



Economic Affairs Interim Committee

61st Montana Legislature

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as of August 12, 2010

Memo

To: Economic Affairs Committee Members
From: Pat Murdo, Committee Staff
Re: Potential for Savings to Go to Premium Payers if Work Comp Savings Realized

This memo addresses issues related to how to pass along expected savings from changes in the medical fee schedule, use of medical utilization and treatment guidelines for work comp claims, and provisions for claim closure and undisputed medical settlements, among other changes in the Labor-Management Advisory Council bill. It does not address self-insured employers. See addendum for comments to this memo from the Department of Labor and Industry consultants.

NCCI BASE - For starters, all private workers' compensation insurers in Montana build their premiums using the loss cost calculated for the state by the National Council on Compensation Insurance, Inc. (NCCI). Montana State Fund's board of directors also rely on NCCI's loss costs and may vary from that. If NCCI projects savings, and includes that in its loss cost calculation, private insurers are to incorporate NCCI's loss cost. However, as the Economic Affairs Committee learned this year, private insurers also may make adjustments. Although this year's NCCI recommended loss cost was a 6.4% reduction, Montana State Fund applied a 4% decrease, while on average the state's largest private insurer, Liberty Northwest, lowered its rates 1.5%. So, even if NCCI incorporates savings into its loss cost data, there is no assurance that the exact reduction will be reflected in Montana policyholders' rates -- no matter the Plan 2 or 3 insurer.

COMPETITION - Supply and demand suggests that pricing responds to competition -- more insurers competing for business in theory ought to reflect any projected savings in lower prices. However, competition only works for the most sought-after business, typically larger businesses or businesses with a low risk for claims. The unknown exposure to claims from small businesses is one of the reasons that fewer insurers compete for these businesses, and Montana State Fund as the guaranteed market has such a high number of its policyholders in this small business group. Absent competition for these policies, Montana State Fund's pricing model, which incorporates class code rates and tiers to refine pricing for employers, may result in limited savings being passed along to higher-risk tiers. This fits with Montana State Fund's directive to be conservative in the face of unknowns (39-71-2311, MCA). As a result, depending on a small company's class code and experience, the company may or may not see its premium prices go lower.

OPTIONS - 1) Use of Caps on Administrative Expenses. By way of analogy, the new federal Patient Protection and Affordable Care Act proposes that insurers report their medical loss ratio, which the U.S. Department of Health and Human Services says is to be at least 80% of the premium dollar spent on health care in the individual and small group markets and 85% of the

premium dollar spent on health care in the large group market. The National Association of Insurance Commissioners is working on definitions. In theory, the goal is to limit administrative expenses (the 20% or 15% remainder). In practice, the problem is how to define administrative expenses and how to define health care expenses. Given that health insurers are facing these rules, the concept could be applied to all workers' compensation insurers. In lieu of all insurers, a cap on administrative expenses could be reapplied to Montana State Fund, which had a 15% cap on administrative expenses until 2001, when Senate Bill No. 145 removed that cap and made other changes requested by Montana State Fund. The previous relevant statutory language read:

39-71-2363 ... (2) (a) Except as provided in 2-15-2015, the executive director shall annually submit to the board for its approval an estimated budget of the entire expense of administering the state fund for the succeeding fiscal year, with due regard to the business interests and contract obligations of the state fund. The administrative expenditures approved by the board may not exceed 15% of the earned annual premium of the prior fiscal year. A copy of the approved budget must be delivered to the governor and the legislature.

(b) The board may approve administrative expenditures in excess of 15% of the earned annual premium of the prior fiscal year, but the excess amount approved may not exceed one-half of the investment income earned in the prior fiscal year.

Among the problems with this approach are:

- premiums could go down but the costs of handling past claims remain static or even increase, depending on policyholders' experience rating; and
- determining what expenses count toward administrative.¹

One estimate of current administrative expenses, taken from the Financial Audit for the Montana State Fund fiscal year ending June 30, 2009, indicates that operating expenses minus benefits and claim payments (a proxy for administrative expenses) were 19.95% of premiums.

2) **Require dividends if trigger is met.** If claims expenses calculated over the prior 3-year period are less than xx% of the premium over that time, the difference in projected and actual claims could be required to be paid out of a dividend pool. The State Fund board currently may declare dividends, with provisions for necessary reserves, appropriate surplus, and consultation with the independent actuary. Changes would be needed in 39-71-2316 and 39-71-2323 for a mandatory approach. A problem with this option is that the State Fund board loses discretion in when to give dividends. One approach might be to put a 2-year limit on the mandated dividend to lower the temptation to use a windfall toward other business-type priorities rather than dividends.

¹According to minutes from the 2001 House Business and Labor Committee, the sponsor of SB 145, Sen. Dale Berry, noted that "...premiums have gone down tremendously and this had put a restriction on the administrative budget, and in fact, it is at the cap right now." He also noted that the Montana State Fund is intended to operate "as a business rather than a bureaucracy".

In response to committee questions, the then executive director of the Montana State Fund, Carl Swanson, noted the following:

- 27 other states with state funds had no cap on administrative expenses as a percent of premiums;
 - administrative costs run 33% - reflecting good management, with private funds running at 45% in administrative costs.
- One committee member asked, with less business and less income, why wouldn't the Montana State Fund cut administration, to which Mr. Swanson replied that they were being proactive and that the declines had resulted in little change in the work load. He also noted that 13,000 businesses pay less than \$1,000 [in premiums]. Minutes from the 2001 Senate Business and Labor Committee noted that Mark Barry of Montana State Fund said there was confusion about what is applicable to the statute.