

II. SCOPE AND APPROACH

Authority for Study

The authority and scope for this study is specified in California Labor Code Section 138.65. This section of the Labor Code was enacted as part of SB 899 in August 2004.

138.65. (a) The administrative director, after consultation with the Insurance Commissioner, shall contract with a qualified organization to study the effects of the 2003 and 2004 legislative reforms on workers' compensation insurance rates. The study shall do, but not be limited to, all of the following:

- (1) Identify and quantify the savings generated by the reforms.
- (2) Review workers' compensation insurance rates to determine the extent to which the reform savings were reflected in rates. When reviewing the rates, consideration shall be given to an insurer's premium revenue, claim costs, and surplus levels.
- (3) Assess the effect of the reform savings on replenishing surpluses for workers' compensation insurance coverage.
- (4) Review the effects of the reforms on the workers' compensation insurance rates, marketplace, and competition.
- (5) Review the adequacy and accuracy of the pure premium rate as recommended by the Workers' Compensation Insurance Bureau and the pure premium rate adopted by the Insurance Commissioner.

Scope

The scope has been limited to the legislative reforms enacted in 2002, 2003, 2004, specifically AB 749, AB 227, SB 228, and SB 899 (these specific bills were discussed previously in Section I).

The specific objectives of the study will be to analyze and evaluate each of the following:

1. Impact of the reforms on claims costs
2. Impact of the reforms on insurance rates
3. Impact of the reforms on insurance industry surplus
4. Impact of the reforms on the California insurance industry
5. The accuracy and adequacy of the WCRIB and CDI rates
6. The status of implementing the reforms
7. The current regulatory structure.

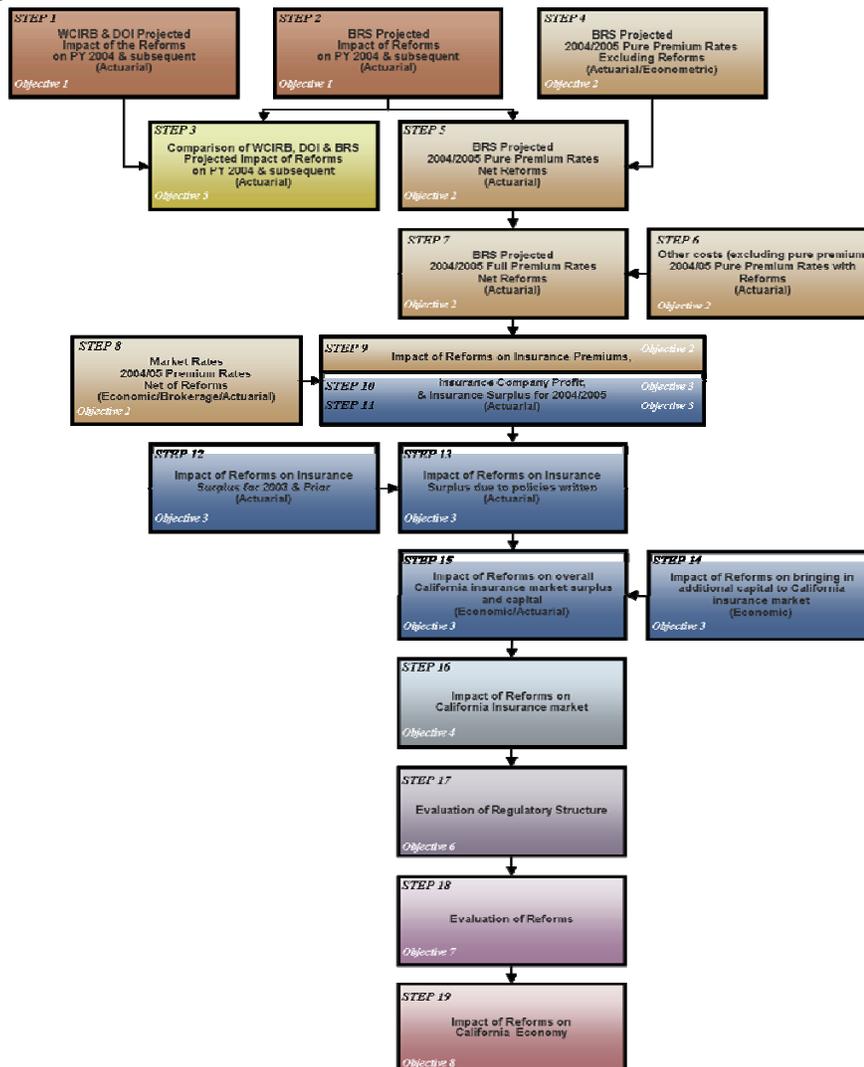
General Approach

This study was conducted by a project team comprised of individuals with expertise in variety of fields including actuarial, claims administration, healthcare, legal, regulatory, and economics.

The actuaries on the study team focused on evaluating the impact of the reforms on workers' compensation costs by analyzing the WCIRB proposed pure premium rates, ratemaking methods, the CDI approved rates. When possible, the study team quantified the extent to which the rates properly reflect the reforms. Our actuarial analysis synthesized industry research with the results of our own claims and legal reviews. There is still significant uncertainty regarding savings generated by the reforms, and we reflected this uncertainty by providing reasonable low, middle, and high estimates.

In order to quantify the likely impact of the reform on claims costs, we conducted detailed claims reviews of four top insurance carriers in California. In addition, interviews were conducted of insurer claims staff and executives. The information gathered through these claims audits and interviews were then shared with the actuaries to verify or refute findings from the actuarial analyzes. Our legal expert reviewed the major issues related to the reform that are undergoing legal determinations by the judges, the WCAB, and the courts.

The following workflow chart illustrates the components of the analysis and how they relate to each other.



Objectives

This study had two main objectives: first, to evaluate the effects of the reforms on costs, regulatory rates and rates charged by insurance carriers; and second, to determine the broad effect of the recent reforms on the insurance market in terms of profitability, surplus, and level of competition. We understand that the conclusions of our report are ultimately intended for high level policymakers in California including the Governor, the Legislature, and the Insurance Commissioner, so we have included concise and clear findings and observations, while avoiding policy level recommendations.

Our specific objectives are to include findings in the following areas

Impact of Reforms on Claims Costs: The reforms have generated claims cost reductions which represent direct savings to insurers,

Impact of Reforms on Insurance Rates: We have analyzed the effect of the reforms not only on insurers' filed rates, but also on the net premium rates that are actually charged after consideration of schedule credits, premium discounts, brokerage fees, claims handling fees, dividends and expected investment return.

Impact of Reforms on Insurance Industry Surplus: The reforms have affected, and will continue to affect, insurance industry surplus in three ways. We have analyzed each of these components separately.

- a. Claims Which Occurred prior to the Reforms: Some of the provisions of the reforms reduce the cost of injuries which occurred prior to the inception of the reforms. For example, an employee who was injured in 2000 may not be able to continue chiropractic treatment in 2004 because he or she has exceeded the limit for those services outlined in SB 899. This would allow the insurance company to decrease its liabilities for that particular injury, resulting in an increase in insurance company surplus. In general, the reforms reduced costs to preexisting injuries, and this increased the surplus of insurers.
- b. Insurance Profitability after Inception of Reforms: Savings brought about by the reforms that are not reflected in insurance rates will increase insurance profitability and thus increase insurance company surplus. This is heavily related to our analysis of insurance company rates.

- c. Impact of Reforms on Market Competition in California: Aggregate insurance industry surplus is affected by the flow of capital to insurers. By analyzing changes in market share, identifying new insurance companies writing business in California, and changes in industry financial strength and available surplus for existing companies, we evaluate the impact of the reforms on attracting more capital and private insurers to California. We also have studied the impact of the reforms on the insurance marketplace by surveying insurance agents, brokers, insurance companies and insured employers. Our analysis has identified differences in employer size, geography and industry group where relevant.

Accuracy/Adequacy of WCIRB and CDI Rates: The WCIRB annually submits advisory “pure premium” rates to the CDI for approval. These rates relate to the expected cost of losses and loss adjustment expenses, and they exclude other costs such as general administration and brokerage.

The rates are “advisory”, meaning insurance companies are under no obligation to use them as a basis for determining their premiums. In 2002, 2003 and 2004 the WCIRB also filed, and the CDI approved, mid-year advisory rates.

We have evaluated the historical accuracy of the WCIRB and CDI rate indications in order to establish a baseline of how effective their projection methods have been in the past.

Evaluation of Reforms: After analyzing the impact of the reforms, we will step back and address whether or not the reforms have met their original expectations. We will discuss:

- a. Status of the Reforms: Which parts of the reforms have been implemented and which have not yet been implemented?
- a. Strengths of the Reforms: What provisions in the reforms have worked well and had their desired effect?
- b. Weaknesses of the Reforms: Which parts of the reforms have hit roadblocks or have not been effective?
- c. Comparison to Other States: How do California workers’ compensation benefits and costs compare with those of other states?
- d. Future Improvements: Are there other regulatory changes that could further improve workers’ compensation?
- e. Monitoring: What system should be put in place to monitor the impact of the reforms?

Evaluation of Regulatory Structure: The insurance industry has been through major upheavals in the past decade, including a widespread shift to open rating,

insurance company under-pricing, carrier insolvencies, changes in market concentration, and benefit reforms. In light of this history, we will compare the health and profitability of California's workers' compensation market to that of other states, to other California industries, and to an economic equilibrium ideal. We will suggest possible changes to the regulatory system as well as methods of monitoring the ongoing health of the insurance industry.

Study Limitations

The following major areas have not been included within the scope of our analysis:

Fairness of Benefit Levels and Medical fees

Fairness of benefit levels to injured workers and medical fees to medical care providers in the workers' compensation system are beyond the scope of this study. Such matters are determined by the statutes, state workers' compensation regulations, case law, and decisions of the WCAB and courts. Several studies in the bibliography address the issue of adequacy of benefits (R. Reville, "Evaluation of the California Permanent Rating System", Rand, 2005; J.P. Leigh et al, "Difference in Workers' Compensation Disability and Impairment Ratings Under Old and New California Law:", UC Davis, 2005; UC Berkeley, 2005; and "Hostile to Physicians, Harmful to the Patients The California Workers' Compensation...Reform?", California Medical Association, 2005). There are studies underway regarding the adequacy of benefit levels. It is expected that there will be more of these studies in 2006 as the reforms develop a longer track record and some of the legal uncertainties in the language of the reforms are clarified.

Quality of and Access to Medical Care

Issues involving whether any given reform might positively or negatively affect the quality of or access to medical care which may have otherwise been provided to an injured worker is beyond the scope of this study. The recent WCRI study, "The Impact of Provider Choice on Workers' Compensation Costs and Outcome", R.A. Victor et al, November 2005 that studied whether the choice of the treating physician should be left to the injured worker, the use of networks of providers created by the employer or carrier, and employee satisfaction of the care received in four states, including California between 2002 and 2003. A study addressing this issue has been initiated by UCLA under contract to CHSWC.

Effect on Self-insured Employers, State of California and Uninsured employers

While the reforms are the same for all employers regardless of how the employer elects to provide workers' compensation coverage pursuant to Labor Code Section 3500, the statute authorizing this study is limited to workers' compensation *insurance* rates and the cost of this study is borne by the workers' compensation insurers, not self-insured employers or the state (as a permissibly uninsured employer). This study does not seek to determine if there have been potential savings on claims costs, excess or reinsurance costs, to the self-insured employers or the state) are

Sustainable Long-term Effects of Reforms

BRS makes no representation that any legislative reform that we may identify as having an effect currently, that such an effect may last for any period in the future. The system is dynamic and the cost or savings from any reform could change tomorrow due to WCAB case law, regulations, additional statutory changes, or court decisions.

The workers' compensation system continues to change and be the subject of analysis. Our study attempts to reflect what is publicly available and studies done as possible. However, we have only been able to incorporate most information through mid-December 2005.