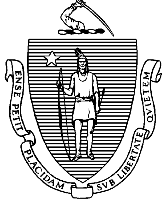

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Opinion, Findings and Decision on Request For Hearing on Commerce Insurance Company's Private Passenger Motor Vehicle Rate Filing Dated November 19, 2007

Docket No. R2007-04

I. Procedural History

On November 19, 2007, the Commerce Insurance Company ("Commerce"), pursuant to M.G.L. c. 175E ("c. 175E"), submitted for my review a filing for private passenger motor vehicle insurance rates ("Commerce filing" or "the filing"). On December 10, 2007, the Attorney General, pursuant to c. 175E, § 7, requested a hearing on the Commerce filing, alleging that the proposed rates were excessive. Two days later, I issued a Notice for a hearing to commence January 9, 2008. The Notice informed the parties that, as identified by the Attorney General, the hearing would address whether the proposed rates are excessive in violation of c. 175E and M.G.L. c. 175A, specifically because of provisions involving: 1) profits; 2) expenses; 3) acquisitions; and 4) losses.[1]

The hearing began on January 9 and concluded on January 10. Thomas L. Boyer, II, ACAS, MAAA, David Appel, Ph.D., and David R. Chernick, FCAS, MAAA, testified on behalf of Commerce. Allan I. Schwartz, FCAS, MAAA, and Stacey Gotham, FCAS, MAAA, were

[1] The Notice also informed the parties that I would determine whether Commerce's risk rating factor is unfairly discriminatory because, as the Attorney General specified, it included one rating component explicitly prohibited by the Commissioner, the purchase of increased limits coverage. That issue became moot when Commerce submitted a corrected filing, removing that component. The Attorney General did not specify what other factors "may be" proxies for rating factors prohibited by 211 CMR 79.00 *et seq*. and, therefore, I excluded the proposed testimony of Birny Birnbaum on proxies, offered by the Attorney General.

witnesses for the Attorney General. Based on the testimony of the witnesses and the documents admitted into evidence, I find and conclude, as follows:

II. Standards of Review and Burden of Proof

A. Standards of Review for Filings Made Pursuant to M.G.L. c. 175E

Commissioners of Insurance, for the past 30 years, have determined that market conditions in Massachusetts did not allow for competitive rates and that those rates for private passenger motor vehicles ("PPMV") would be fixed-and-established. On July 16, 2007, after holding a hearing as in past years, I concluded that there was sufficient competition in the PPMV insurance market and that it was not necessary for me to fix and establish the rates (the *"July 16 Decision"*). I subsequently promulgated 211 CMR 79.00 *et seq*. to govern the requirements for company rate filings for this line of insurance. The 19 insurers currently writing PPMV insurance made individual rate filings with the Division of Insurance ("Division") on November 19th pursuant to c. 175E and G.L. c. 175A, with effective dates of April 1, 2008.

Section 4 of c. 175E mandates that "[r]ates shall not be excessive or inadequate, as herein defined, nor shall they be unfairly discriminatory." It further provides that '[n]o rate shall be held to be excessive unless [it] is unreasonably high for the insurance provided." My task under c. 175E is to determine whether a company's proposed rates satisfy the statutory and regulatory standards. I may not disapprove proposed rates if they fall within a range of reasonableness, and otherwise satisfy the requirements of the general laws. *E.g.*, *Attorney General v. Commissioner of Insurance*, 450 Mass. 311 (2008) (homeowner insurance rates); *Travelers Indemnity Co.* v. *Commissioner of Insurance*, 362 Mass. 301, 305 (1972) (noncompulsory automobile insurance rates).[2] I do not set the rates under c. 175E. My authority is limited strictly to disapproving a rate or, under very limited circumstances set forth in the statute, approving it.

I look at the proposed overall rates generated by the rate filing viewed as a whole in determining whether a company's proposed rates are excessive for the insurance provided. This approach was summarized aptly by Commerce's expert witness, Dr. Appel, who stated that

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[2] See also *Bankers Life and Casualty Co. v. Commissioner of Insurance*, 427 Mass. 136 (1998) (Medicare supplement insurance policy rates); *Blue Cross & Blue Shield of Massachusetts v. Commissioner of Insurance*, 420 Mass. 707 (1995) (Medicare supplement insurance policy rates); *Workers' Compensation Rating & Inspection Bureau* v. *Commissioner of Insurance,* 391 Mass. 238, 245 (1984) (workers' compensation rates); *Liberty Mutual Insurance Co. v. Commissioner of Insurance*, 366 Mass. 35, 41-42 (1974) (workers' compensation rates); *Massachusetts Medical Service v. Commissioner of Insurance*, 344 Mass. 335, 339 (1962) (fees for surgical services).

"[v]irtually every state's statutes contain language requiring rates to be 'not excessive, inadequate or unfairly discriminatory.' In this context, it is the overall rate, and not the individual component of the rate, that must meet this standard." I also look at whether the proposed rates are generated using generally accepted actuarial approaches to ratemaking. 211 CMR 79.05(5). Finally, I may look to the existence of a reasonable degree of competition in the area with respect to the classification to which a rate is applicable as "material evidence", but not conclusive evidence, that such rate is not excessive. c. 175E, § 4(a).[3]

B. The Burden of Proof

The Attorney General may request a hearing on a rate filing under c. 175E § 7, but the insurer has the burden of proving that its rate filing complies with c. 175E, M.G.L. c. 175A and the Regulations. 211 CMR 79.13(11); see *Blue Cross v. Commissioner of Insurance*, 397 Mass. 117 (1986); *Travelers Indemnity Co. v. Commissioner of Insurance*, 326 Mass. 301 (1972). Disputes challenging particular aspects of the rate filing are, by themselves, insufficient to demonstrate that proposed overall rates do not meet statutory standards.

The Attorney General contends that her task in c. 175E, § 7 hearings is to ensure that filings provide fair and reasonable rates. Achieving that goal requires a "fair" hearing that, she avers, includes meaningful review of rate filings, discovery of insurers' data, and investigation of "all pertinent issues." She asserts that a separate standard applies to her review, but neither explains the relationship between her stated mission and the statutory standard for reviewing c. 175E rate filings, nor reconciles the concept of "reasonable" rates with the expectation that rates must fall within a range of reasonableness.

The Attorney General argues that this §7 hearing was neither full nor fair. She complains that "time periods were truncated, discovery prohibited, subpoenas vacated, subjects excluded and testimony struck." Her discontent, however, arises from her misapprehension of the premise of this hearing and the burden of proof. She overlooks that I only can review compliance of Commerce's filing with statutory standards rather than explore alternative approaches. Indeed,

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[3] Commerce references this standard but applies it very broadly. It states that "[t]he existence of competition constitutes 'material evidence' that the rates are not excessive." Commerce asserts that such material evidence exists based on my *July 16 Decision*, in which I found that market conditions were sufficient to sustain a competitive rating environment. It does not provide any further analysis of the existence of competition in this current market with regard to the classification in which such rates will be applicable. My *July 16 Decision* is meager evidence of this factor. My *July 16 Decision* speaks to competition generally in the marketplace rather than to the specifics that appear to be required under c. 175E, § 4(a).

the Attorney General bears no burden of proof and has no role in establishing a different rate for Commerce. See my December 21, 2007 *Order on Discovery*. The record of this proceeding, including arguments and orders on the motions made by the parties, speaks for itself. The rulings and orders are consistently cognizant of the overall scope of this proceeding, of the specific limits on the disputed issues as set out in the Attorney General's initial request for a hearing, and of the time constraints engendered by the need to have new rates in place within a time frame that will maximize the benefit to consumers of managed competition in rates.[4]

III. Substantive Issues

A. The Profit Provision

Commerce's witnesses testified that the profit provisions selected in the filing are based on actuarially sound methods, are reasonable and do not result in excessive rates. The return of equity model used in the Commerce filing was explained by Mr. Boyer, who is responsible for the actuarial review and filing. He stated how he recognized investment income in the filing. Dr. Appel asserted that the profit provisions are not excessive and are based on a reasonable target rate of return. He also stated that Commerce relied upon a standard methodology for deriving the profit provision in its rates and has used an "extremely conservative" estimate of the fair return on equity, resulting in a profit provision that, if anything, is biased low. Mr. Chernick testified that Commerce's profit provisions for liability and physical damage coverages are similar to those used by PPMV insurers in states with an open competitive rating environment and are reasonable; furthermore; some use higher profit provisions than are in the filing.

The Attorney General alleges that the profit provisions in the filing are "unreasonable and excessive." She argues that they are "substantially" higher than the profit permitted in prior rate decisions and higher than any profit provision charged by an automobile insurance company in Massachusetts for at least the last 25 years. She has five specific criticisms.

1. Profit loading

Dr. Appel testified that the cost of capital in the Commerce filing is not unsupported; the

[4] The time sensitivity of this proceeding is extraordinary. It occurs within the context of the change from a fix-and-establish system to a managed competition system in approximately eight months. The schedule was set in accord with the provisions of 211 CMR 79.11 and 79.12, which impose express timelines for proceedings on c. 175E rate filings. The rates filed on November 19 are to take effect on April 1, 2008, when the current fix-and-establish rates applicable to all insurers, including Commerce, expire by operation of law. Companies require timely decisions in order to reprogram computer systems and generate the renewal notices that companies must send to policyholders 45 days before a policy expires under the law (*i.e.*, February 15 for April 1 renewals). These regulatory procedures were tailored to ensure timely completion of this proceeding.

filing clearly states that the cost of capital, defined as the fair rate of return on GAAP equity, was selected by Commerce management as the minimum return investors would require in order to retain capital in the company. He stated that this was an entirely acceptable method of determining the fair and reasonable return for purposes of the filing. Dr. Appel also asserted that the value Commerce used reflects an appraisal of the required return by those individuals who are most directly responsible for raising capital to support its insurance operations. He argued that in a competitive system, as opposed to the fix-and-establish system, management's judgment is adequate support for a target rate of return. He nevertheless compared Commerce's target rate of return to an insurance industry cost of capital figure based on using what he described as two widely used models, the Fama French Three Factor version of the Capital Asset Pricing Model and the Discounted Cash Flow model. He testified that this comparison of the company's target rate of return and a calculated *insurance industry* cost of capital analysis supports the Commerce target as being "quite conservative."

Mr. Schwartz testified that the cost of capital in Commerce's filing is unsupported and excessive. He objects to the selection of a target rate of return on equity ("ROE") as a corporate objective. He contends that this ROE is not properly supported by a method, document or calculation, which he deems constitutes a violation of certain actuarial standards of practice ("ASOPs") issued by the Actuarial Standards Board. Mr. Schwartz also charges that the ROE target is not a capital target; that "capital" would be equity plus debt. The Attorney General argues that Massachusetts law, in c. 175E, § 4(b) (emphasis added by the Attorney General) requires consideration of "a reasonable rate of *return on capital* after provision for investment income . . .." Mr. Schwartz evaluated the Commerce filing against a benchmark: the cost of capital value from the *Decision on 2007 Private Passenger Insurance Rates*. He asserts that this comparison shows that Commerce's profit provision is excessive. He also states that Dr. Appel's comparison of Commerce's profit provision to that of the industry is based on methodologies that Commissioners have found unreasonable.

2. Debt

Dr. Appel explains that sometimes an insurer issues both debt and equity, the sum of which may be referred to as capital, and then determines a rate of return to the total capital of the company, including the debt as well as the equity. He states that the filing appropriately adopts a return on equity approach, exclusive of a return on debt capital. He explains that consideration

of the cost of debt is accounted for in Commerce's estimate of its prospective pre-tax return on investments, so that the cost of debt properly has been considered in the filing.

Mr. Boyer asserts that Commerce listed nothing for interest expense at line 13 of its 2006 Annual Statement, and that line 13 is considered in calculating net investment income, line 17. He therefore explains that Commerce's debt expense is not included in the net investment income reported in its 2006 annual statement. The Commerce investment income subsequently is adjusted for debt expense in the profit model, and thus, he asserts, is not double-counted as Mr. Schwartz alleges.

Mr. Schwartz asserts that the adjustment for debt in calculating an investment return in Commerce' filing is unsupported, fails to include any calculations, and produces an excessive profit provision. He states that the lack of documentation is inconsistent with ASOPs. He complains that the filing contains an unsupported adjustment for debt that reduces the investment income credited to policyholders. He asserts that Commerce's annual statement shows that it has no debt and makes no interest payments. The Attorney General disputes Dr. Appel's testimony on rebuttal that the adjustment for debt in the filing is based on a debt value that appears in Commerce's Form 10-K. The Attorney General argues that Commerce's 10-K is irrelevant because it deals with the holding company rather than the insurer Commerce. Mr. Schwartz also claims that the method used by Commerce to calculate investment income returns already includes a deduction for interest expense (*i.e*., debt). He states that not only is Commerce trying to include a deduction for debt that Commissioners of Insurance consistently have determined is inappropriate, it is trying to double count that improper value.

3. Leverage ratios

Dr. Appel testified that Commerce reasonably has estimated expected leverage in coming to its selected underwriting profit provision in its filing. He declares that there is no generally accepted method of allocating insurer equity to line of business, and maintains that Commerce's use of a combination of written premium and loss and loss adjustment expense ("LAE") reserves is a method that is reasonable and consistent with industry practice. He estimated the premium to surplus ratios that would result if Commerce had relied upon the allocation method promulgated by the National Association of Insurance Commissioners (NAIC) for use in the Insurance Expense Exhibit supplement to an insurance company's annual statement, arguing that this would constitute an unbiased test of the reasonableness of Commerce' s selections. The

results he obtained were nearly identical to those developed by Commerce using its own methodology.

Mr. Schwartz challenges the level of reserves and the accuracy with which the loss, including the LAE, reserves have been established in the filing. He asserts that PPMV insurance is a low risk line of insurance, both countrywide and in Massachusetts. He maintains that the tendency has been to establish redundant (*i.e*., excessive) loss reserves for this line of insurance.

4. Asset returns

Dr. Appel testified that Commerce properly and reasonably considered investment and other income in its filing as required under the statute. He explains that Commerce obtained the proportions of assets in each class and the recent realized returns on these asset classes directly from its investment department. Mr. Boyer confirms that there are no judgmental adjustments to Commerce's portfolio returns in its filing. Dr. Appel affirms that these values are likely to be the best estimate of the actual returns that Commerce will realize in the next policy year. On the other hand, he believes that Commerce's rate request is understated based on an exercise he did using Commerce's actual mix of assets by type and maturity, based on Schedule D of its annual statement, and the current yields available on such assets in United States capital markets.

Mr. Schwartz argues that the debt adjustment to the asset return in Commerce's filing is unsupported and improper. He claims that the method used by Commerce to calculate investment income returns already includes a deduction for interest expense (*i.e*., debt).

5. Profit load for towing and substitute transportation

Mr. Boyer explained that he used his actuarial judgment to select a 12.5 % profit load for the coverages of towing and substitute transportation based on the service focus that each coverage provides. He believed that a profit load more in line with service type profit loads was appropriate, but also opined that the profit load is below a reasonable selection for the type of coverage provided. He testified that the selected profit load does not impact the overall rate level.

Mr. Schwartz states that Commerce does not provide any calculations or support for the issues of substitute transportation and towing, and that the value used by it is arbitrary. He declares that the same profit factor should be used for substitute transportation and towing as for physical damage. He does not comment on the impact the value has on the overall rate level.

6. Sources of revenue

Dr. Appel asserts that Commerce has included all sources of revenue and all reasonable costs at the values anticipated for the coming year when the proposed rates will be in effect. Mr. Boyer testified that Commerce treats its finance charge and other fee income, such as check fees and fees for various bill-paying events, as offsets to expenses, with the bulk of the fee income being finance charge income. Although the Attorney General argues that Commerce's selection of a low value for this income improperly increases the expenses in the filing, she seems not to pursue the charge that the filing "fails to include" these sources of income.

Analysis and Conclusion

The Attorney General's comparison of the profit provisions in the filing to the profit provisions approved by Commissioners of Insurance under the fix-and-establish system is irrelevant.[5] She fails to recognize that this proceeding, conducted pursuant to c. 175E and 211 CMR 79.00 *et seq*., differs fundamentally from a proceeding to fix-and-establish rates on an industrywide basis. I must consider a particular company's filing based principally on its own data in a c. 175E, § 7 proceeding. It is not my task to look at aggregate industrywide data for the purpose of developing an underwriting profits provision that reasonably reflects the average financial needs of a mythical "Every Company," but is specific to none.

In c. 175E filings a company must develop a profit provision that reasonably reflects its financial needs and that, when included in its proposed rates, will produce an overall value that complies with the statutory standards and will allow it to compete for business in the marketplace. In a competitive market, companies are free to incorporate their own target profit provisions into their proposed rates; price competition is expected to exert pressure on rates and to provide some control on target profit levels. Differences between profit provisions charged in a fixed-and-established system and those in a competitive market are to be expected. In the former, the profit provision is calculated for the entire industry; in the latter, the profit provision is developed by each company, based on its own operations and financial needs. The issues to be addressed in c. 175E, § 7 decisions are whether a profit provision is developed using generally accepted actuarial principles and falls within a range of reasonableness.

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[5] See my *Ruling on The Commerce Insurance Company's Motion for a More Definite Statement*, and my statement in the record after the Attorney General's cross examination of Commerce's witnesses in which I stated that the Attorney General need not, and should not, propose alternative "benchmark" numbers for the profit provision, as it is not allowed under c. 175E.

Dr. Appel convincingly describes the return investors require in order to induce them to provide capital to a firm, known as the "cost of capital." This is the cost to a firm of acquiring capital in equity markets. He explained that, in contrast to the method used in fix-and-establish decisions, which calculated a weighted-average cost of capital applied to a total amount of capital, Commerce's filing approached this process by setting a target return on equity capital only, and multiplied that target return on equity capital by its equity capital only, considering the required cost of debt separately, in another place, as a reduction to projected pre-tax investment income. I find that the Commerce filing as a whole therefore enables me to apply the measurement that the Legislature intended when it required in c. 175E, § 4(b) that I give "[c]onsideration …, to the extent applicable, . . . to a reasonable rate of return on capital after provision for investment income . . .."

There may be some validity to Dr. Appel's observation that Commerce executives are best situated to estimate what the company will need to pay to attract investor capital in the coming policy year. I, however, am not prepared to hand over the determination of this matter to the unfettered discretion of c.175E filers. I found it significant that Dr. Appel compared Commerce's target rate of return to an *insurance industry* cost of capital analysis, arrived at based on the use of two widely used models, which supports the Commerce target as being conservative. Mr. Schwartz's opinion that PPMV insurance is of less than average risk compared to property casualty insurance in total misses the point that the behavior of investors relative to investing in PPMV insurers, and specifically in Commerce, is the proper focus in this aspect of this proceeding; not an ivory tower assessment of the "true risk" of such an investment.

I find that the actuarial methodology used in the filing is sound and is consistent with generally accepted actuarial methods and techniques, including applicable ASOPs, and that the actuarial assumptions, selections and judgments made by Commerce are all reasonable. Commerce has met its burden of proving that the profit provisions in its rate filing are within a range of reasonableness.

B. The Expense Provisions

The Attorney General contends that Commerce's contingent commission expenses and its general and other acquisition expense provisions are excessive.

1. Contingent Commission expenses

All three Commerce witnesses offered testimony responding to the Attorney General's

contention that its rate filing inappropriately includes a "substantial provision" for contingent commissions. Mr. Boyer testified that contingent commissions were included in the expense provision to account for the expected cost of the incentive contracts that Commerce has with most of its agency force. He observed that the Division has approved proposed 2008 rates from three companies that similarly include provisions for contingency commissions.[6] He also pointed out that the Division's rate filing instructions include specific guidance on handling contingent commissions separately from standard commissions and overrides.

Dr. Appel testified that because contingent commissions are a predictable expense for Commerce they must be considered in ratemaking. Like direct commissions, they are an expense to the company, not a distribution of profit to shareholders. In most states, he observed, contingent commissions are implicitly approved in the rate regulatory process.

Mr. Chernick testified that contingent commission arrangements are typical in the industry, and that Commerce must compete with other insurers for business generated by independent agents based both on product price and commissions. For that reason, he states, an actuarially sound rate must include a provision to cover the costs of contingent commissions.

Mr. Schwartz testified that Commerce should not be allowed to include a provision for contingent commissions in its rates because past Commissioners of Insurance consistently have determined that they should not be included as a component of rates in prior fix-and-establish decisions. The Attorney General characterizes contingent commissions as a form of "profit-sharing" between insurance companies and their agents. He stated that contingent commissions are not "expenses," but during cross-examination he testified that, depending on context, they could be viewed as either an expense or a profit.

Analysis and Conclusion

The Attorney General does not contend that Massachusetts law prohibits or limits the payment of contingent commissions to insurance producers or that prior decisions have prohibited them outright. She also does not challenge the reasonability of the contingent commission provision in the filing. Her sole argument is that in prior decisions fixing-and-establishing PPMV insurance rates, Commissioners of Insurance have rejected proposals to include contingent commissions. I find that decisions rendered in the past on the exclusion of

[6] The Attorney General did not request hearings on those rate filings, which have been placed on file by the Division.

contingent commissions in the fixed-and-established rates are irrelevant to these proceedings under c. 175E.

Ample testimony from Commerce supports a conclusion that the new competitive market is different. Contingent commissions now are one basis for legitimate competition in the industry. Indeed, that is why the Division's rate filing instructions explicitly provide for the possibility of such an expense. It is neither my role, nor the role of the Attorney General, to decide what expenses a company should incur in a competitive insurance market provided no such expenses violate the law. Companies that unwisely spend money will enjoy less success in the market, and this experience alone will alter future conduct.

Mr. Boyer testified that, while contingent commissions may be based in part on the profitability of a particular agent's book of business, they are an expense to Commerce. No evidence links contingent commissions to overall *company* profitability rather than to an *agent's* performance. The facts do not support the Attorney General's argument that inclusion of contingent commissions in rates is a *sub rosa* approach to increasing the profit provision in Commerce's rates. I find that inclusion of a reasonable provision for contingent commissions does not constitute evidence that the overall rates are excessive.

2. General and Other Expenses

Mr. Boyer testified that Commerce expects its general and other acquisition expense dollars to increase in 2008 because of the transition to a competitive market. A combination of the premium decrease ordered under the Commissioner's *Decision on 2007 Private Passenger Insurance Rates* and the proposed rate reduction in the Commerce filing means that the premium base from which the expense ratio is calculated will be lower. He testified that the selected value for Commerce's finance charge and fee income is lower than its historically indicated percentage because he does not expect fee income in a competitive environment to match the levels indicated for 2005 and 2006. He asserted that his values for the expense values and miscellaneous income values were selected based on standard actuarial practice and are reasonable.

Dr. Appel asserted that Commerce's selected expense provisions for 2008 are consistent with the historical experience. Data in Appendix B to the filing, he stated, demonstrate that the selected expense ratio for both the liability and physical damage coverages is less than that shown for the company's most recent experience. He also opined that Commerce's selected

values are lower than the industry average expense data. With respect to finance charge and fee income, Dr. Appel testified that Commerce appropriately relied on its estimate of the level of such income in a competitive environment. He commented that the Attorney General improperly focuses on a single aspect of expenses, the general expense component, rather than looking at the reasonableness of the overall rate, which is what the regulator properly considers.

Mr. Chernick observed that the Attorney General focuses on Commerce's selection of somewhat higher values in the general and other acquisition expense categories, but ignores the company's selection of a value for the commission expense category that is less than the historical average. Mr. Chernick believes that the actuarial methodology used in the filing, and the actuarial assumptions, selections and judgments, are sound and are consistent with generally accepted actuarial methods and techniques.

The Attorney General asserts that Commerce ignored its own historical data and selected arbitrarily higher expense values and an arbitrarily low value for income from finance charges and other fees that historical data do not support. Because Commerce treats its finance charge and fee income as offsets to expenses, the Attorney General argues that its selection of a low value for that income improperly increases the expenses in the filing.

The Attorney General criticizes the increase in Commerce's selected general expense and other acquisition expense factors, arguing that the company has not identified the particular costs that it expects to incur in a competitive rating environment that would materially affect expenses and that its selected general expense provision is unsupported. She asserts that Commerce has not supported its selected provision for miscellaneous income from installment payments and other fees in 2008, which is one-quarter of the actual income earned by Commerce in the past from such sources. Commerce's alleged failure to support elements of the filing, the Attorney General argues, means that the filing is inconsistent with certain ASOPs. She asserts that a competitive rating environment should put downward pressure on expenses and that an increase in costs is contrary to reasonable expectations and inconsistent with ASOPs.

Analysis and Conclusion

Expense provisions in rate filings are expressed as a percentage of expected premiums. The expense ratio necessarily varies with changes in the projected dollars needed to cover expenses in the rate year and the amount of premium that the company expects to collect. The Attorney General asserts that the expense provision in the filing is unsupported and inconsistent

with actuarial standards of practice because Commerce did not provide specific information on the reasons for its anticipated expense increases and because of its lower than average historical experience.

The Attorney General's position is built on two assumptions: 1) that the expense ratios in a competitive rate environment should not differ materially from the industry average generated in a fix-and-establish environment; and 2) that it is reasonable to expect expenses to decrease in a competitive market. Both of these assumptions are economic assumptions that would not rest on company data. Although the Attorney General does not bear the burden of proof in this proceeding, she offers no facts supporting these economic theories so her challenge is weakened almost to the point of exhaustion.[7] She disregards the fact that the expense ratio under fix-and-establish rates was based on the average expense ratio for the industry as a whole. Some companies had expense ratios that were higher or lower than the average. As is true for profit targets, competition requires companies to account for their own expenses as part of their rates. It is not rational to expect individual company expense ratios to be the same as the industry average, particularly at the beginning of managed competition. Only by forcing recognition of an individual company's expenses into its rates can the effect on the competitive cost of the insurance product be observed and modified. She also overlooks the fact that 2008 represents a transition year from the fix-and-establish system to a competitive market. Generalized statements about differences in expense ratios and the potential effect of a competitive market on company expenses have even less evidentiary value in this setting.

Testimony from the Commerce witnesses squarely addresses the connection between the new competitive environment and what the company considered in developing its expense provision. Mr. Boyer testified that Commerce has invested in "people, systems and software" in preparation for competitive rating, and that its investment has increased at "a very high rate" for 2008. The anticipated value of miscellaneous fee income is, similarly, based on expectations regarding the effect of competition. At the same time, premiums are expected to decline. It is reasonable, therefore, to expect that the expense ratio will change for 2008. Mr. Schwartz had no

[7] While the filer of a rate filing has the burden of proof, meaning the burden of persuasion, the Attorney General, when challenging proposed rates, may have a burden of production. If the Attorney General does not produce any meaningful challenge to proposed rates, the ultimate burden of persuasion on a filer is certainly made easier.

specific knowledge about expenses in a transition period or experience with regard to a transition from a fix-and-establish marketplace to a competitive market.

The Attorney General criticizes the values in the Commerce filing because they do not represent actual calculations from data but were selected utilizing judgment, although Ms. Gotham testified that informed judgment is a permissible approach with respect to prospective values. Mr. Boyer stated that his judgment was informed by projections of fixed dollar expenses and other information about budget items; his selected value was informed by calculations that examined historical values and future budgeted values. The Attorney General provides alternative calculations based on historical data, but does not assert that the Commerce filing utilizes methodologies that are actuarially unacceptable or produce rates that are outside a range of reasonableness. ASOP 41, Section 3.4 establishes that compliance with the applicable law, regulation or standard, and any practice-specific ASOP governing the actuarial services that are the subject of the report "shall be deemed compliance with this standard." Mr. Schwartz agreed that Division regulations set out the form of the rate filing, and that Commerce had included the data required under the regulation. I am persuaded that Commerce should not be required to support its filing by identifying changes to line items in its budget, particularly with regard to projected advertising and marketing expenses. Mandating disclosure of the precise allocation of company internal expenses could affect adversely its competitive position, particularly here where many other companies with whom Commerce competes and which are not subject to requests for hearing by the Attorney General would not have to disclose this information.

Commerce has persuaded me that the actuaries who prepared the Commerce filing acted consistent with generally accepted actuarial standards, including applicable ASOPs.

C. The Loss Pure Premium Trends

Mr. Boyer testified that Commerce's prospective pure premium trend selections are based on a number of indicated trend regressions using ultimate accident year data and judgment. He based his selections on observations that: 1) frequencies have been dropping for most liability coverages for the past several years, but in his opinion these trends will not continue; 2) frequency is affected by weather, and recent experience suggests that the mild winters of the most recent two years may be surpassed in intensity and duration by the winter of 2007-2008; and 3) actuarial standards require reasonability in trend selections but the work product, which includes the indication itself as well as the final rate, should be considered as a whole rather than

judged on the parts. He explained that Commerce's historical data for accident years ending December 31, 2000 - 2006 were used to calculate these trend estimates because more recent loss data are not yet mature. In selecting loss trends for the prospective period, Mr. Boyer considered that the Community Insurance Fraud Initiatives ("CIFIs") will have a diminishing impact over time. He did not conduct an external analysis of the impact of the CIFIs, which is specific by territory, on losses, because the managed competition regulations do not permit making territory-specific adjustments.

Mr. Chernick testified that Commerce's loss trend selections, which are within a range of reasonableness, assume that the fairly large negative frequency trends will not continue. He believes that there is a distinct possibility that the base data used in the Commerce rate level indication reflect relatively mild winters in 2005-2006 and 2006-2007 and would tend to be a negative influence on historical Massachusetts frequency trends.[8] Mr. Chernick testified that automobile accident frequencies have generally been decreasing countrywide over the last ten plus years. He stated that countrywide Fast Track data on property damage liability and collision coverages indicate that accident frequency is no longer decreasing.[9] Mr. Chernick states that Commerce's selections relating to accident severity are based on the historical data and generally are in line with current inflationary pressures. He concludes that the trend selections in the Commerce filing are reasonable but, because they do not anticipate an increase in accident frequency, are, in his opinion, on the low side of a reasonable range. He believes that the actuarial methodology used in the filing is sound, consistent with generally accepted actuarial methods and techniques, and utilizes reasonable actuarial assumptions, selections and judgments.

The Attorney General asserts that the loss provision in the filing is excessive because Commerce "ignores its own historical loss trends and 'selects' arbitrary loss trends that improperly increase the losses in the filing." She contends that it was improper for Commerce to use a positive loss trend for the historical period July 1, 2004 to July 1, 2006 when its data showed that losses, particularly for bodily injury, were actually decreasing during this period. The Attorney General does not dispute Commerce's prospective loss trends that are applied from

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[8] Mr. Chernick states that this data demonstrates that the winters of 2005-2006 and 2006-2007 had higher than average temperatures, less than average inches of snowfall and less than average number of snow days.

[9] Mr. Schwartz, the Attorney General's expert, testified that he has used Fast Track data when it "was reliable for whatever purpose I was using it in that particular context."

the latest data point to the policy period, but asserts that Commerce improperly applies the *prospective* trends to the historical loss period from July 1, 2004 through July 1, 2006. Ms. Gotham testified that Commerce's approach is based on the assumption that between the end of 2006 and the policy period in 2008, losses will slightly increase while, she asserts, the data show that in the historical period between 2004 and 2006 losses decreased substantially. She attributes these decreases largely to the salutary effects of the CIFIs.

Analysis and Conclusion

The Attorney General challenges Mr. Boyer's use of judgment to adjust historical data. The statute applicable to rate filings under c. 175E specifically observes that judgment is one basis for developing rates. c. 175E, § 4(b). The parties do not disagree that the decrease in losses related to implementation of the CIFIs will stabilize. Nor do they dismiss the effect of weather on losses; Ms. Gotham has prepared calculations that adjust historical loss data to take weather into account. No party purports to predict future weather patterns.

I find that the actuarial methodology used by Commerce in its filing is sound and is consistent with generally accepted actuarial methods and techniques, including applicable ASOPs, and that the actuarial assumptions, selections and judgments made by Commerce are all reasonable estimates of projected losses based on a review of the relevant data and current expected economic and environmental conditions. In particular, I find that Mr. Boyer's loss trend selections and his underlying assumptions are reasonable. Commerce has met its burden of proof that its filed rates are not excessive by reason of the loss trending used in its filing.

IV. Conclusion

Commerce has met its burden of proof on the issues that have been the subject of this proceeding; therefore its filing is not disapproved.

This decision has been filed this 25th day of January, 2008 in the office of the Commissioner of Insurance. Any party aggrieved by this decision may, within twenty days, file a petition for review in the Supreme Judicial Court for Suffolk County.

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Nonnie S. Burnes
Commissioner of Insurance