Deloitte.

Deloitte Consulting LLP
555 W 5th Street
Los Angeles, CA 90013
USA

Tel: +1 213 688 0800
Fax: +1 213 688 0100
www.deloitte.com

September 1, 2023

Mr. Steve Wendling
Audit Manager
Washington State Auditor's Office
3200 Capitol Way
P.O. Box 40031
Olympia, WA 98504

RE: Department of Labor & Industries' 2024 Experience Rating Plan Changes

Dear Mr. Wendling,

Deloitte Consulting LLP ("Deloitte Consulting") has completed its review of the changes to the State of Washington Department of Labor & Industries' ("the Department") experience rating plan for premium rates effective January 1, 2024. Per the Department's request, we have reviewed changes to the parameters of the 2024 experience rating plan to assess whether the changes made are reasonable and consistent with actuarial standards of practice as issued by the Actuarial Standards Board and whether they attempt to limit unreasonable fluctuations in premium rates.

The Deloitte Consulting team appreciates the time and effort dedicated by the Department to help us understand the changes to the experience rating plans as well as the resources devoted to providing us with the appropriate data needed to perform our review.

Summary of Findings

Based on communications with the Department's actuarial team and our review, we understand that although no process or methodology changes were made to the experience rating plan this year, the following assumption changes have been made to the experience rating plan values:

Changes to Experience Rating Plan Values

	2024	2023
Maximum Claim Value	$405,520	$382,810
Medical Only Claim Deductible	$3,670	$3,570
Maximum Primary Loss	$57,562	$52,047
Maximum Excess Loss	$347,958	$330,763
Load Factor	0.9888	1.0027
Primary Actual Loss Assumptions		
Numerator constant	$62,920	$56,670
Denominator constant	$37,750	$34,000
Split point	$25,170	$22,670

We note that the general assumptions (maximum values and medical only deductible) and the underlying assumptions used in the calculation of the Primary Actual Losses are updated each year based on averages of the latest data available. Additionally, the expected loss rates ("ELRs") by risk class were revised, along with the 2024 credibility tables. The expected loss ranges in the credibility tables increased by 2.5% due to the change in the average level of the ELRs over the past year. For reference, these tables can be seen in the Appendix.

Based on our review of the Department's methodology for updating and revising the experience rating plan and subject to the limitations and reliance discussed below in Distribution and Limitations, we believe that the Department's changes to its experience rating plan listed above for premium rates effective January 1, 2024 are reasonable. Further, we believe that the Department's experience rating process and calculations are consistent with actuarial standards of practice as issued by the Actuarial Standards Board and common insurance industry practices with respect to experience rating plans. We note that the assumptions which changed over the past year are primarily the result of empirical loss experience and inflationary factors.

Although it is our opinion that the Department's experience rating plan changes are reasonable, there may be opportunities for the Department to further enhance its plan. In 2012, Deloitte Consulting was hired to independently review the claim free discount & experience rating plans. The Department also tested the performance of the Claim Free Discount table. The conclusion from our study was that the programs were balanced overall and that the performances of the programs were as good, if not better, than similar programs in other states. We understand that the Department will continue to review key parameters of the experience rating plan in the future. Those key parameters include the following:

- The split point that divides an employer's losses in the experience period into "primary" and "excess" components (which are now being updated every year);
- The amount of credibility assigned to an employer's actual primary and excess losses in the experience period;
- The expected losses for the employer in the experience period; and
- The targeted average experience modification factor.

As mentioned above, after the Department studied past experience of firms in Washington State, the parameters underlying the primary loss formula were updated to reflect the experience in more recent years and enhance the experience rating plan.

Background – Washington's Two-Tiered Experience Rating Plan

Washington has two separate experience rating plans that have been effective since 1972. The first is the Compensable-Claim-Free experience rating plan, which provides a discount from an employer's base premium if that employer has no compensable claims during the 3-year experience period used in the experience rating plan. The discounts vary from 10% to 40% depending on the size of the employer as measured by its expected losses. These discounts were determined by the Department in a 2006 study. According to information from the Department, approximately 80% of all employers in Washington qualify for this plan. As these are relatively small employers, they collectively comprise approximately 20% of the premiums paid despite comprising 80% of the employer population. Note that we did not review the Compensable-Claim-Free experience rating plan this year, as there were no significant changes from 2023.

The second experience rating plan applies to those employers that are not eligible for the Compensable-Claims-Free plan and is referred to hereafter as the "Regular Plan". The Regular Plan is structured in a manner similar to that typically seen in the workers' compensation industry as well as that employed in the National Council on Compensation Insurance, Inc.'s ("NCCI") plan. In this plan, an employer's actual losses are compared to its expected losses in order to determine if an employer's loss experience in the upcoming year is likely to be higher or lower than an average employer in its class. The comparison of actual versus expected losses relates to the plan's experience period, which consists of three years. For premium rates effective January 1, 2024, the experience period includes fiscal years 2020, 2021, and 2022.

The underlying theory of experience rating is employers that have higher actual losses than expected during the historical experience period are likely to continue to have higher losses than other employers in its class in the upcoming policy period. The converse holds as well; employers with lower than expected losses in the historical experience period are likely to have lower losses than other employers in its class in the upcoming policy period. Those in the higher-than-expected group receive an experience modification factor greater than 1.00, which increases their base premium. Those in the lower-than-expected group receive an experience modification factor less than 1.00, which reduces their base premium. If an employer has actual losses equal to expected losses in the experience period, the experience modification factor would be 1.00, and there would be no change to the base premium. In all of these cases, the goal of the plan is to charge premiums that are more consistent with the level of expected losses for the individual employer as compared to their base premium.

Our review of the Regular Plan is discussed below.

Review of Key Parameters – Regular Plan

We reviewed the actuarial process, calculations, and assumptions supporting the key parameter changes in the Department's Regular Plan for premium rates effective January 1, 2024. We also discussed the Department's internal plan review process with the Department's actuarial team. The Department provided us with internal experience rating plan work papers for our review.

Below, we comment on the major parameters used by the Department in the Regular Plan.

1. *Split point for Primary versus Excess losses*

In the Regular Plan, losses in the experience period are divided into primary and excess components. Primary losses are assigned more credibility than excess losses, as they are more predictable. Experience rating plans that divide losses into primary and excess components are known as "split plans" and are commonly used in the industry. We note that the Department studies the past experience data and has updated the primary loss formula parameters for rating year 2023. These parameters are expected to be updated each year to account for changes to the average empirical loss experience and inflationary factors.

In the Regular Plan, primary loss split points vary by individual claim size, starting at $25,170 and going as high as $57,562 in 2024. The change in the primary loss formula parameters resulted in a 11.0% increase to the minimum primary loss split point (compared to $22,670 in the prior analysis). The maximum primary loss split point changes each year based on the selected maximum claim value. Due to a large discount rate reduction in 2020, the average fatality cost has increased significantly. The Department used a three-year weighted average (excluding COVID-19 claims) of fatality cost to derive the maximum claim value (compared to a five-year weighted average excluding COVID-19 claims last year). As a result, the maximum claim value increased from $382,810 to $405,520 (or a 5.9% increase). We note that a five-year average would have indicated a maximum claim value of $407,316 (or a 6.4% increase) and a maximum primary loss split point of $57,583 (compared to the selected $57,562).

2. *Primary and Excess Credibility*

Credibility is a key feature of any experience rating plan. Small employers can have fortuitous losses, but larger employers tend to have more predictable loss experience. Credibility recognizes that the larger the employer, the more predictive past loss experience is of future performance. In the Regular Plan, the credibility assigned to primary and excess losses is based on the size of an employer's expected losses. Therefore, the higher the employer's expected losses, the more credibility weight that is assigned to that employer's experience in determining its experience modification factor. The maximum primary credibility is 100% for employers with approximately $1.5 million of total expected losses or higher during the three-year historical experience period (which is comparable to last year). The maximum excess credibility is 86% for employers with approximately $2.6 million of total expected losses or higher during the three-year historical experience period (which is comparable to last year).

The Department derived credibility tables as part of its 2006 study ("Report on the Proposed Changes to the 2007 Washington State Fund Experience Rating Plan"). According to that report, the process used by the Department to determine the credibility was based on an optimization analysis that is commonly used for experience rating parameters. The major goal was to minimize the variance in employer loss ratios after the application of experience rating. An additional goal was to reduce the expected rate change when an employer moves from the Compensable-Claims-Free plan into the Regular Plan.

The credibility tables for 2024 are similar to those used in 2023, but the expected loss ranges are adjusted by the change in the average level of the ELRs since last year. The change in the average level of the expected loss rates was calculated by dividing the 2024 expected losses for the three-year experience period of fiscal years 2020-2022 by the 2023 expected losses for the three-year experience period of fiscal years 2019-2021. The expected losses for each individual year in the experience period were calculated as the sum of the expected loss rate multiplied by the exposure corresponding to that year, separately for each risk class. The total expected losses were calculated as the sum of the expected losses for each year in the experience period (fiscal years 2020-2022). Both the calculated and the Department selected change in average level of the ELRs for 2024 was 2.5%. While adjusting the expected loss ranges in the credibility tables in such a manner is reasonable, we recommend that the Department test the new tables in order to conclude whether the variance in employer loss ratios after application of experience modification factors continues to be optimized.

3. *Expected Losses*

The expected losses for an employer are based on the exposure for that employer during the historical experience period (usually hours worked) multiplied by an ELR. The ELR depends on the risk class of the employer and is derived from the base rate analysis performed by the Department. ELR's are divided into primary and excess components. This allows the Department to compute primary and excess expected losses for each employer. The ELRs are calculated such that the overall experience modification factor equals the Department target of 0.91. The process entails applying an off-balance factor (which the Department calls a load factor) of 0.9888 (compared to 1.0027 last year), which allows the overall experience modification factor to equal 0.91. The Department's process for computing ELR's is generally consistent with industry practice.

4. *Targeted Overall Average Experience Modification Factor*

The Department has historically targeted an overall experience modification factor of 0.91, thereby allowing employers to receive, on average, a 9% discount. It is our understanding that the Department targets this 0.91 experience modification factor for two reasons. First, the Department wants to provide a substantial incentive to employers to remain claim-free. Second, the Department has seen, on average, that employers who are new to the State of Washington workers' compensation system generally have worse than average experience. Since new employers automatically receive an experience modification factor of 1.00, targeting a 0.91 experience modification factor essentially includes a provision that anticipates worse than expected experience. The selection of the 0.91 targeted overall experience modification factor is identical to that selected last year. We recommend that the Department periodically review this policy of targeting an experience modification factor other than 1.00 as part of its overall review of the experience rating plan.

COVID-19 Impact

The experience rating process this year does not consider any potential direct or indirect effects of the COVID-19 pandemic and the Department has made the decision to exclude all COVID-19 claims from an individual policy in the experience rating calculation. We note that the majority of the experience period (fiscal years 2020-2022) now includes the direct effects of the pandemic. The data used in this analysis is as of March 31, 2023 and we believe that most of the indirect effects of the pandemic have stabilized. Therefore, we believe the impact of the COVID-19 pandemic is not material to this analysis. We also conclude that it is reasonable to exclude an estimate of the indirect effects of the pandemic and to exclude the actual COVID-19 claims in the 2024 experience rating plan. We also note that this exclusion is consistent with the approach occurring in the broader insurance industry in other states.

Conclusion

The process followed by the Department's actuarial team for determining any relevant changes to the experience rating plan appears reasonable and consistent with actuarial standards of practice as issued by the Actuarial Standards Board. We have reviewed the process, calculations, and assumption changes to the experience rating plan and find them to be reasonable and generally consistent with typical industry practice and the NCCI's experience rating plan.

Distribution & Limitations

This letter has been prepared for the internal use of the State Auditor's Office and the Department solely for the purpose of evaluating the appropriateness of the 2024 experience rating plan changes developed by the Department actuaries. It is neither intended nor necessarily suitable for any other purpose. We have prepared this letter for use by individuals who have a degree of technical competence in insurance matters. This letter should be studied in its entirety before any judgments are made about the conclusions in the letter. It is our intention that this letter be used in its entirety, as a whole, and not segmented for other purposes. Deloitte Consulting personnel are available to discuss any questions or concerns regarding this letter.

To the extent that this letter is requested and distributed beyond the State of Washington as required by law, we request a listing of those receiving the letter. Deloitte Consulting shall have no liability, regardless of form, to any person or entity other than the State of Washington for any action taken or omitted to be taken by such parties in respect of this letter. Third parties should recognize that the furnishing of this letter is not a substitute for their own due diligence and may not place any reliance on this letter or data contained herein that would result in the creation of any duty or liability by Deloitte Consulting to any third party.

Deloitte Consulting has relied upon data provided by the Department for this analysis. A specific audit to verify the accuracy or completeness of the data is beyond the scope of this letter. While we have reviewed the data with regard to its reasonableness and consistency, we have relied on such data without audit or verification and our conclusions are based on the assumption that it is accurate and complete. In addition, Deloitte Consulting reviewed the process, calculations, and assumptions underlying the experience rating plan prepared by the actuarial team of the Department. If the underlying information provided is inaccurate or incomplete, the results of our analysis may likewise be inaccurate or incomplete.

The services we performed throughout this engagement do not constitute an audit, review, examination, or other form of attestation as those terms are defined by the American Institute of Certified Public Accountants ("AICPA"). Any use of the word "review" within this letter should be interpreted in the common use of that term, and not in the definition of "review" promulgated by the AICPA.

* * * * * * * * * * * * * * * * * * * *

Please contact us at the following numbers if you would like to discuss any aspect of this letter or have any questions or comments.

Michael Green is an Associate of the Casualty Actuarial Society. Rod Morris and Matthew Crotts are Fellows of the Casualty Actuarial Society. Michael, Rod, and Matthew are Members of the American Academy of Actuaries and meet their qualification standards for rendering the opinions in this letter.

Sincerely,

Michael Green, ACAS, MAAA
Principal
Deloitte Consulting LLP
(312) 486-3075

Rod Morris, FCAS, FSA, MAAA
Specialist Leader
Deloitte Consulting LLP
(213) 688-3374

Matthew Crotts, FCAS, MAAA
Specialist Leader
Deloitte Consulting LLP
(213) 688-1883