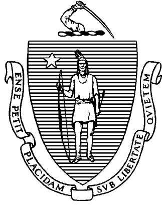

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Opinion, Findings and Decision on Request For Hearing on Safety Insurance Company's Private Passenger Motor Vehicle Rate Filing Dated November 27, 2007

Docket No. R2007-06

I. Procedural History

On November 19, 2007, the Safety Insurance Company ("Safety"), submitted a filing for private passenger motor vehicle ("PPMV") insurance rates to the Commissioner of Insurance ("Commissioner") for her review pursuant to G.L. c. 175E ("c. 175E"). In accord with 211 CMR 79.19, Safety amended its filing on November 27. On December 17, 2007, the Attorney General, pursuant to c. 175E, §7, moved for a hearing on Safety's rate filing, alleging that the proposed rates were excessive. On December 18, the Commissioner issued a hearing notice ("Notice") scheduling a hearing to begin on January 11, 2008.[1] The Notice informed the parties that, as identified by the Attorney General, the hearing would cover whether the rates are excessive, in violation of G.L. c. 175A and c. 175E, specifically because of 1) the cost of capital and asset returns in the profit provision; 2) inclusion in the expense provision of contingent commissions; and 3) Safety's loss trends.

The Commissioner designated us as presiding officers for this proceeding. The hearing occurred on January 11. Kenneth E. Carlton, FCAS, MAAA and Glenn Hiltpold, FCAS, MAAA testified for Safety. Allan I. Schwartz, FCAS, MAAA and Stacey

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[1] On December 19, 2007, the Commissioner announced that the Division of Insurance had completed its review of Safety's filing and did not intend to disapprove it. The filing was placed on file with an effective date of April 1, 2008. That action does not affect the Attorney General's statutory right to request a hearing.

Gotham, FCAS, MAAA were witnesses for the Attorney General.[2] Based on the testimony of the witnesses and the documents admitted into evidence we find and conclude, as follows:

II. Standard of Review and Burden of Proof

Commissioners of Insurance have determined that conditions in Massachusetts were such that rates should be fixed-and-established industrywide for PPMV insurance for the past 30 years. On July 16, 2007, after a hearing was held as in past years, the Commissioner concluded that sufficient competition existed in the PPMV insurance market such that it was not necessary for her to fix-and-establish those rates (the "*July 16 Decision"*). Subsequently, the Division of Insurance ("Division") promulgated 211 CMR 79.00 *et seq*., to govern the requirements for company rate filings for PPMV insurance rates in a competitive market. The 19 insurers currently writing this line of insurance submitted individual rate filings to the Division pursuant to c. 175E and G.L. c. 175A, with effective dates of April 1, 2008.

Chapter 175E, §4 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."[3] The Commissioner's task, under c. 175E, is to determine whether a company's proposed rates satisfy the statutory and regulatory standards.[4] She may not disapprove rates if they fall within a range of reasonableness, and otherwise satisfy the requirements of the general laws. *Attorney General v. Commissioner of Insurance*, 450 Mass. 311 (2008). The Commissioner does not set the rates under c. 175E. Her authority is limited strictly to disapproving a rate or, under very limited circumstances set forth in the statute, approving it.

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[2] Prefiled testimony of Birny Birnbaum, a witness for the Attorney General, was stricken on Safety's motion on the ground that it addressed risk rating factors, a matter that is not at issue in this proceeding. That portion of the prefiled testimony of Stacey Gotham that relates to manual rates also was stricken for a similar reason.

[3] The Attorney General, however, defines "excessive" as the difference between the result of calculations performed by her witnesses and those performed by or on behalf of Safety.

[4] The Attorney General alleges only that Safety's proposed rates are excessive, and we will review them only to determine compliance with that standard.

The Commissioner looks at the proposed overall rates generated by the rate filing viewed as a whole to determine whether a company's proposed rates are excessive for the insurance provided. She also considers whether the proposed rates are generated using generally accepted actuarial approaches to ratemaking. 211 CMR 79.05(5). Finally, she 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.[5] c. 175E, §4(a).

G.L. c. 175E, §7 allows the Attorney General to request a hearing on a rate filing. The rate filer, however, has the burden of proving that its filing complies with c. 175E, G.L. c. 175A, and the 211 CMR 79.00 *et seq*. regulations. 211 CMR 79.13 (11). Challenges to particular aspects of the rate filing are insufficient, *per se*, to demonstrate that an overall rate does 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 premise 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 the regulator, the Commissioner, only can review compliance of Safety's filing with statutory standards rather than explore alternative approaches. Indeed, the Attorney General bears no burden of proof and has no role in establishing a different rate for Safety.

[5]Safety references this standard but applies it very broadly. It states that "[o]n July 16, 2007, the Commissioner found that there is competition in the market. Thus, as a matter of law, the economic pressure of price competition from other insurers must weigh in favor of a finding that Safety's rates are not excessive, especially where, as here, Safety has offered evidence to show that its rates are more favorable to consumers than those of many of its competitors." The Commissioner's *July 16 Decision*, however, is meager evidence of this factor. It speaks to competition generally in the marketplace rather than to the specifics that appear to be required under c. 175E, §4(a). Safety did satisfy this standard with regard to one element of its profit provision, as found *infra*.

See our O*rder on Discovery* dated January 3, 2008. 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 forth 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 and discounted rates.[6]

III. Substantive Issues

A. Underwriting Profits

Mr. Hiltpold testified about Safety's underwriting profit provision, which is based on an analysis of its operating profits. He stated that the target return on equity reflects investor expectations as determined when Safety's parent company conducted an initial public offering. Safety then calculated an operating profit margin and its estimated prospective investment income. The latter was developed by discounting insurance cash flows to zero and considering Safety's historic investment earnings.

Mr. Hiltpold, after comparing Safety's target return on equity, or cost of capital, to the values proposed by other companies in their rate filings, determined that Safety is near the median for all companies making c. 175E filings, and that its underwriting profits provisions are lower than some companies. Mr. Carlton, Safety's expert witness from Milliman, confirmed that Safety's selected cost of capital is reasonable based on Milliman's study of that cost as compared to those of other property and casualty companies.[7] He opined that Safety's cost of capital is less than what Milliman determined to be the average with regard to the other companies and, therefore, is reasonable.

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[6] 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 within 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 amended rates, filed on November 27, are to take effect on April 1 2008, when the current fix-and-establish rates applicable to all insurers, including Safety, expire by operation of law. Companies also must reprogram their computer systems and generate their renewal notices to include such rates and send these notices to their policyholders no later than February 15th, as required under the law. These regulatory procedures were tailored to ensure timely completion of this proceeding.

[7] Mr. Carlton also submitted prefiled testimony regarding a Milliman report regarding an internal rate of return profit model. He withdrew such testimony and related exhibits at the beginning of his testimony based on his finding the previous evening that the Milliman model was flawed. We do not rely on any opinion of Mr. Carlton or Milliman in this decision with regard to that model or any of its findings.

Mr. Hiltpold testified that he did not include income on surplus in his calculation of prospective investment income because the Division's regulation does not require it. It provides: "[i]n determining the reasonableness of profits, the evaluation shall include consideration of all investment income attributable to the line of insurance." 211 CMR 79.05(9). Actuarial literature, he explained, allows exclusion of investment income from surplus in ratemaking because the surplus does not belong to policyholders but represents owner's equity.

Mr. Hiltpold also excluded finance charge income from Safety's calculation of investment income because it is the subject of a separate filing with the Division. Finance charges provide income to Safety to offset the reduction in investment income resulting from the delayed receipt of premium; Mr. Hiltpold did not view them as part of the insurance loss transfer. He further justified Safety's exclusion of finance charge income as it offset his decision to exclude the effect of federal income taxes in his discounted cash flow model. Mr. Hiltpold testified that Safety's method is consistent with sound actuarial principles and that his assumptions decrease the underwriting profits provision in the filing, resulting in lower rates for consumers. He stated that Safety's profit provision does not result in a rate that is unreasonably high for the insurance provided.

The Attorney General alleges that the profit provisions in Safety's rate filing are "unreasonable and excessive" and "substantially" higher than the profit permitted in prior rate decisions and than any profit provision charged by an automobile insurance company in Massachusetts for at least the last 25 years. Specifically, she asserts that Safety's profit provision is excessive because: 1) it did not document the source for its proposed 12 percent return on equity; 2) it did not include investment income in its surplus; and 3) it ignored income that it will receive from finance charges or other miscellaneous sources. The Attorney General argues that past decisions on PPMV insurance rates acknowledge that insurers earn investment income on surplus funds and receive income from miscellaneous sources, such as finance charges, and concludes that such income should be reflected in the underwriting profits provision. She contends that omitting such income from the rate filing is inconsistent with Actuarial Standard of Practice ("ASOP") No. 30 and Casualty Actuarial Society Ratemaking Principles.

Discussion and Conclusion

The Attorney General's comparison of the profit provisions in Safety's filing to those approved under the fix-and-establish system is irrelevant. She fails to recognize that this proceeding, conducted on a filing made pursuant to c. 175E and 211 CMR 79.00 *et seq*., differs fundamentally from a proceeding to fix-and-establish industrywide insurance rates under G.L. c. 113B. We are considering a particular company's rate filing that is based primarily on its own data and developed from methodologies that it chooses. It is not our task to look at aggregate industrywide data to develop an underwriting profit provision that reflects the average financial needs of a mythical "Every Company," but is specific to none.

A company must develop a profit provision that reasonably reflects its financial needs and that, when included in its proposed rates, produces an overall competitive rate that complies with the statutory standards. Companies in a competitive market are free to incorporate their own target profit provisions into their proposed rates; price competition is expected to exert pressure on rates to provide some control on target profit levels. Differences between profit provisions developed for an entire industry in a fixed-and-established system and those developed for individual companies in a competitive market, based on their own operations and judgment about their financial needs, are to be expected.[8]

That Safety's underwriting profit provision would be lower if it were based on industrywide input values from a prior rate decision does not demonstrate that Safety's rate is excessive. The prior rate decision, and its use of such input values, is irrelevant to this proceeding. The issue in this decision is whether Safety's profit provision uses generally accepted actuarial techniques and falls within a range of reasonableness.

Safety has explained its reasons for selecting its cost of capital and for choosing the methodologies to which the Attorney General objects. No evidence suggests that it is unreasonable to select a cost of capital that reflects investor expectations. Indeed, as stated by Mr. Hiltpold, no actuarial standard requires formal modeling of the cost of capital.

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[8] Safety's demonstration of where its return on equity falls in comparison to other companies, constituted "material" evidence that this component of its underwriting profit provision is not excessive. See c. 175E, §4(a).

The Attorney General, however, argues that by excluding investment income on surplus and finance charge income from its profits provision, Safety failed to comply with c. 175E, §4 and ASOP 30. The relevant part of the statute, however, instructs the Commissioner to consider, "to the extent applicable . . . a reasonable rate of return on capital after provision for investment income . . . and all other factors, including judgment factors, deemed relevant within and outside the Commonwealth." 211 CMR 79.06 (4)(n) instructs insurers to include in rate filings information on "underwriting profit, including due consideration of investment income." Neither the statute nor the regulation imposes a specific methodology for calculating investment income. Neither identifies finance charge income as a factor that must be included or otherwise addressed in connection with rate filings. That Safety's rate might be different if it had chosen to include investment income on surplus and finance charge income in its underwriting profit provision is not a sufficient reason to conclude that its proposed rates are excessive for the insurance provided. It need not select methodologies that are identical to those used to fix-and-establish rates or to conform to those chosen by other companies or the Attorney General.[9]

The Attorney General's allegation that Safety's chosen methodologies do not comply with ASOP No. 30 is a path leading to nowhere. The Attorney General attempts to substitute an application of that standard for the statutory standard of review of competitive rate filings. Even if the evidence were sufficient to demonstrate non-compliance with an ASOP, the Attorney General has not linked non-compliance to a determination that Safety's overall rates are excessive.[10]

On this record, we find that Safety has met its burden of proof relating to the underwriting profits provisions in its proposed rates.

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[9] In any event, the methodologies used to develop the underwriting profits provisions in fixed-and-established rates were not static, but changed over time to reflect the use of different models.

[10] We also do not find relevant the Attorney General's argument that Safety's rate filings do not comply with Actuarial Standards of Practice relating to documentation. Even if the evidence were sufficient to demonstrate non-compliance with an ASOP, the Attorney General has not linked non-compliance to a determination that a rate is excessive. She merely contends that because a filing omits documents describing the reasons for its rate projections it lacks sufficient clarity to enable another actuary practicing in the same field to evaluate the work and appraise its reasonableness and validity. Mr. Schwartz's testimony, however, confirmed that any such alleged omission did not prevent him from looking at the data in the filing and making his own projections. Ms. Gotham testified that the information in Safety's filing was sufficient for her purposes, too.

B. Commission Expenses

Mr. Hiltpold stated that the Casualty Actuarial Society's ratemaking principles support inclusion in rates of all costs associated with the transfer of risk. Because Safety, as an independent agency company, incurs the cost of paying contingent commissions to producers, disregarding that cost in the rates would be inconsistent with sound actuarial methods. Indeed, Safety's inclusion of such costs in its commercial motor vehicle and homeowners insurance rate filings never has been challenged. These other insurance lines and filings are subject to the same standards as PPMV insurance filings under c. 175E.

Mr. Hiltpold opined that Safety's expense provision is not excessive because it does not result in a rate that is unreasonably high for the insurance provided. He testified that the company's overall commission expense, including contingent commissions, is comparable to that in the rate filings of its competitors who also conduct business through independent agents. Mr. Carlton also testified that it is reasonable to recognize contingent commissions in expense provisions, asserting that ratemaking should provide for all costs associated with the transfer of risk.

The Attorney General argues that Safety should not be allowed to include contingent commissions in its rates because Commissioners of Insurance consistently have excluded them in prior fix-and-establish decisions. Mr. Schwartz also observes that Safety's commissions to premium ratio is higher than its historical ratio resulting in a "substantial" provision for contingent commissions that is excessive. She characterizes such commissions as a form of profit sharing that increases an already excessive profit provision that policyholders are asked to fund. The Attorney General asserts that contingent commissions have been criticized as "creating serious potential conflicts of interest and leading to anticompetitive effects such as the steering of business away from more cost effective carriers."

Discussion and Conclusion

The Attorney General does not contend that Massachusetts law prohibits or limits the payment of contingent commissions to insurance producers. The mere inclusion of

such a provision, she argues, renders Safety's proposed rates excessive.[11] She argues that because decisions fixing and establishing rates did not allow them to be included, they should continue to be rejected in a competitive environment.[12]

Those past decisions are not relevant with respect to rate filings made pursuant to c. 175E. Testimony from Mr. Hiltpold and Mr. Carlton supports Safety's argument that including contingent commissions in the rates is consistent both with actuarial principles of ratemaking and rate filings made by competing agency companies in Massachusetts. No evidence supports the Attorney General's argument that inclusion of contingent commissions in rates is a *sub rosa* approach to increasing the profit provision in those rates. Her observation that commissions in Safety's proposed rates are a higher percentage of premium than that shown by its historical experience is not *per se* evidence that rates are excessive.[13]

C. Loss Trends

Mr. Hiltpold testified that Safety selected its trend factors based on a combination of statistical analyses of historical accident year ultimate loss pure premiums and actuarial judgment. Using judgment, he states, is reasonable because of changes to the historical factors that affected Safety's claims history during the experience period. Mr. Hiltpold's judgmental analysis anticipates that the decrease in loss frequencies that occurred after the creation of Community Insurance Fraud Initiatives ("CIFIs") in October 2003 will not continue at the same rate and reflects a non-recurring one-time redistribution of exclusive representative producers, which decreased Safety's accident year 2006 loss pure premiums. His trend factors also assume that weather-related claims will return to an average level, after two years of lower than normal occurrence, and consider 2007 loss data.

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[11] The Attorney General offered no testimony or evidence to support the assertions in her request for a hearing that contingent commissions have been criticized as "creating serious potential conflicts of interest and leading to anticompetitive effects such as the steering of business away from more cost effective carriers."

[12] The Attorney General states that no prior decision suggested that companies may not pay contingent commissions.

[13] The Attorney General's argument that because Safety's filing includes a regulated commission expense pure premium, the inclusion of an additional provision for contingent commissions makes the rates *per se* excessive is not persuasive.

Because Safety writes 11.2 percent of the voluntary risks in the market, Mr. Hiltpold credibility-weighted his selected trends with industry trend factors, from the Automobile Insurers Bureau ("AIB"). Mr. Hiltpold testified that Safety's trending methods reflect sound actuarial practice and that credibility-weighting its results with the industry's is a reasonable way to incorporate industry trends with the company's own data. He stated that Safety's selected trends compare favorably with those filed by its competitors.

Mr. Carlton testified that he separately reviewed the trends underlying Safety's historical claim frequencies and severities, and derived loss trends that were higher than those that Safety used in its filing. He testified that severity trends showed a steady increase consonant with positive inflation, and that frequency increased from 1997 to 2003, but declined sharply from 2004 through 2006. Because that decline was associated with specific occurrences, and because Safety's 2007 data indicate a frequency increase for liability and collision claims, Mr. Carlton selected frequency trends of 0.0. He concluded that Safety's rates, although lower than they would be if the company had utilized his trend factors, are within a range of reasonableness.

The Attorney General does not object to Safety's prospective loss trends but contends that it ignored historical loss data and selected unreasonable and excessive historical loss trends. Safety averaged separately calculated trends for each of three historical experience periods, calendar years 2004, 2005 and 2006, and projected unity (*i.e.*, flat) or increased loss trends for the historical period. Ms. Gotham testified that the decrease in losses during the historical period in large part resulted from the reduction of fraud brought about through CIFI task forces and, since 2005, improvement of poor road conditions that decreased losses under the comprehensive insurance coverage.

Discussion and analysis

The Attorney General does not contest Safety's trend factors for the prospective rate effective period, but only for the historical period. Safety developed those trends from a mathematical analysis of its historical data and judgment with respect to future conditions. Ms. Gotham testified that she did not find any problems with Safety's methodology, did not consider its use unreasonable, and that Safety's filing provided her with adequate information to do her analysis. Ms. Gotham agreed with Safety's witness

that the magnitude of loss reductions resulting from CIFI activities would not be the same in the future as in the historical period. Her testimony confirms that the actuarial process involves both mathematical calculations and judgment, and that actuaries are expected to consider all relevant information available to them when projecting for the future and to weigh that information in making a judgment. The Attorney General's sole point of contention is that Safety's calculated losses are higher than those she calculated because they are based on other observed data. Ms. Gotham, however, testified that different actuaries could produce different results that are within a range of reasonableness.[14] On this record, we conclude that Safety met its burden of proof to show that the use of its selected trends does not result in an excessive rate.

IV. Conclusion

The Safety Insurance Company has met its burden of proof regarding the issues that are the subject of its proceeding. Safety's rates are not disapproved.

DATED: January 25, 2008

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Elisabeth A. Ditomassi Presiding Officer	Tesha M. Scolaro Presiding Officer

Affirmed this 25th day of January 2008.

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Nonnie S. Burnes
Commissioner of Insurance

Any person aggrieved by this decision may, in accordance with G.L.c. 175E, §13, petition for review in the Supreme Judicial Court for Suffolk County.

[14] The Attorney General commented on but did not object specifically to Safety's decision to weight its trend factors with those developed by the AIB. 211 CMR 79.06 (4) requires filings to include information on credibility.