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Opinion, Findings and Decision on
The Arbella Mutual Insurance Company's
Private Passenger Motor Vehicle Rate Filing
Dated November 27, 2007

Docket No. R2007-09

I. Procedural Background

On November 19, 2007, the Arbella Mutual Insurance Company ("Arbella") submitted a filing for private passenger motor vehicle ("PPMV") insurance rates for review by the Commissioner of Insurance ("Commissioner") pursuant to G.L. c. 175E ("c. 175E"). In accordance with 211 CMR 79.19, Arbella amended its filing on November 27. On December 17, 2007, the Attorney General, pursuant to c. 175E, §7, moved for a hearing on Arbella's filing, alleging that its rates were excessive. On December 18, the Commissioner issued a notice for a hearing to commence on January 18, 2008. The notice informed the parties that the hearing would address the Attorney General's allegations that Arbella's proposed rates are excessive, in violation of G.L. c. 175A and c. 175E, specifically because of: 1) calculations for physical damage cash flows, asset returns, investment tax rates, cost of capital and the leverage ratios in the profit provision; 2) inclusion in the expense provision of contingent commissions; 3) the loss provision; 4) the alleged inflation of indicated costs for collision and comprehensive coverages resulting from application of the symbol drift factor; and 5) an allegedly erroneous expense calculation.

The Commissioner designated us as presiding officers for this proceeding. The hearing occurred on January 18. Betsy Branagan, FCAS, MAAA and Richard A. Derrig,

Ph.D. testified for Arbella. Allan I. Schwartz, FCAS, MAAA and Stacey Gotham, FCAS, MAAA testified for the Attorney General.[1]

II. Standard of Review and Burden of Proof

Commissioners of Insurance have determined that conditions in Massachusetts were such that the Commissioner should fix-and-establish industrywide rates for PPMV for the past 30 years. On July 16, 2007, after a hearing 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.[2]

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" and that evidence "that a reasonable degree of competition exists in the area with respect to the classification to which such rate is applicable shall be considered as material, but not conclusive evidence, that such rate is not excessive." The Commissioner's task under c. 175E is to determine whether a company's proposed rates satisfy the statutory and regulatory standards.[3]

The Commissioner 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. She looks at the

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[1] On Arbella's motion, prefiled testimony of Birny Birnbaum, and a portion of the prefiled testimony of Stacey Gotham, FCAS, MAAA, witnesses for the Attorney General, were stricken on the grounds that such testimony addressed matters that were not at issue in this proceeding.

[2] The Division of Insurance completed its review of Arbella's proposed rates and put them on file on January 8, with an effective date of April 1, 2008. That action does not affect the Attorney General's statutory right to request a hearing.

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

proposed overall rates generated by the rate filing as a whole to determine whether a company's proposed rates are excessive for the insurance provided. She considers whether the proposed rates are generated using generally accepted actuarial approaches to ratemaking. 211 CMR 79.05 (5).

G.L. c. 175E, §7 allows the Attorney General to request a hearing on a rate filing. The rate filer has the burden of proving that its filing complies with c. 175E, G.L. c. 175A, and 211 CMR 79.00 *et seq*. See 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. Contrary to the Attorney General's assertion in her brief, a company's rate is not necessarily excessive if one component of it proves to be excessive. It is possible that a rate component may be excessive but that the overall rate may be within a range of reasonableness after all the other components are factored together. For example, an inadequate component could temper an excessive component, resulting in a reasonable rate.

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 only can review compliance of Arbella'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 Arbella. See our *Revised Order on Attorney General's Motion for Discovery* dated January 7, 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 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 and reduced rates.[4]

III. The Substantive Issues[5]

A. Material Evidence of Competition

Section 4 of c. 175E provides that: "[e]vidence that a reasonable degree of competition exists in the area with respect to the classification to which such rate is applicable shall be considered as material, but not conclusive, evidence that such rate is not excessive." Arbella argues that the Commissioner may consider variances in the c. 175E filings by other insurers as evidence of reasonable competition, and to consider reasonable competition as evidence that Arbella's rates are not excessive.

Dr. Derrig asserted that variations in such factors as coverage options, discounts, rating plans, and rate filing methods are hallmarks of a workable competitive market. Relying on expert testimony given at the Commissioner's June 2007 hearing on competition in the market for PPMV insurance, he concluded that the number of companies in the market is adequate to support competition. Dr. Derrig's testimony documented variations in 17 c. 175 E filings, as amended on November 27, 2007, and further commented that later filings in February 2008 are likely to show additional movement towards competition. He testified that, even in a transition year to full competition, filings show significant variations in filing methods and outcomes from those methods, as compared to the most recent fixed-and-established rates. Exhibit A to his

[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 and amended on November 27, are to take effect on April 1, 2008, when the current fix-and-establish rates applicable to all insurers, including Arbella, 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.

[5] The Attorney General requested a hearing on Arbella's application of the symbol drift factor and an alleged error in the expense calculation. Ms. Branagan testified that Arbella corrected the two errors that the Attorney General identified. Arbella submitted the corrected pages to the Division and provided copies to the Attorney General. The Attorney General stated at the hearing that the symbol drift factor was no longer an issue, and that she would address continuing issues with the expense portion of the filing in her posthearing brief. We do not address the symbol drift factor in this decision based on the Attorney General's representation at the hearing that this is no longer an issue.

testimony analyzed a number of aspects of those filings, including differences in the financial provisions, discounts, and enhancements to products the company offers.

Discussion and Analysis

The Commissioner's *July 16 Decision* on competition in the market for PPMV speaks to competition generally rather than to the specifics that appear to be required under c. 175E, §4. Her finding that competition is sufficient to support a competitive market does not, in itself, establish that proposed rates in any individual filing satisfy that criterion and are not excessive. Dr. Derrig's testimony for Arbella does provide some independent evidence to demonstrate that Arbella's rates, measured by that criterion, are not excessive. The introduction of many new products and rating variables constitutes some indicia of competition within certain classifications. While this finding is not dispositive of the issues in this case, it does present material evidence that Arbella's rates are not excessive.

B. Underwriting Profits

Arbella adopted the profit provisions filed by the Automobile Insurers Bureau ("AIB") in its October 22, 2007 advisory rate filing for companies writing less than one percent of the market for PPMV insurance. Dr. Derrig testified that the AIB's profit provision was developed from an internal rate of return ("IRR") model and was the result of averaging its 2008 modeled profit provision with the profit provision from the 2007 fix-and-establish rate decision. He stated that the AIB chose parameters for the IRR model that would approximate the average insurer writing this line of business, anticipating that the underwriting profits provision it produced would be appropriate for the under one percent companies and be a potential source of values, such as the cost of capital, that any other insurer might wish to adopt.[6] Dr. Derrig stated that the combined ratio in the advisory filing was a reasonable estimate for use in 2008 competitive rates.

The Attorney General alleges that the profit provision in Arbella's rate filing is unreasonable because the methodology used to develop the provision is inconsistent with the underwriting profit methodologies that have been determined to be appropriate for

[6] Dr. Derrig testified that the AIB used loss cash flows of the under one percent companies but calculated most of the parameters using national data. Its filing did not include any Arbella-specific data.

PPMV in Massachusetts and leads to excessive rates.[7] She asserts that Arbella inappropriately adopted its underwriting profit provision from the AIB advisory filing for under one percent companies rather than use its own data.

Discussion and Analysis

The Attorney General's principal complaint is that Arbella's adopted underwriting profit provision is inappropriate and unreasonable because it is based on methodologies that were rejected in a prior fix-and-establish rate decision. Her invocation of a prior rate decision under a different statute is irrelevant to this proceeding. The Attorney General did not request a hearing on any other filing by a company that adopted the profit provisions in the AIB's advisory filing. She offers no support for the contention that it was incorrect for Arbella to adopt it.

A company must choose a profits provision that reflects its financial needs and that, when included in its proposed rates, produces an overall rate that complies with the statutory standards and produces competitive rates under c. 175E.[8] In a competitive market, companies are free to incorporate their own choice of underwriting profit provisions into their proposed rates; price competition is expected to exert pressure on profit levels in rates.

C. Expense Provision

1. Contingent Commissions

Ms. Branagan testified that Arbella's expense provision properly includes an amount for contingent commissions.[9] She stated that Arbella pays such commissions in order to compete, and that it expects to incur the expenses included in its expense provision. Ms. Branagan commented that the Casualty Actuarial Society's Statement of Principles regarding property and casualty insurance ratemaking state that a rate is an "estimate of the expected value of future costs" and that it "provides for all costs associated with the transfer of risk." She also observed that ASOP No. 29, "Expense Provisions in Property/Casualty Insurance Ratemaking," similarly requires that rates

[7] Mr. Schwartz testified that the procedures at issue include, but are not limited to, physical damage cash flows and calculation of the investment tax rate. In her brief, the Attorney General asserts that the AIB's equity beta and bond yield are also contested.

[8] Dr. Derrig's testimony summarizes some of the differences among the individual company filings submitted in November 2007.

[9] That provision, Ms. Branagan testified, includes both contingent and override commissions.

reflect all expenses to be incurred in connection with the transfer of risk, and specifically includes commission and brokerage fee expense. Arbella included its expected contingent commission expenses in its filing in accord with those principles. In Ms. Branagan's opinion, Arbella's filing produces rates that are reasonable and not excessive.

Dr. Derrig testified that his review of 20 company rate filings under c. 175E showed that commission percentages ranged from zero to 17.5 percent, reflecting the costs of the company's chosen distribution system. Ten companies included a provision for contingent commissions, reflecting competition among them to acquire good risks.

The Attorney General asserted that Arbella's commission expense provision is a form of profit sharing that increases the already excessive profit provision that policyholders are asked to fund. Mr. Schwartz testified that contingent commissions should not be included in Arbella's expense provision because a series of prior decisions fixing-and-establishing PPMV insurance rates consistently have determined that they should not be included. He testified that he agrees with the principle that a rate is an estimate of the expected value of future costs and should reflect the conditions expected during the rate effective period, but excludes contingent commissions on the theory that they are not associated with the transfer of risk.

Discussion and Conclusion

The Attorney General does not contend that Massachusetts law prohibits or limits the payment of contingent commissions to insurance producers or challenge the reasonability of the actual contingent commission provision in Arbella's rate filing.[10] The mere inclusion of such a provision, she argues, renders Arbella's proposed rates excessive.[11] The Attorney General contends that because decisions fixing and establishing rates did not allow them to be included, they should continue to be rejected in a competitive environment. Those past decisions are irrelevant to individual company rate filings made pursuant to G.L. c. 175E.

[10] The Attorney General states that prior decisions did not suggest that companies may not pay contingent commissions, but did not allow that expense to be passed on to consumers as part of the insurance rate.

[11] The Attorney General offered no testimony or other 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."

Testimony from Ms. Branagan and Dr. Derrig supports Arbella'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. The observation that commissions in Arbella's proposed rates are a higher percentage of premium than commissions in prior rates is not *per se* evidence that rates are excessive. 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 the rates.[12] It would be unreasonable and possibly prejudicial to Arbella to disapprove a contingent commission expense provision in its filing while allowing such a provision in other companies' rate filings.[13] On this record, Arbella has met its burden to show that its commission expense provision complies with generally accepted actuarial principles and does not produce excessive rates.[14]

2. Other expenses

The Attorney General's request for a rate hearing asserted that Arbella's expense calculation was erroneous. Arbella moved for a more definite statement of this issue and, at the December 28, 2007 prehearing conference we ordered the Attorney General to provide one. She failed to do so. Mr. Schwartz's prefiled testimony described a particular mathematical error. Ms. Branagan testified that Arbella corrected the error, revised and reviewed its selected expense provisions, and recalculated the indicated rate changes by coverage. She stated that Arbella's rate change was not impacted because its selected values remain well below the recalculated indicated rate changes. Ms. Branagan testified that Arbella's expenses, expressed as percentages of premium, may be higher in the future than in the past because, as rates go down and fixed expenses remain constant, expenses as a percentage of premium will increase. In her opinion, all of Arbella's selected expense values are reasonable.

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[12] Mr. Schwartz testified that all commission payments are expenses from a company's point or view and are so booked under the National Association of Insurance Commissioners' standard accounting system.

[13] The Attorney General did not ask for a hearing on all rate filings that included contingent commissions in their expense provisions.

[14] Arbella argues that its burden is limited only to contingent commissions rather than override commissions because the Attorney General alleged that only contingent commissions were excessive in her December 17th letter to the Commissioner. While Arbella's argument is persuasive, we do not need to make a ruling on this issue in view of our more general finding that there is no reasonable reason to exclude contingent, or override commissions for that matter, in Arbella's rate filing.

The Attorney General objects that Arbella, after correcting the expense provision, changed some of its selected values for fixed and variable expenses. She argues that Arbella's selections are unsupported and excessive. The Attorney General asserts that the fixed expense values in Arbella's November 19, 2007 filing were correct, that Arbella did not explain the reason for changing its selected value, and that it should not have been allowed to change that value in its corrected filing. She complains that Arbella did not adopt the result of its corrected calculation of its variable expenses but, without explanation, selected a higher value.

Discussion and Conclusion

Pursuant to 211 CMR 79.11 (5) a party moving for a hearing on a rate filing must provide a detailed statement of issues specifying each aspect of the rate filing on which a hearing is sought. 211 CMR 79.12 requires a party to submit in advance of the hearing a summary of the issues on which each of its witnesses will testify. The prehearing order issued in this matter required parties to prefile testimony in advance of the hearing. In none of those documents did the Attorney General identify changes to Arbella's fixed and variable expense values as an issue in this proceeding, although she had ample time to do so.[15] Considerations of fairness require that a party requesting a hearing identify all issues in advance. Nevertheless, because Arbella failed to raise the Attorney General's failure to provide a more definite statement either at the hearing or in its brief, and addresses in its brief the Attorney General's arguments on expense values, we consider this issue.

The essence of the Attorney General's argument is that Arbella changed its selected expense values after correcting a calculational error in its initial filing and that those changes are excessive. Her argument is not persuasive. As is apparent from Ms. Branagan's testimony, expense percentages change as estimates of premium change. Changes to a rate component do not automatically produce a rate that is excessive; but must be viewed in the context of the entire rate. Arbella points out that the differences in its selected values did not change its overall selected rate change, which remains below its indicated rate changes.

[15] Mr. Schwartz's prefiled testimony was submitted on January 15, a week after Arbella submitted its corrected pages.

D. Loss trends

Ms. Branagan testified about Arbella's selected loss trend provisions, stating that according to ASOP 13 an actuary "should apply trending procedures which appropriately reflect projected changes in such components as claim costs, claim frequencies, expenses, exposures and premiums over the trending period." She testified that she utilized a generally accepted actuarial practice in applying the same trend value to the historical period and bringing the trends forward to the future. Ms. Branagan stated that the decreases in losses for bodily injury ("BI") and personal injury protection ("PIP") coverage slowed in 2005-2006, and that the AIB's analysis of industrywide loss trends suggests that the benefits of the Community Insurance Fraud Initiative ("CIFI") programs are waning and will level off in the near future.[16] Ms. Branagan judgmentally selected Arbella's loss trend for BI, PIP, comprehensive and collision, and the AIB's trend factor for property damage liability ("PDL") to reflect the changing environment.[17] In general, she stated, her selected trends were slightly lower than those developed by the AIB, and better reflect Arbella's experience. Ms. Branagan opined that the loss provisions used in Arbella's rate calculation will produce rates that are reasonable and not excessive.

The Attorney General contends that Arbella's selected loss trends for the historical experience period are unreasonable and lead to increased losses. She asserts that they are inconsistent with trends based solely on observed experience and higher than the indicated trends shown in the Arbella filing. Ms. Gotham testified that it is actuarially incorrect to ignore historical loss ratio data and project higher trends for coverages during the historical period. She asserted that the decreased losses in the historical period resulted in large part from the reduction in fraud brought about by the CIFI task forces and the remediation of poor road conditions on Interstate 95 since 2005. Ms. Gotham performed her own calculations and concluded that Arbella's loss trends for the historical period resulted in excessive rates.

Discussion and Conclusion

The Attorney General only objects to Arbella's historical loss trends rather than its trend factors for the prospective rate effective period. Arbella developed those trends

[16] Ms. Branagan posited that increases in gas prices, changes in weather patterns and driving habits affect losses, but did not link those factors to the particular decline in bodily injury losses after 2003.

[17] In developing that trend, the AIB concluded that its analysis of industrywide data showed that good weather conditions in 2006 likely affected property damage claims for that year.

from a mathematical analysis of its historical data and actuarial judgment about future conditions. Ms. Gotham testified that Arbella's application of loss trend factors to historical periods is a standard actuarial technique, provided loss ratios from year to year are considered to be random. She agreed that future improvements from CIFI efforts are likely to be smaller than past improvements, and that weather is a random factor.[18] Arbella's invocation of judgment in this instance is based on sound actuarial principles and is supported by calculations in the rate filing. No evidence supports a contrary conclusion. On this record, we find that Arbella has met its burden of showing that its selected loss trend factors are based on an accepted actuarial technique and do not produce excessive rates.

IV. Conclusion

Based on the record, we find that the Arbella Mutual Insurance Company has met its burden of demonstrating that its proposed rates comply with the statutory and regulatory standards and are not excessive. Arbella's rate filing is not disapproved.

DATED: January 30, 2008

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Elisabeth A. Ditomassi
Presiding Officer

Tesha M. Scolaro
Presiding Officer

Affirmed this 30th day of January 2008.

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Nonnie S. Burnes
Commissioner of Insurance

Any person aggrieved by this decision may petition for review in the Supreme Judicial Court for Suffolk County within 20 days in accordance with G.L.c. 175E, §13.

[18] Both Ms. Branagan and Ms. Gotham referred to other factors that might affect loss trends, but neither attempted to quantify the effect of such factors.