She stated that the point-based plan would set base rates at 1 for

¹¹ Ms. Blank testified that she did not have the data available to measure the effect on the subsidy of applying interclass constraints under the new system, but that she intended to perform those calculations in the future.

¹² The SDIP is required to be revenue neutral, and therefore requires that insurance rates reflect a balance of credits and surcharges. Generally, however, the value of credits is higher than the amount of surcharges and therefore, to achieve revenue neutrality, a so-called "off-balance" factor is calculated and applied to the average rates. Under the current SDIP, surcharges and credits for each driver/territory are calculated, and an off-balance factor is calculated for that cohort. The factor effectively increases the manual rates for experienced operators, sometimes to a rate higher than that for inexperienced operators in the territory. Interclass constraints are then applied to correct that imbalance. According to Ms. Blank's testimony, under the point system the off-balance for inexperienced operators would be lower than for experienced operators,

driver/territory classes, and that because it eliminates the artificial increase to the base rate for experienced operators, a comparison of the rates for experienced and inexperienced drivers in a particular territory would result in fewer occasions in which interclass constraints would be required in order to ensure that rates for experienced drivers are less than those for inexperienced drivers. The result, Ms. Blank concluded, would be a reduction in the amount of territorial subsidies resulting from interclass constraints, but not the elimination of those subsidies.

The AIB argues, and the SRB agrees, that class and territory relativities have historically been addressed in the Main Rate portion of the annual proceeding to fix-and-establish private passenger insurance rates, and that subsidy issues should continue to be addressed in that forum.¹³ No party to this proceeding seeks to abandon the public policy that has long supported subsidies for urban territories. The AG points out that the *Decision on 2005 Rates* ordered the parties to develop a grid system that would improve the clarity and transparency of the subsidy system. I do not find persuasive the argument that the SRB's proposal should be rejected because the SRB's filing does not incorporate specific recommendations for preserving subsidies. Assuming that rates continue to be fixed-and-established for 2006, the parties are expected to address this issue in the Main Rate proceeding.

4. The Plan Structure

The parties to this proceeding do not disagree that SDIP rating factors are intended to recognize expected differences in the loss potential of drivers, that they should be actuarially reasonable and that the SDIP should reward operators who maintain incident-free driving records. The merits of any SDIP are therefore measured, in part, by the extent to which it reflects increased or decreased risk presented by various classes of insureds. That risk is generally analyzed as a function of two aspects of a person's driving history: 1) the length of time that the individual has been driving; and 2) the surchargeable incidents on his or her record. The SDIP, currently and under the SRB proposal, recognizes both as relevant factors. In Massachusetts, drivers with less than six years of experience are

because the surcharge percentage is lower. The surcharge percentage is lower for inexperienced drivers because the base rate is so much higher.

¹³ The proceeding to determine whether to renew the fix-and-establish procedure for 2006 private passenger automobile rates will begin in May 2005.

classified as inexperienced. Any person who has been licensed for six years is classified as “experienced,” independent of the individual’s actual driving record. The fixed-and-established rating procedure produces a statewide average rate which, for purposes of developing the manual rates, is then allocated by driver class, groupings that are based on the length of time that a person has been a licensed driver, and territory rating. Each individual driver is then assigned to an SDIP step; that step determines whether he or she will receive credits or surcharges from the average rates. For inexperienced drivers, the SDIP step assignment reflects both the number of years of driving experience and any surchargeable incidents that have occurred in those years; for experienced drivers, the SDIP step reflects the number of surchargeable incidents within the past five years.

The SRB proposal eliminates SDIP steps, instead applying credits and surcharge points directly to the average rates for a particular driver class/territory configuration. Ms. Gotham characterized the SRB proposal as, basically, a transfer from a step system to a point system, further commenting that the two systems are “pretty comparable,” aside from building in step reductions for years of incident-free driving experience. Both systems, she noted, are generally based on incidents during a five-year experience period.

Under the current SDIP, inexperienced operators enter the system at Step 15 and receive a credit for each year of clean driving experience, until they reach Step 9.¹⁴ The credit shows on the bill as a reduction in premium. The SRB proposal works from the classes established for inexperienced drivers; each class incorporates three years of driving experience (0 through 2 and 3 through 5). As under the current rating system, an inexperienced operator remains within the same driver class until he or she has accrued three years of experience and then, by virtue of reassignment to a different driver class, moves into the next class for the next three years. The SRB proposal does not differentiate within these classes by the number of years of experience, arguing that to do so violates the prohibition against age rating. After accruing six years of driving experience, the individual is considered an experienced operator. Operators with five or six years of incident-free experience will receive a credit, but no further reductions for maintaining an incident-free record, and are surcharged for at-fault accidents or violations.

¹⁴ The base from which credits are calculated is Step 15, even though the average step is approximately 11.

The AG argues that the step-based SDIP directly rewards inexperienced drivers who maintain clean records by giving them a credit for each such year. Such credits are appropriate, he asserts, because the data show that driving experience improves over time, and that pure premiums for drivers in the inexperienced classes show reductions each year. In contrast, he asserts, the SRB's proposal starts an inexperienced operator with zero points at a rate level that is comparable to that of a Step 10 driver and, if the individual maintains a clean record, keeps him or her at that level for five years, until he or she is eligible for a "clean in five" discount.

The AG's argument appears to misinterpret the SRB's proposal which lowers the base rates for inexperienced operators with clean records after three years of driving experience; it therefore preserves the existing rate differential and offers an incentive to attain and maintain such a record. I am not persuaded that moving inexperienced drivers to lower-rated classes, whether through direct rate reductions or through an SDIP credit system, is tantamount to age rating. While a majority of drivers new to the system are recently licensed young drivers, experience rating is based on a cohort of inexperienced drivers of all ages.

The SRB proposal takes a different approach and offers a different benefit to inexperienced drivers, lowering rates by driver class and territory, but requiring a longer experience period before offering a class-based rate reduction. The SRB argues that step ratings do not reflect the actual accident claims made by operators at that step, but only accidents for which they were found to be at fault and received a surcharge. It considers that the probability is equal that a person at any step will be involved in a surchargeable incident. Therefore, the SRB takes the position that step rating is not an accurate measure of the risk that a driver presents to an insurer. Ms. Blank's testimony that, in competitive markets, the rates do not differ for drivers with under three years of experience because inexperienced operators, as a class, are more likely to have accidents, and surcharging is less meaningful, supports the conclusion that its approach is reasonable. I note, as well, Ms. Gotham's testimony that the credibility of the data may become an issue when looking at subcategories of drivers in the inexperienced classes, and that the low differentials between classes of inexperienced drivers indicate that their prospective losses do not differ significantly.

The SRB's proposal starts from the premise that it is preferable to develop a base rate for each class/territory combination based on historical data, and to rely on the prospect of significant rate increases resulting from surcharge points as an incentive to maintain a clean driving record. In contrast, the current system is based on the premise that starting inexperienced operators at an artificially high step level, and lowering that step level for each year of a clean record, offers an appropriate incentive. By separating, for purposes of initial SDIP rating, driving experience (*i.e.*, the length of time a person has been licensed), from driving history, the SRB point-based proposal relies on the concept that SDIP surcharges should directly reflect points accrued by a particular driver, independent of his or her experience level. It also offers a uniform incentive to all drivers who accrue points: a reduction in the number of points associated with an incident after three years of clean driving.

The AG argues that the SRB's proposal would result in less accurate pricing for drivers. However, pricing accuracy is, for a number of reasons, an elusive concept, particularly in a system which in which rates are adjusted to reflect aspects of public policy, and the application of the SDIP itself must be adjusted to conform to the statutory requirement of that it be revenue-neutral. Memoranda addressing the SDIP step differentials prepared by the AIB in 2002 and 2004 note that the current step-based system overcharges insureds who receive credits and undercharges risks that receive surcharges. That the actuarial analyses prepared by the AG and the SRB produce different results, depending in part on the underlying data, is not surprising. Pricing accuracy, furthermore, encompasses more than a comparison of potential average rate increases or decreases; it should also address improved fairness relative to experienced and inexperienced drivers. The AG does not assert that continuation of the current SDIP, even with updated differentials, will reduce inequities in the current system.

The SRB and the AG do not disagree on certain premises about the driving population. Inexperienced operators in all driver classes have worse driving records than experienced operators; data on subsets of the inexperienced driver classes confirm that, overall, driving records improve with experience.¹⁵ For all operators with incidents on

¹⁵ The SRB filing includes a chart showing liability claim frequencies for experienced and inexperienced operators by number of surcharged incidents. At all levels of surchargeable incidents, including zero,

their driving records, the longer the time between the date of the incident and the current rating year, the lower the likelihood of an additional incident. To reflect that improvement, the SRB proposal reduces by one the point value assigned to an incident for drivers with one surchargeable incident on their records who have subsequently had three years of clean driving experience.

Unlike the bonus/malus approach embodied in the current SDIP, which is based on starting inexperienced operators at a so-called neutral step, and allowing them to work their way down, the SRB proposal would start with a base of 1.00 for driver class/territory combinations, and apply surcharges that multiply the number of points that the individual driver has incurred by a point differential, expressed as a percentage of the base rate for that class/territory combination. Consistent with current ratesetting methodology, the base rate itself is developed from three years of policyholder experience, and will be recalculated each year based on the three most recent years of experience. The SRB's approach differs significantly from the current system principally in terms of the base rate to which credits or surcharges would be applied. I am persuaded that grounding an SDIP on base rates developed for driver class/territories is reasonable.

The AG bases his opposition to the SRB's proposal in part on conflicting opinions of its effect, as compared to the current system, on driver classes. Data quality issues make comparison of the effect of the SRB's proposal to the current SDIP particularly challenging. Both the AG and the SRB rely on data maintained by the Merit Rating Board ("MRB") to support their analyses. However, approximately 150,000 inexperienced operators have been misclassified as experienced (Class 10) drivers. The AG's assertion that the SRB proposal would improperly reduce the rates for inexperienced operators misclassified in step 10 is based on the premise that such drivers will remain in that class. He offers no support for that conclusion, and I am not persuaded that it provides a basis for rejecting the SRB's proposal. Revisions to the classification rules in the private passenger automobile manual, approved for 2005, are expected to resolve misclassification issues. To maximize the accuracy of the point-based SDIP, the SRB is directed to update its

inexperienced principal operators have significantly higher claim frequencies. The chart suggests that, for drivers with less than four years of experience, inexperience is a more critical indicator of risk than the number of surchargeable incidents.

calculations based on the most recent available data, including territorial assignments for 2005.

5. Credit Provisions

The SRB notes that c. 175, §113B requires a downward premium adjustment, called an excellent driver award, to be applied to drivers with no surchargeable incidents within the five years immediately preceding the applicable rate year. The SRB initially recommended that an excellent driver award, in the form of a six percent credit, be given to experienced operators who have five years of incident-free driving or one minor violation, arguing that the rate differential between those two groups is six percent. However, in its brief, the SRB recommends that both inexperienced and experienced operators receive an excellent driver discount of six percent if they have had no incidents in the past five years. The AG objected to the SRB's initial proposal for a six percent discount on the grounds that under the step system all drivers with five clean years are rewarded by assignment to Step 10, with the rate reduction associated with that change, and that an additional benefit would not be warranted. He asserts that the pure premium of experienced operators that are clean in five is virtually identical to those with one minor violation, and that the SRB's rate differential results from basing its calculations on data that include misclassified insureds.

The statute requires that drivers with no surchargeable incidents in the past five years receive a rate reduction. Under a point-based SDIP, an award in the form of assignment to Step 10 will no longer be available. The SRB's filing provides for a reduction, in the form of a credit, for such drivers. Application of the award to both experienced and inexperienced operators is appropriate under the statute. The SRB recommends a higher reduction for experienced operators with six or more years of incident-free driving.¹⁶ The AG does not object to this approach.

¹⁶ The SRB's calculations showed a indicated rate differentials of 26 percent for liability and 30 percent physical damage for drivers that have six years of clean driving records, *i.e.*, those now rated at SDIP Step 9. The SRB's recommendation for a 17 percent credit acknowledges that factors such as driver age, gender, the length of residency in Massachusetts, the age of the insured vehicle, and the presence of multi-car discounts may affect the indicated rate. Ms. Blank testified that the recommended credit would also lessen the effect on the premium of an experienced driver who incurs surcharge points.

6. Calculation of Point Differentials.

Rating differentials are an essential part of any merit rating system, whether they are used to calculate premiums as a function of step or point-based rating. Under the current SDIP, credit and surcharge step differentials are calculated separately for liability and physical damage coverages. Historically, SDIP rating differentials have not been reviewed annually, but changes have periodically been recommended.¹⁷ Currently, the SDIP differential for liability is 7.5 percent and for collision is 7.0 percent; as noted above, for 2005 the parties stipulated that, for experienced operators rated at Step 20 or above, a ten percent differential would apply to steps above 19.

The SRB does not propose to change the practice of calculating separate point differentials for liability and physical damage. However, it proposes a change to the methodology for estimating credit and surcharge point differentials, for the stated reason that regression analyses work well to calculate the pure premiums for drivers with one to four incidents in the experience period but overstate or understate those pure premiums for drivers with no incidents in at least the past five years. For that reason, the SRB recommends using a linear regression to describe the relationships between drivers with incidents in their driving records and a direct data analysis to determine the rate credits for drivers with clean driving records for five years or more. The AG does not object to this change in methodology.

The SRB calculates its step differentials from pure premium data that incorporate a variable loading of the residual market losses, a proceeding that departs from the AIB's methodology that develops average variable class and territory rates by taking out from the average rates resulting from the Commissioner's decision the pure premiums for the residual market loss, other expenses, commission expense for collision coverage, and the SDIP reconciliation. Although the SRB sometimes refers to the residual market losses as the "facility deficit load" and the AG refers to it as the "residual market deficit," or

¹⁷ The AIB's March 23, 2004 SDIP Step Differential Analysis, attached to the AG's filing, notes that the step differential for liability was raised from seven to 7.5 percent in 2002, and that the step differential for collision was raised from six percent to seven percent effective January 1, 2000. The AG also attached to his filing a copy of the AIB's memorandum on step differentials dated March 22, 2002. The 2002 memorandum recommended a change to the liability step differential for 2003, to 7.5 percent. The 2004 memorandum indicated, for all operators, an 8.1 percent step differential for the liability coverages and a 7.4 percent differential for collision coverage. The AIB concluded that the results support an increase in the step differential, but did not recommend filing for a change.

“facility deficit load,” the value in question is not the deficit that Commonwealth Automobile Reinsurers (“CAR”) calculates each year for policies that are ceded to the residual market. It is, rather, a calculation of the additional amount that policyholders insured in the voluntary market must pay to subsidize residual market claim dollars that exceed the loss provisions in the rates charged to policyholders insured through the residual market.

Ms. Blank confirmed that the facility deficit load cannot vary by driver class or territory, and testified that the AIB’s calculation separated out residual market losses because its approach also addresses voluntary loss pure premium.¹⁸ Inclusion of both as a variable expense for the purpose of developing the loss pure premium that is a basis for estimating point differentials is appropriate. Ms. Gotham, reviewing the AIB’s formula for determining the portion of residual market losses that are paid by voluntary insureds, testified that variable loading of losses is more equitable, because it produces a less significant difference between the pure premium differential and the adjusted (or flattened) differential, but questions whether it is permissible under the statute. Nevertheless, the AG argues, in his brief, that the SRB has stated no reason for the proposed change, and that it changes the AIB’s longstanding interpretation of the statute.

Neither the SRB nor the AG disputes that the residual market deficit, as calculated by CAR, may not be distributed to insureds based on driver class or territory. Looking at the record as a whole, it appears that terms such as “residual market load” and the “residual market deficit” are used to refer not to the CAR deficit but to the AIB’s split calculation of losses into those for voluntary policies and policies written on the residual market. I am not persuaded that the AIB’s calculation should be interpreted as a response to the statute governing the allocation of the residual market deficit or that the AIB’s analysis produces a result that is equivalent to the residual market deficit as calculated by CAR. I note, too, that the *Decision on 2005 Rates* concluded that commission expense pure premium should be included in the rates as a variable element, a change from the prior practice. On this

¹⁸ G.L. c. 175, §113B, ¶1, provides that in fixing and establishing premium charges in accordance with that section, the deficit of the residual market plan established under G.L. c. 175, §113H shall not be distributed to risks based on classification or territory. At issue is whether including the residual market losses as separately calculated by the AIB with other losses in the variable portion of the rates for purposes of calculating SDIP step differentials would violate the statute.

record, I find that the SRB's methodology will produce a more equitable result, and therefore approve it.

In addition, the SRB recommends applying different surcharge point differentials to experienced and inexperienced operators. In its March 2004 analysis, the AIB concluded, based on its evaluation of step differentials for experienced and inexperienced operators, that the step differential for experienced operators should be larger and that the statewide differential is probably too large for inexperienced operators. The SRB calculated the expected frequency of surchargeable incidents for experienced drivers and those with, respectively, one to three and four to six years of experience, and concluded that the percentage surcharge per SDIP point should be lower for inexperienced drivers than for experienced drivers. Ms. Gotham made no specific recommendations for separate step differentials for experienced and inexperienced operators, but testified that they could be calculated separately. I am persuaded that it is appropriate to develop step differentials for experienced and inexperienced operators.

The SRB specifically recommends surcharge point differentials of 13.5 percent for experienced and 7.5 percent for inexperienced operators. For both groups, the same point differential would apply to both liability and collision coverages. Its analysis is developed from data for 2002. SDIP differentials, whether applied to steps or points, should be based on an analysis of the most recent data; the AG, although he recommends retention of the current step system, also recommends updating step differentials. We approve the SRB's new methodology for developing point differentials for the SDIP to take effect in 2006. However, we will not approve specific point differentials or credits for incident-free experience at this time, but direct that such differentials be developed using the SRB's methodologies applied to 2003 data. The parties are to address the specific point differentials in the Main Rate portion of any proceeding to fix-and-establish private passenger automobile insurance rates for 2006.

V. Summary

The SRB's proposal to replace the step-based SDIP with a point-based SDIP, and its methodology for developing point differentials are hereby approved. The point differentials for 2006 are to be developed using 2003 data.

The SRB's proposal to age incidents for operators with no more than three incidents during the experience period, all of which are at least three years old, by reducing the surcharge points attributable to each incident by one, and its recommendation for adding bodily injury claims to surchargeable incidents are hereby approved. The parties are ordered to prepare and submit the necessary regulatory changes on or before July 1, 2005.

The parties are further ordered to take appropriate steps to ensure that Rule 29 of the Private Passenger Automobile Insurance Manual for 2006 is timely amended to incorporate the SRB's recommendation on the assignment of inexperienced occasional operators to insured automobiles.

Dated: April 29, 2005

Jean F. Farrington
Presiding Officer

I have reviewed the records of the hearing and the findings, decisions, orders and ruling of the Presiding Officer. I approve and adopt her findings, decisions, orders and rulings in all respects as my decision on the Safe Driver Insurance Plan for use in calendar year 2006.

Julianne M. Bowler
Commissioner of Insurance

Any person or organization aggrieved by any part of this decision may, within twenty days of the date hereof, file a petition for review by the Supreme Judicial Court, as provided in Section 113B of Chapter 175 of the Massachusetts General Laws.