

**STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
DEPARTMENT OF BUSINESS REGULATION
233 RICHMOND STREET
PROVIDENCE, RHODE ISLAND 02903**

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| IN RE:NORCAL Mutual Insurance Company | : | |
| Medical Malpractice Insurance | : | |
| Physicians and Surgeons Program | : | |
| Rate Filing | : | DBR No. 05-I-0142 |
| | : | |
| (Filed July 7, 2005) | : | |
| | : | |

DECISION

**I.
TRAVEL**

This matter came to be heard before the Department of Business Regulation ("Department") as a result of a rate filing received by the Department on July 7, 2005 from Norcal Mutual Insurance Company ("Norcal"). The filing requests an overall rate level increase of 10% for Physicians and Surgeons Program.¹ All rates were proposed to be effective on January 1, 2006. The rates now in effect for Norcal's Physician and Surgeon Program were approved effective January 1, 2005 pursuant to a Decision of the Department rendered in DBR No. 04-I-0114.

In accordance with the provisions of R.I. Gen. Laws § 27-9-10, 42-14-1 *et seq* and 42-35-1 *et seq.*, on July 25, 2005 the Director of the Department designated Elizabeth Kelleher Dwyer, Deputy Chief of Legal Services and Paula M. Pallozzi, Chief Property & Casualty Insurance Rate Analyst, as Co-Hearing Officers in this matter. The

¹ The filing represented that an overall rate level increase of 41.3% was indicated, however, Norcal requested that the Department approve only a 10% increase.

Department was assisted by Theodore J. Zubulake, FCAS, MAAA, FCIA, ARM and Debra Stein, ACAS, MAAA.

An initial prehearing conference was held on August 4, 2005. The Department issued a Pre-Hearing Order scheduling cut off dates for motions to intervene, discovery and filing of Regulation 39(b) statements. The public hearing was scheduled for September 27, 2005.

Motions to Intervene were filed by the Rhode Island Trial Lawyers Association (“RITLA”) and the Rhode Island Medical Society (“RIMS”). No objection was filed to the Motion to Intervene filed by RIMS. Norcal objected to the Motion to Intervene of RITLA. On September 14, 2005, the Co-Hearing officers issued an order granting the Motions to Intervene of RIMS and RITLA. RITLA subsequently filed a copy of an order of the Providence County Superior Court admitting Jay Angoff, Esq. *pro hac vice* for purposes of this proceeding.

On September 27 and 28, 2005 the public hearing in this matter was held. Genevieve M. Martin, Esq., and Jodi Norse Bourque, Esq., appeared on behalf of the Attorney General; R. Kelly Sheridan, Esq. appeared on behalf of Norcal; Jeffrey Chase-Lubitz, Esq., appeared on behalf of RIMS and Miriam Weizenbaum, Esq. and Jay Angoff, Esq. appeared on behalf of RITLA. Bruce Williams, ACAS, MAAA and David Apell, Ph. D testified on behalf of Norcal. Michael J. Ileo, Ph. D and Anthony J. Grippa, FCAS, MAAA testified on behalf of the Attorney General. Admitted as full exhibits were AG1 through AG12, Norcal Exhibits 1 through 4 and DBR Exhibit 1. RIMS Exhibit 1 was offered for the Department’s consideration. Two members of the public offered comments. Patricia DePrete testified that she was with the Urban League of

Rhode Island. Ms. DePrete urged the Department to approve rates "...that are fair, that they meet the needs of the insurers to pay claims and maintain services, but do not go beyond those needs." (Transcript of 9/27/05 page 6) Ms. DePrete indicated that the Urban League was concerned as to the effect of medical malpractice rates on the overall health care system. Dawn Wardyga, Director of Family Voices, also offered public comment. She indicated that Family Voices represents the families of malpractice victims. Ms. Wardyga urged the Department to keep in mind the families who need to be assured that their medical professionals "...have access to comprehensive affordable malpractice insurance..."

The Attorney General stated at the opening of the hearing that, after conversations with Norcal representatives, they no longer advocated the recommendation in their Regulation 39(9)(b) statement.² The Attorney General indicated that the additional information received in discussions with Norcal had caused them to agree that the requested 10% overall rate level increase was justified. An Addendum to the Attorney General Regulation 39(9)(b) statement was filed on September 26, 2005, one day prior to the hearing. The Addendum clarified that the Attorney General did not agree with the 41.3% indication claimed by Norcal, however, adjusting for their methodology differences, the Attorney General's actuary had calculated an overall rate level increase of 10.7%.

RITLA did not file a Regulation 39(9)(b) statement or an alternative rate level calculation. However, at the hearing RITLA argues that the requested rate level increase was excessive for the following reasons:

² The Attorney General's Regulation 39(9)(b) statement filed on September 19, 2005 had recommended an overall rate level increase of 3.4%.

1. Severity Trend – RITLA argues that the manner of selection skews the trend high. RITLA recommended that the Department use, not the 10.7% requested, but a 6.3% trend.

2. Frequency Trend – RITLA argues that in the last two filings Norcal used a frequency trend of 0% but in this filing they use a 4% trend. RITLA argues that a 0% frequency trend should be used consistent with the Decision in *In re ProSelect* DBR No. 05-I-0111 issued September 23, 2005 (hereinafter referred to as the “*ProSelect Decision*”) and *In Re Norcal* DBR No. 03-I-0218 issued November 20, 2003 (hereinafter referred to as the “*Norcal Decision*”).

3. Loss Development – RITLA argues that in the selection of the age-to-age factors the straight all year average should be omitted.

4. Selection of Loss and Allocated Loss Adjustment Expenses (“ALAE”) Ratio – RITLA argues that a premium weight should be used in addition to the weights that are given for responsiveness and stability.

5. Selection of Ultimate Losses and ALAE By Year – RITLA argues that paid development should be given some weight.

6. Rate of Return – RITLA argues that the 10% requested was too high especially since the Department accepted 6% in 2003. RITLA requested that the Department look at the surplus increases indicated in the annual statements and Norcal’s actual rate of return in making this determination.

7. Differences with Rhode Island and California filings – RITLA argues that the Department should consider the differences between Norcal’s last California filing and this filing in disallowing certain requests. The differences indicated by RITLA were

(1) commission rate, (2) Death, Disability, and Retirement (DD&R) load, (3) Excess Policy Limits/Extra Contractual Obligation (“XPL/ECO”) load, (4) Unallocated Loss Adjustment Expenses (“ULAE”) and (5) the peer review charge.

8. Overall Market Differences – RITLA argues that the Department should not accept inconsistencies in the manner in which the rate indication is calculated such as the loss trend rate and the rate of return.

Although they did not provide a specific number, RITLA argues that when the adjustments listed above are made the result would be “...a significant double digit decrease in Norcal’s rates.” (Transcript of 9/28/05 page 115)

II. JURISDICTION

The Department has jurisdiction in this matter pursuant to R.I. Gen. Laws §§ 27-9-10. The hearing was conducted in accordance with the provisions of the Administrative Procedures Act, R.I. Gen. Laws §§ 42-35-1 *et seq.*

III. DISCUSSION

A. WHAT JUDGMENTS AND ASSUMPTIONS ARE APPROPRIATE IN ASSESSING NORCAL’S RATE LEVEL NEEDS

By its nature, the actuarial determination of an insurance company’s rate level need is subject to a considerable amount of actuarial judgment. Both the Attorney General and RITLA take issue with certain methods and assumptions that Norcal applied in calculating their rate level indication.

A discussion of these issues and the Department’s decision and reasoning follows.

Loss Development Factors

In selecting loss development factors, Norcal followed the approach the Department set out in the *Norcal Decision*.

The Attorney General accepts the factors selected by Norcal to be reasonable. The Attorney General's actuarial expert stated, "...I thought their selections were reasonable." (Transcript of 9/28/05 page 98) He added, "I still believe that the selected development factors, given the historical development data that was available, were reasonable." (Transcript of 9/28/05 page 98)

RITLA argues that it would be more appropriate to omit the straight all-year average in order to give less weight to the 1994 year results, which they view as being abnormal. "So, I would recalculate the loss development factor, taking out that straight all year average." (Transcript of 9/28/05 page 108)

The Department continues to find the *Norcal Decision* approach to be appropriate, and rejects the RITLA position that by considering the straight all-year average undue weight is given to the 1994 year results. The Department accepts Norcal's selected loss development factors.

As discussed later, the Department accepts Norcal's rejection of the results of the paid development method for estimating ultimate losses.

Loss Trend

Norcal selects a loss trend rate of 12.0% based on a loss trend rate of 13.1% that they calculated in the following manner.

Norcal performed various exponential regression analyses of their Rhode Island physicians & surgeons claim frequency data spanning the period 1996-2004. They then

calculated an arithmetic average of the five trend rates with the highest R-Squared values. The resulting average is 8.7%, and due to the wide range of indications and fits, Norcal stated that they selected a frequency trend rate of 4.0%.

Norcal performed various exponential regression analyses of their Rhode Island incurred physicians & surgeons claim severity data spanning the period 1995-2004. They then calculated an arithmetic average of the five trend rates with the highest R-Squared values. The resulting average is 10.7%.

Combining their selected frequency trend rate and severity trend rate results in a loss trend rate of 15.1% based on Norcal's Rhode Island loss experience. Consistent with the *Norcal Decision*, Norcal then averaged this trend rate with the ISO trend rate of 8.0%. The result, 11.6%, was then increased by 1.5 percentage points to reflect the \$1 million per claim limit. This result is 13.1%. Norcal stated on page 4 of their Actuarial Memorandum, "due to the limited amount of data currently available for Rhode Island and the potential flattening indicated by the emerging experience for the most recent two years, we have judgmentally mitigated the resulting projected net trend rate." Norcal selects a loss trend of 12.0%.

The Attorney General accepts Norcal's selected frequency trend rate, but does not accept the severity trend rate that is implied by Norcal's calculations and selections. The Attorney General instead selects a loss trend rate of 10.3% that is based on Norcal's selected 4.0% claim frequency trend rate, a severity trend rate that is based on alternative "rolling averages" exponential regression analyses that they performed on the Norcal Rhode Island \$500K limit data, and an adjustment to the \$1M limit level of +1.0 percentage point.

RITLA takes issue with Norcal's selection of the 10.7% severity trend from among the results of the various regression analyses that Norcal performed. RITLA argues, "the average of the averages, or the total average of those 12 is 6.25%. Coincidentally, maybe, exactly the same rounding up as the severity trend that ProSelect selected. So, we would recommend that the panel, in recalculating this increase, use a 6.3% severity trend..." (Transcript of 9/28/05 pages 105)

The Department finds it appropriate to give consideration to Norcal's physician and surgeon frequency and severity experience in Rhode Island in selecting the loss trend rate. For this reason the Department rejects RITLA's position that the Department should select the same 6.3% loss trend rate that the Department accepted in the *ProSelect Decision*. However, the Department takes issue with Norcal's selected loss trend rate. In particular the Department rejects Norcal's selection of indicated frequency and severity trend rates based on the regression analyses that produce the highest R-Squared values. On this point the Department agrees with the Attorney General. In light of the fluctuating pattern in Norcal's historical trend rate experience, a high R-Squared value does not imply a better fit. The Attorney General's actuarial expert stated, "... R-Squared by itself is not a sufficient measure of what is a reasonable trend." (Transcript of 9/28/05 page 90) However, the Department does not find compelling the Attorney General's rationale for selecting a severity trend rate based on the result of the 1997-2004 regression analysis (among all of the regression analyses that the Attorney General performed).

The Department also rejects Norcal's 1.5 percentage point adjustment to reflect the \$1 million per claim limit. On this point the Department agrees with the Attorney General's adjustment of 1.0 percentage point. The Attorney General's actuarial expert,

referring to the *Norcal Decision*, stated "...the discussion was about a \$250,000 limit, and there was a consensus, that the Order adopted of a 1.5% add-on to go from a \$250,000 per claim limit to \$1 million per claim limit. Since this was \$500,000 to \$1 million, I judgmentally changed the 1.5% to 1.0%." (Transcript of 9/28/05 page 93)

Neither Norcal nor the Attorney General considered the existence of a premium trend. For the reasons explained by Norcal on page 4 of their Actuarial Memorandum, the Department finds it appropriate not to reflect a premium trend in this filing.

The Department accepts the following manner of selecting the net loss trend.

- Determine a severity trend based on the results of the incurred development method for losses capped at \$500,000 per claim that is based on a weighted average of the exponentially fitted trends over the following periods: 1996-2000 (weight of 5.0); 1996-2001 and 1997-2001 (weight of 4.0); and 1996-2002, 1997-2002, and 1998-2002 (weight of 3.0); 1996-2003, 1997-2003, 1998-2003 and 1999-2003 (weight of 2.0); 1996-2004, 1997-2004, 1998-2004, 1999-2004 and 2000-2004 (weight of 1.0).
- Determine a frequency trend based on Norcal's experience that is based on a weighted average of the trends over the following periods: 1996-2000 (weight of 5.0); 1996-2001 and 1997-2001 (weight of 4.0); and 1996-2002, 1997-2002, and 1998-2002 (weight of 3.0); 1996-2003, 1997-2003, 1998-2003 and 1999-2003 (weight of 2.0); 1996-2004, 1997-2004, 1998-2004, 1999-2004 and 2000-2004 (weight of 1.0).
- Multiply the indicated severity trend by the indicated frequency trend to derive an indicated net loss trend.

Average the indicated net loss trend with the ISO trend rate of 8.0%.

- Add 1.0 percentage point to adjust for the \$1 million per claim limit.

The result is a loss trend rate of 10.6%.

The Department finds this approach to be consistent with the *Norcal Decision*, subject to an expansion of the years that are considered to recognize the additional information that is now available.

Increased Limit Factor (“ILF”) Development

Norcal’s selection of ultimate losses and ALAE by year is based on the results of the two incurred methods. One method uses data limited to \$1 million as the base. The other method uses data limited to \$500,000 as the base, and adjusts the indications to \$1 million limits using increased limit factors.

On page 3 of their Actuarial Memorandum Norcal states, “the selected ILFs by report year are based on a weighted average of the projected ILF detrended and the actual ILF developed to ultimate. The selected weights reflect the volatility in the emerged ILFs at earlier evaluation points, providing this data with increasing weight as more claims are resolved. The projected ILF is selected based on a variety of average indications trended to the upcoming year. The annual ILF trend rates were selected based on statistical goodness of fit statistics and judgment.”

The Department accepts Norcal’s methodology as reasonable with the exception of the trend rate and the weights. The Department calculates a trend rate of 0.7% based on the methodology that is consistent with the Department’s calculation of the loss trend rate. The Department calculates weights based on the methodology that is consistent

with the Department's calculation of the stability weights used in the selection of the loss and ALAE ratio.

Selection of Ultimate Losses and ALAE by Year

Norcal's selection of ultimate losses and ALAE by year is consistent with the *Norcal Decision* in that they reject the consideration of the results of the paid methods. The Attorney General takes issue with Norcal's approach because, in their opinion, the incurred methods may produce estimates of ultimate losses and ALAE that are too high due to what they find to be abnormally high level of reported losses attributed to a few large claims. Therefore, the Attorney General gave weight to the results of the paid method for losses limited to \$500,000 and ILF applied for \$1 million limit for the years 2000 through 2004. The Attorney General's actuarial expert stated, "... because four of the five years had a difference of at least a half million dollars in the columns (3) and (4), I used that as my criteria for those five years, that is starting with the year 2000, to apply a one-third weight to the limited paid method." (Transcript of 9/28/05 page 77)

RITLA argues that the paid development should get some weight stating "the Attorney General has made the judgment that the incurred method limited at \$500,000 should get one-third weight. I think that is a reasonable judgment. I think it would also be reasonable to give some weight to the other paid method, but I do think it is important not to give as much weight to the incurred method but to give some weight." (Transcript of 9/28/05 page 109)

The Department questioned Norcal's actuarial expert on this point. In response, Norcal's actuarial expert stated, "I do think the incurred method provides a reasonable estimate for all years including 2002." (Transcript of 9/27/05 page 176)

The Department agrees with Norcal's actuarial expert on the point raised by the Attorney General, continues to find (please refer to the *Norcal Decision* for discussion) the paid methods not to be as reliable as the incurred methods, and, therefore, accepts Norcal's method of selection.

Selection of Loss and ALAE Ratio

Norcal's method of selecting a loss and ALAE ratio is an attempt to be consistent with the systematic weighting approach accepted by the Department in the *Norcal Decision*.

The Attorney General accepts Norcal's method of selecting a loss and ALAE ratio.

RITLA argues "...that the [Department] give a premium weight in addition to the weights that are given in Exhibit 1, Sheet 2 for responsiveness and stability. This is something that was done in the ProSelect filing." (Transcript of 9/28/05 page 108 and 109)

The Department accepts Norcal's weighting approach with two exceptions:

- The years 1996 and 1997 should be considered. While Norcal's approach follows the approach accepted by the Department in the *Norcal Decision* in that seven years of experience is considered, the Department did not intend for only the most recent seven years to be considered. (In the *Norcal Decision* the years 1994 and 1995 were not considered due to the occurrence of what Norcal testified as being unusual loss experience.)
- A premium weight should be reflected. The Department added the consideration of premium volume in their *ProSelect Decision* and although it has much less of

an impact than it did in the ProSelect filing, the Department finds this modification to their approach to be appropriate.

The Department accepts the following manner of determining the Selected Loss and ALAE Ratio.

- Assign a “responsiveness weight” to years 2004 back to 1996 of 9 for 2004, 8 for 2003, 7 for 2001, etc.
- Assign a “stability weight” to years 2004 back to 1996 equal to the percentage of the estimated ultimate losses and ALAE reported (maximum of 100%).
- Assign a premium weight to years 2004 back to 1996 equal to the “on level earned premium.”
- Normalize the product of the three (3) weights.
- Apply the normalized weights to the on-level trended ultimate loss and ALAE ratios by year.

Credibility of Norcal’s Loss Experience

This issue concerns the credibility of the estimates of Norcal’s on-level trended ultimate incurred losses and ALAE for use as a basis for projecting Norcal’s ultimate loss and ALAE ratio for year 2006. Both Norcal and the Attorney General consider Norcal’s data not to be fully credible and adjust for this. RITLA did not raise this as an issue.

Full Credibility Standard

Norcal selects 1,500 claims as their full credibility standard, the standard accepted by the Department in the *Norcal Decision*. The Attorney General does not take issue with this standard.

However, in determining the number of claims to apply against the standard, Norcal reduced their claim counts by 50% as the Department did in the *Norcal Decision*. The Attorney General did not make this adjustment.

The Department accepts Norcal's manner of determining the credibility of their loss experience with one exception:

- Because the Department considers Norcal's loss experience over the period 1996 through 2004 in selecting the Loss and ALAE ratio, the Department considers Norcal's estimated ultimate number of incurred claims over the period 1996 through 2004.

Complement of Credibility

Norcal's manner of determining the complement of credibility is to consider their prior rate level indication, less the approved rate increase, adjusted by loss trend. The Attorney General takes issue with this approach as they did not accept Norcal's prior rate level indication. Therefore, the Attorney General determines the complement of credibility as the loss trend that was accepted by the Department in the *Norcal Decision*.

The Department agrees with the Attorney General on this issue. The Department accepts in principle Norcal's manner of determining the complement of credibility, which is to consider the prior rate level indication, less the approved rate increase, adjusted by loss trend. However, as respects this filing, the Department does not accept Norcal's consideration of their prior rate level indication. The Department's reason is that while the Department accepted Norcal's prior proposed rate changes as being reasonable, they did not make a finding on the full amount of the rate level indication that had been

calculated by Norcal. Therefore, the Department finds the consideration of loss trend only and not the prior rate level indication to be appropriate in this filing.

However, the Department does not agree with the Attorney General's use of the net loss trend rate that was accepted by the Department in the *Norcal Decision*. The Department finds it appropriate to use the net loss trend rate that it accepts for this filing, 10.6%, for the purposes of calculating the complement of credibility.

ULAE Percentage

Norcal selects the ULAE provision based on an average of two methodologies applied to their countrywide data. Method 1, which relies on the ratio of paid ULAE to paid indemnity and ALAE, produces a ULAE provision of 16.9%. Method 2, which relies on the ratio of paid ULAE to paid indemnity, ALAE, and 50% of the change in case reserves, produces a ULAE provision of 16.4%. Norcal selects a ULAE provision of 16.7%.

The Attorney General questioned Norcal on the two methods as a proper measure of an appropriate ULAE load. In Norcal's response 5b to Attorney General data request 2nd set, Norcal states, "in lines of business where more than a year can pass between the date a claim is opened and the date it is closed, the paid to paid ratio may allow a mismatch between the paid ULAE and the paid loss and ALAE. Assuming that roughly 50% of the ULAE is paid when the initial investigation occurs and the case reserve is established, placing 50% weight on the change in case reserves is intended to mitigate this mismatch. This method and the 50% factor are set forth by John Kittel in his article in the 1981 Casualty Actuarial Society discussion paper program."

The Attorney General agrees that this correction is appropriate for a line of business in which there may be extended periods of time between the date a claim is opened and the date it is closed. Therefore, the Attorney General selects the ULAE provision based entirely on Method 2.

RITLA argues that Norcal is inappropriately charging Rhode Island policyholders more for ULAE than they charge their California policyholders. Norcal responded to this point by saying the factor included in the referenced California filing was in error in that it did not include the additional load for copy costs. Norcal's actuarial expert stated, "we did not include that additional load for copy costs in the California rate filing. That was an oversight." (Transcript of 9/28/05 page 13)

The Department agrees with the Attorney General that Norcal's Method 2 is more appropriate for physicians and surgeons business in which there may be extended periods of time between the date a claim is opened and the date it is closed.

The Department accepts Norcal's explanation for the difference from their California load.

The Department finds a ULAE load based on the results of Method 2 to be reasonable.

DD&R Load

The DD&R load is added to cover the cost of future claims from the free tail coverage provided by Norcal after death, disability, or retirement as long as certain conditions are met. Norcal bases their selected DD&R load on their Rhode Island physician age distribution and a mortality table. The mortality table is the same table accepted by DBR in the *Norcal Decision*.

The Attorney General accepts Norcal's DD&R load as reasonable.

RITLA takes issue with the fact that Norcal's proposed DD&R load of 4.5% exceeds Norcal's DD&R load in California of 0.0%. Norcal responded to this point by saying the DD&R data was included in the loss data. Norcal's actuarial expert stated, "the rate regulation process in California at that time did not allow a separate load, but instead we were directed to include the DD&R data with the rest of the loss data. So, there is DD&R loaded into the final rate indication." (Transcript of 9/28/05 page 8)

The Department accepts Norcal's explanation for the difference from their California load, and finds Norcal's DD&R load to be reasonable.

XPL/ECO Load

Consistent with the *Norcal Decision*, Norcal included a 4% provision for their potential liability for losses in excess of policy limits and extra-contractual obligations (XPL/ECO) based on their countrywide experience.

The Attorney General argues that the load should be zero based on Norcal's Rhode Island loss experience only. RITLA takes issue with the fact that Norcal's proposed XPL/ECO load of 4.0% exceeds Norcal's XPL/ECO load in California of 0.0%. Norcal responded to this point by saying the XPL/ECO data was included in the loss data. Norcal's actuarial expert stated, "...the data shown in the California filing is on a total limit basis, so all the loss and ALAE data includes the XPL data as well." (Transcript of 9/28/05 page 10)

In reference to the requested XPL/ECO factor, Norcal is referred to the discussion in the *ProSelect Decision*. Although it does not make a material difference in this filing, the Department would not approve a factor higher than that approved in the *ProSelect*

Decision. Norcal should seriously consider, prior to their next filing, whether any development has occurred in this area with regard to *Asermely* and, therefore, whether the factor continues to be warranted.

Physicians Administrative Defense (“PAD”) Load

The PAD coverage was introduced by Norcal in 2000. PAD coverage provides coverage for claims that involve the administrative aspects of running a medical practice as opposed to claims involving the practice of medicine itself. On page 5 of the Actuarial Memorandum Norcal stated that, “...due to the limited volume of Rhode Island data, and especially the Rhode Island PAD data, we have based the PAD loading on the average of the indications developed based on the Rhode Island and countrywide experience.”

The Attorney General accepts Norcal’s PAD load as reasonable.

The Department accepts Norcal’s PAD load as reasonable.

Expenses

Norcal treats commissions, peer review fees, and premium tax as variable expenses. Licenses and fees, and general underwriting expenses are treated as a fixed component. The commission rate of 7.5% and the peer review fee of 1.0% are based on contractual agreements. The premium tax of 2.35% is the rate paid by Norcal to the State of Rhode Island based on direct written premium. Licenses and fees are 0.34%, and general underwriting expenses are 10.4% based on Norcal’s Rhode Island data for 2000 through 2004.

The Attorney General accepts Norcal’s expense provisions as reasonable.

RITLA takes issue with the commission rate of 7.5% stating, “... the issue of the Commission has already been discussed in the hearing two years ago, and we didn’t

discuss it much today. I don't intend to now, but the fact remains, that the 7.5 percent that Norcal pays the Medical Society for each policy gives Norcal a competitive advantage." (Transcript of 9/28/05 page 114)

RITLA also takes issue with the fact that Norcal's proposed peer review fee of 1.0% exceeds Norcal's peer review fee in California of 0.0%. Norcal responded to this point by saying the peer review fee was reflected in the California filing in general expense. Norcal's actuarial expert stated, "we do pay a peer review fee in California. That would be reflected on Exhibit 13 in general expense." (Transcript of 9/28/05 page 17)

The Department accepts Norcal's explanation of the basis for their variable and fixed expense provisions, and finds Norcal's expense provisions to be reasonable.

Profit & Contingencies

Norcal proposes a profit & contingencies margin of 0.23%. Norcal derived this margin by selecting a target after-tax return of 10.0% and converting it into a profit & contingencies margin based on certain assumptions and the application of an Internal Rate of Return (IRR) model. These assumptions include an investment rate, an equity ratio, and the timing of premium, loss, expense, and investment cash flows.

The Attorney General recommends a profit & contingencies margin of -12.47%.

The primary drivers of the difference between Norcal's proposed profit & contingencies margin and that recommended by the Attorney General are the target return and the investment rate. The Attorney General either accepts or finds the remaining differences not to be significant: Norcal's reserve to surplus equity ratio of 3 to 1 (with the reserve including the unearned premium reserve), the various cash flows assumed by

Norcal, the treatment of certain expenses as variable rather than fixed, and the structure of the IRR model that Norcal uses.

The difference in the positions of Norcal and the Attorney General on the target return center around three issues: (1) what is an appropriate return on equity capital, (2) whether a return on debt capital should be reflected in selecting the target return, and (3) the cost amount assigned to debt and preferred equity (hereafter collectively referred to as “debt”) if debt capital is reflected.

Norcal selects an after-tax return on equity capital of 10% and attributes no weight to debt. Hence, Norcal’s target after-tax return is 10%. The Attorney General accepts Norcal’s after-tax return on equity capital of 10%, but attributes 18.85% weight to debt, and assigns a cost to debt of 4.55%, to arrive at an after-tax target return of 8.97%.

Norcal’s expert witness on the issue of the profit & contingencies margin, explained that Norcal selected an after-tax return on equity capital of 10% as being “...such a modest return for bearing the risk of writing medical malpractice...that it was not going to generate dispute” (Transcript of 9/27/05 page 16). He added that it is his opinion 10% is “...extremely conservative” (Transcript of 9/27/05 page 24) because he currently estimates closer to 11% as a benchmark cost of equity capital for the property & casualty insurance industry. “My current estimates are closer to 11 percent than 10 percent, but as we have said, Norcal, I believe, selected 10 percent for a reason, and I believe the reason has to do with trying to avoid dispute about that particular issue.” (Transcript of 9/27/05 page 30) Norcal’s economist further added that upward adjustments would likely need to be made to the benchmark cost of equity capital to

reflect the relative riskiness of medical malpractice insurance and Norcal's specific company circumstances. "That is just a starting point because I think most anyone in this room would agree that medical malpractice is amongst the riskiest activities in which property & casualty insurers are engaged, and hence that itself may require a higher cost than average. Then there are individual company circumstances that may also affect cost of capital as well...In Norcal's case you have a relatively small insurer writing a single line of business. A substantial portion of their business is in a single state. The line of business is a particularly risky line of business. Those factors tend to mitigate in favor of a higher cost of capital..." (Transcript of 9/27/05 page 28 and 29)

The Attorney General's economic expert witness on the profit & contingencies margin, stated, "the 10% as the cost of equity I do not find unreasonable." (Transcript of 9/27/05 page 125) He further added, "It's conceivable, if I had done an independent cost of capital analysis, I would have concluded that the cost of equity capital for Norcal is actually higher than 10%. At the same time, I may have concluded that something less is true..." (Transcript of 9/27/05 page 120)

Norcal's economic expert stated that he would not normally attribute any weight to debt. "I have done some studies many years ago looking at the nature of debt in the capital structure. In many instances that debt is not used to support insurance operations, and I don't think regulators normally believe or think of insurance companies, the insurance operating companies, as being substantially funded by debt. I believe policyholder surplus is thought to be equity commitment on the part of the company. So I would not normally calculate a weighted average cost of capital, but I can't say that this is never done." (Transcript of 9/27/05 page 51)

The Attorney General's expert had a different position on this issue. He stated, "ten percent as the cost of capital, I find unreasonable...Now Norcal, in and of itself, does not have any debt capital, until recently when it issued surplus notes. So they differ in that respect from the value line investment company. But if we are going to use as a surrogate the industry cost of equity capital and input that to Norcal, then it is my judgment and my professional opinion that we have to do the same thing for the way they finance their operation generally. When one looks at the way value line companies have financed their operations historically, some companies are 100 percent equity, others only as much as 50 percent equity, but on a composite basis they tend to be financed on 80 percent equity, 85 percent equity; 15 percent debt, 20 percent debt. I believe that is the proper way to establish what the cost of capital is to a property & casualty insurer."

(Transcript of 9/27/05 page 126 and 127)

As to the issue of the cost assigned to debt, Norcal's expert stated that he found the before tax cost for debt stock of 4.55% that is selected by the Attorney General to be "...extremely low, and inappropriate. Currently, long-term government bonds are yielding in excess of 4 percent. So I don't think that a company like Norcal could issue debt at a 4 and a half percent yield rate and be able to credibly sell debt in the capital market." (Transcript of 9/27/05 page 53)

The Attorney General's expert explained the basis for the 4.55% cost of debt that he used in his calculations. He stated, "I ascribed a 4.55% cost of debt, which was a weighted average of short-term debt and long-term debt, where the long-term debt was based on the Lehman Brothers rate as of April, if my recollection serves me, of this year." (Transcript of 9/27/05 page 129)

As respects the investment rate, Norcal uses an after-tax rate of 2.86% while the Attorney General recommends an after-tax rate of 4.58%. Norcal's rate of 2.86% is, according to their expert, "...the after-tax yield that corresponds to a 4.64% before-tax yield which was the average yield on the Lehman Aggregate Bond Index at the date that the filing was put together." (Transcript of 9/27/05 page 54 and 55) Norcal's expert also stated, "...Norcal relied on the index because, as I understand it, Norcal's portfolio is principally debt secured. Approximately 80% of Norcal's portfolio is comprised of debt securities." (Transcript of 9/27/05 page 55)

In commenting on this, the Attorney General's expert stated, "the 2.86% proposed by Norcal in the filing, in my view, is totally at odds with reality. It assumes that Norcal's investment portfolio is comprised 100 percent of taxable bonds..." (Transcript of 9/27/05 page 132) That is, the Attorney General's expert is saying that Norcal accepted the average Lehman Aggregate Bond Index rate in full, even though their own investment portfolio is not fully bonds.

Norcal's expert stated that while Norcal may be incorrect in assuming a 100% bond portfolio, the Attorney General "...relied on a portfolio composition for Norcal as reflected in the Norcal Mutual Insurance Company Annual Statement, but Norcal Mutual itself is one component of a larger holding company or a larger consolidated entity, which includes other entities, and Norcal Mutual holds the stock of their subsidiaries as an asset, as a common stock asset, in the asset portfolio of Norcal Mutual. [The Attorney General's expert] was correct in finding that almost 31% of Norcal Mutual's assets are common stock, but if you look at the consolidated entity, which is the proper entity to look at from an economic perspective, the consolidated entity has only about 12% of their

assets in common stock...” (Transcript of 9/27/05 page 55 and 56) Norcal’s expert went on to state “...if you use a 12% weight on common stock, an 80% weight on bonds, and the remainder in cash and short-term investments, you end up with the yield rate that instead of 2.86% or 4.58%, the yield rate is about 3.1%.” (Transcript of 9/27/05 page 57)

The Attorney General’s recommendation of a 4.58% after-tax rate is based on Norcal Mutual’s actual portfolio composition, which is approximately 31% common stock. But, the Attorney General’s expert stated that he accepts Norcal’s expert point about considering Norcal on a consolidated basis and that doing so he would agree that the 12% weight, instead of 31% weight, is reasonable. However, he also stated that one would then need to consider other assumptions that have been made on a consolidated company basis as well, and since this has not been done (the Attorney General’s expert stated that he was not provided with Norcal’s consolidated financial statement), he stands by the 31 percent weight he assigned to common stock. To the question, “so is it your position that you are not prepared to accept the use of the 12 percent; you are standing by the 31 percent weight that you are using?” The Attorney General’s expert responded, “Yes, that would be my position.” (Transcript of 9/27/05 page 138)

The Attorney General’s recommended 4.58% after-tax rate is also based on an assumed return on common stocks of 12.4%. Norcal’s expert found this assumption to be inconsistent with the Attorney General’s expert’s acceptance of Norcal’s selected 10% equity return in deriving their target return. The Attorney General’s expert stated that he would have to update Norcal’s expert’s cost of capital study to determine what an appropriate alternative value might be. His conclusion, therefore, was that “it should be higher than 11.1 but possibly lower than 12.4.” (Transcript of 9/27/05 page 142)

The third consideration that leads to the 4.58% after-tax rate recommended by the Attorney General is the tax rate used. Norcal assumed a tax rate of 34%, while the Attorney General finds an effective tax rate of approximately 30% to be more appropriate. The Attorney General's expert noted that Norcal's expert acknowledged that Norcal's average tax rate over the past five years has been approximately 30%. "He said the average tax rate over the past five years is about 30 percent. This is what I am using in Table B." (Transcript of 9/27/05 page 144)

As respects the amount of weight (including 0%) that should be attributed to debt in determining the target after-tax return, the Department notes that even the Attorney General's expert acknowledged that there is no commonly held view among economists on this issue. In response to the question, "so, different economists could have different views on this issue?" the Attorney General's expert responded, "Yes." (Transcript of 9/27/05 page 130 and 131)

However, the Department agrees with Norcal's expert that the 10% equity return selected by Norcal is conservative (low), that a cost of debt of 4.55% is low, and is of the view that should it be appropriate to consider debt that doing so with a more appropriate equity return and debt cost would not likely produce a target after-tax cost of capital that is less than 10%. The Department, therefore, accepts Norcal's target after-tax return of 10%.

The Department agrees with Norcal's expert and the Attorney General's expert that the 2.86% after-tax investment rate used by Norcal is too low, but is uncertain as to the appropriateness of either Norcal's expert's re-calculated rate of approximately 3.1% or the Attorney General's recommended rate of 4.58%. The Department, therefore,

selects the average of 3.1% and 4.58%, or 3.84% as the after-tax rate to be used to calculate the profit & contingencies margin in this filing.

The Department accepts Norcal's IRR model, and all other assumptions and calculations made by Norcal in determining the profit & contingencies margin. The Department estimates that the profit & contingencies margin that results from a 10% after-tax return and a 3.84% after-tax investment rate is approximately -5.2%, and accepts -5.2% as the profit & contingencies margin.

B. OVERALL RATE LEVEL CHANGE

The Department's calculations result in an overall rate level increase of 22.6%. Therefore, the Department finds Norcal's requested overall rate level increase of 10.0% will result in rates that are not excessive, inadequate or unfairly discriminatory.

C. MEDICAL SPECIALTY CLASSIFICATION CODES

Norcal is proposing to shift the few physicians currently classified as Internal Medicine (Non-Invasive) from Class 2 to Class 1 in order to consolidate the subspecialties which, according to Norcal, are not appreciably different. In particular, Norcal is proposing to consolidate two internal medicine subspecialties that are currently in Class 2 (Codes 8965 and 8993) with the two internal medicine subspecialties currently in Class 1 (Codes 8920 and 9014). The four subspecialties will now be identified collectively as Internal Medicine (Non-Invasive) and will be rated as Class 1. There is a resulting rate reduction for physicians in class codes 8965 and 8993. Norcal based their decision to consolidate these classes on underwriting judgment and the lack of significant differentiation between these subspecialties.

Norcal is also proposing to add new subspecialties to reflect the changing health care environment. These subspecialties were assigned to classes based on underwriting judgment.

Norcal did not perform a rate level analysis by class. In response to question 19 of the Department's data request 1, Norcal stated, "We performed a review of our class plan as part of our most recent prior filing. The historical data volumes associated with each of these subclasses is relatively small and generally it will be several years before enough additional experience has emerged to provide a useful supplement to the prior review."

The Attorney General did not take issue with this proposed change.

The Department finds the proposed changes in the class plan to be reasonable.

IV. FINDINGS OF FACT

1. On July 7, 2005 Norcal filed a request to increase rates for their Physicians & Surgeons Program.

2. The filing requests an overall rate level increase of 10%. All rates are proposed to be effective on January 1, 2006. The rates now in effect for Norcal were approved effective January 1, 2005.

3. The Attorney General indicated at the hearing that they agreed with the 10% request although they disagreed with some methodology and Norcal's representation that a 41.3% overall rate increase was justified.

4. RITLA listed a number of areas with which they disagreed and indicated that when those factors were taken into account "...a significant double digit decrease in Norcal's rates" would be warranted but did not propose any specific numbers.

5. The findings and recommendations in this Decision are based upon judgments and assumptions used by the Department in order to ascertain the appropriate rate relief. The findings in this filing may not be applicable to future rate requests since conditions and situations may change depending on the credibility of the data provided by the filer. Clearly, the Department could have reached a different decision had the parties presented the Department other information for consideration. It is important to note that the Department relied on and accepted the data contained in the filing without independent audit.

6. With regard to loss development factors, the Department accepts Norcal's selected loss development factors.

7. With regard to the loss trend rate, the Department accepts the following manner of selecting the net loss trend.

- Determine a severity trend based on the results of the incurred development method for losses capped at \$500,000 per claim that is based on a weighted average of the exponentially fitted trends over the following periods: 1996-2000 (weight of 5.0); 1996-2001 and 1997-2001 (weight of 4.0); and 1996-2002, 1997-2002, and 1998-2002 (weight of 3.0); 1996-2003, 1997-2003, 1998-2003 and 1999-2003 (weight of 2.0); 1996-2004, 1997-2004, 1998-2004, 1999-2004 and 2000-2004 (weight of 1.0).
- Determine a frequency trend based on Norcal's experience that is based on a weighted average of the trends over the following periods: 1996-2000 (weight of 5.0); 1996-2001 and 1997-2001 (weight of 4.0); and 1996-2002, 1997-2002, and 1998-2002 (weight of 3.0); 1996-2003, 1997-2003, 1998-2003 and 1999-

2003 (weight of 2.0); 1996-2004, 1997-2004, 1998-2004, 1999-2004 and 2000-2004 (weight of 1.0).

- Multiply the indicated severity trend by the indicated frequency trend to derive an indicated net loss trend.

Average the indicated net loss trend with the ISO trend rate of 8.0%.

- Add 1.0 percentage point to adjust for the \$1 million per claim limit.

The result is a loss trend rate of 10.6%.

The Department finds this approach to be consistent with the *Norcal Decision*, subject to an expansion of the years that are considered to recognize the additional information that is now available.

8. Neither Norcal nor the Attorney General considered the existence of a premium trend. For the reasons explained by Norcal on page 4 of their Actuarial Memorandum, the Department finds it appropriate not to reflect a premium trend in this filing.

9. With regard to the ILF development, used to adjust the \$500,000 limit indications to \$1 million limits, the Department accepts Norcal's methodology as reasonable with the exception of the trend rate and the weights. The Department calculates a trend rate of 0.7% based on the methodology that is consistent with the Department's calculation of the loss trend rate. The Department calculates weights based on the methodology that is consistent with the Department's calculation of the stability weights used in the selection of the loss and ALAE ratio.

10. With regard to the selection of ultimate losses and ALAE by year, the Department accepts Norcal's average of the results of the two (2) incurred loss development methods to be reasonable.

11. With regard to determining the selected loss and ALAE ratio, the Department finds appropriate the following manner of calculation:

- Assign a "responsiveness weight" to years 2004 back to 1996 of 9 for 2004, 8 for 2003, 7 for 2001, etc.
- Assign a "stability weight" to years 2004 back to 1996 equal to the percentage of the estimated ultimate losses and ALAE reported (maximum of 100%).
- Assign a premium weight to years 2004 back to 1996 equal to the "on level earned premium."
- Normalize the product of the three (3) weights.
- Apply the normalized weights to the on-level trended ultimate loss and ALAE ratios by year.

12. With regard to the credibility of Norcal's Loss Experience, the Department accepts Norcal's manner of determining the credibility of their loss experience with one exception:

- Because the Department considers Norcal's loss experience over the period 1996 through 2004 in selecting the Loss and ALAE ratio, the Department considers Norcal's estimated ultimate number of incurred claims over the period 1996 through 2004.

With regard to the complement of credibility, the Department finds the consideration of loss trend only and not the prior rate level indication to be appropriate in this filing. The Department also finds it appropriate to use the net loss trend rate that it accepts for this filing, 10.6%, for the purposes of calculating the complement of credibility.

13. With regard to the ULAE percentage, the Department finds a ULAE load of 16.4% based on the results of Method 2 to be reasonable.

14. With regard to the DD&R load, the Department finds Norcal's DD&R load to be reasonable.

15. In reference to the requested XPL/ECO factor, Norcal is referred to the discussion in the *ProSelect Decision*. Although it does not make a material difference in this filing, the Department would not approve a factor higher than that approved in the *ProSelect Decision*. Norcal should seriously consider, prior to their next filing, whether any development has occurred in this area with regard to *Asermely* and, therefore, whether the factor continues to be warranted.

16. With regard to the PAD load, the Department finds Norcal's PAD load to be reasonable.

17. With regard to expenses, the Department accepts Norcal's explanation of the basis for their variable and fixed expense provisions, and finds Norcal's expense provisions to be reasonable.

18. With regard to profit & contingencies, the Department estimates a margin of approximately -5.2% based on a 10% after-tax return and a 3.84% after-tax investment rate, and accepts -5.2% as the profit & contingencies margin.

19. The Department finds the proposed class plan changes to be reasonable.
20. Any conclusion of law which is also a finding of fact is hereby adopted as a finding of fact.

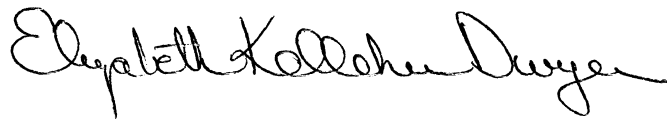
**V.
CONCLUSIONS OF LAW**

1. Norcal's request for rate relief was filed at the Department of Business Regulation in accordance with the applicable statutes and regulations pertaining thereto.
2. The Department of Business Regulation has jurisdiction in this proceeding in accordance with R.I. Gen. Laws §§ 27-9-10, 42-14-1 *et seq.* and 42-35-1 *et seq.*
3. The standard of review under which this filing is to be evaluated is to determine whether the changes requested will produce rates that are excessive, inadequate or unfairly discriminatory.
4. The definition of "excessive" applied in the Departments' review is whether the requested rates are likely to produce an underwriting profit that is unreasonably high for the class of business or if expenses are unreasonably high in relation to services rendered.
5. An overall rate level increase of 10.0% will result in rates that are not excessive, inadequate or unfairly discriminatory.
6. Norcal's proposed 10.0% rate level increase is comprised of a +10.5% change in base rates and a -0.4% change in rate level due to a change in the class plan.
7. The filed changes shall be effective on January 1, 2006.
8. Any finding of fact that is also a conclusion of law is hereby adopted as a conclusion of law.

**VI.
RECOMMENDATIONS**

In accordance with the Findings of Fact and Conclusions of Law set forth above, we find that the requested overall rate level increase of 10% will not result in rates which are excessive, inadequate or unfairly discriminatory.

October 24, 2005



Elizabeth Kelleher Dwyer, Co-Hearing Officer

October 24, 2005



Paula M. Palozzi, Co-Hearing Officer

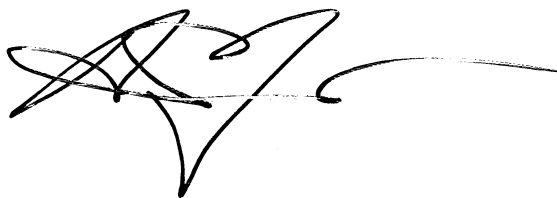
ORDER AND DECISION

I have read the Hearing Officers' Decision and Recommendation in this matter, and I hereby

ADOPT
 REJECT
 MODIFY

the Decision and Recommendation.

ENTERED AS AN ADMINISTRATIVE ORDER OF THE DEPARTMENT OF BUSINESS REGULATION THIS 24th DAY OF OCTOBER, 2005.



A. Michael Marques
Director and Insurance Commissioner
Department of Business Regulation

THIS DECISION CONSTITUTES A FINAL DECISION OF THE DEPARTMENT OF BUSINESS REGULATION PURSUANT TO RHODE ISLAND GENERAL LAWS TITLE 42, CHAPTER 35. AS SUCH, THIS DECISION MAY BE APPEALED TO THE SUPERIOR COURT SITTING IN AND FOR THE COUNTY OF PROVIDENCE WITHIN THIRTY (30) DAYS OF THE DATE OF THIS ORDER. SUCH APPEAL, IF TAKEN, MAY BE COMPLETED BY FILING A PETITION FOR REVIEW IN SAID COURT.