



Ohio Bureau of Workers' Compensation Comprehensive Study

Pricing Process: Administrative Cost Calculation
Report 2.5

Deloitte Consulting LLP
Group 2
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Audit • Tax • Consulting • Financial Advisory.

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Executive Summary

Introduction

The administrative expenses of the Bureau of Workers' Compensation ("BWC") and the Industrial Commission ("IC") are reflected in the Administrative Cost Fund ("ACF"). The BWC assesses employers in order to recover the administrative costs of operating both the BWC and the IC. Included in these costs are administrative costs, salaries, rents, and other operating expenses, as well as the costs associated with the safety and loss activity of the BWC's Safety and Hygiene Division. The ACF includes costs associated with loss adjustment expenses ("LAE") as well as other operating expenses. All of the BWC's LAE, with the exception of the administrative expense associated with the Health Partnership Program ("HPP"), are reflected in the ACF.

The ACF operates on a pay-as-you-go basis. Assessments are intended to cover the administrative costs in the upcoming year. They are not intended to fully fund the LAE liabilities. As a result, the ACF has a significant deficit of \$774 million as of June 30, 2008. This is due to the fact that the LAE liabilities are reflected in the ACF at their estimated ultimate value, while no offsetting asset is included for future assessments (in contrast to other Funds, including the DWRP which operates on a pay-as-you-go-basis but includes an asset for future assessments that offsets the unfunded liability in the BWC's financial statement).

The BWC does not have flexibility in determining the ACF assessment due to the pay-as-you-go status of the Fund. As a result, our analysis of the ACF is focused on the allocation of the assessment between LAE and other operating expenses relative to industry benchmarks. We also compared the administrative load as a percentage of premium, relative to industry. Our analysis does not focus on alternative means for assessing employers, as the methodology is a result of the Ohio Revised Code rather than a management decision of the BWC.

Conclusions

Findings

The BWC's overall administrative cost loading appears to be lower for similar functions performed within the industry and other state funds in relation to premium.

Deloitte Consulting's primary recommendation for the ACF relates to the classification of expenses between LAE and other operating expenses. This classification is important because the LAE liability is estimated by the BWC's consulting actuary based on the relationship of paid LAE to paid loss. If the amount of expense classified as LAE is inappropriately high or low, then the LAE liability in BWC's financial statements would be impacted.

It appears that the BWC has a higher proportion of expenses in LAE as compared to the industry. The BWC classifies 82% of administrative expenses as LAE and the remaining 18% as operating expenses. The industry average is approximately 70%-75% LAE and 25-30% operating expenses. If the percentage of expenses classified as LAE fell from 82% to 75%, the likely effect would be a reduction in the LAE reserve carried in the BWC's financial statements.

Recommendations

Our primary recommendation with respect to the ACF is as follows:

- **Evaluate the Allocation of Administrative Expenses Between LAE and Other Operating Expenses:** The BWC has had a wide range of allocation percentages between LAE and other operating expenses over recent years. In the past six years, the percentage has varied between 66% and 82%, averaging 78% over this time. The fact that the percentage has varied by a wide amount over this time, and the fact that the current percentage is higher than the industry suggests that there is a need to re-evaluate the process for classifying

these expenses between these components. We emphasize that this is not simply an exercise in apportioning dollars between accounts; changes to LAE expense will have a direct impact on the BWC's LAE reserve and therefore the net assets in the ACF and the BWC as a whole.

The Deloitte Consulting team appreciates the time and effort dedicated by the BWC over the course of this engagement.

The Situation

RFP Task Reference	RFP Task Description	Task Category
Section 5.1.2 #27, page 14	Conduct a study on the administrative cost calculation used in employer rates. This evaluation should include a review of the allocated and unallocated loss adjustment expenses of the BWC.	Pricing & Programs

The BWC includes an administrative loading to cover the internal BWC and Industrial Commission (“IC”) costs of administration, salaries, rent, and other operating costs. For private employers, the current administrative loading is 13.67% for BWC costs, and an additional 1.98% for the costs associated with the IC. The revenue and expenses associated with administrative costs are recorded in the Administrative Cost Fund (“ACF”). The ACF operates on a pay-as-you-go basis, and shows a significant deficit in the BWC financial statements. This deficit is due to the liabilities for loss adjustment expenses (“LAE”) for all unpaid claims, in addition to LAE paid on claims during the year

Methodology

Our approach to the study includes a comparison of the BWC’s administrative cost loading to its peers, and a review of the allocation of this expense load between LAE and operating expenses relative to industry norms.

Primary Constituents

- **BWC Administrator, Chief Financial Officer and Chief Actuarial Officer** - Responsible for management of the BWC’s financial strength;
- **BWC Actuarial Department** – Responsible for assessing reasonableness of the BWC’s third party actuary’s recommended administrative cost loadings; and
- **BWC Fiscal Operations Department** – Responsible for recommending BWC administrative cost loadings for employer rates.
- **BWC Accounting Department** – Responsible for recommending the apportionment of the administrative costs loading between LAE and operating expenses.

Information and Data Gathered

Interviews

Deloitte Consulting practitioners discussed the administrative expense loading with BWC leadership and staff. The following individuals were very helpful in answering our questions and responding to requests for information and data.

- Assistant Director - Actuarial Department
- BWC Chief Financial Officer
- BWC Director of Accounting
- Director - Fiscal Operations

Information/Data Request

Deloitte Consulting was provided financial information by responsible officers and employees of the BWC. Specifically, we were provided with the following:

Provided by the BWC

- History of the administrative cost loadings from 1976 to the present;
- Breakdown of the administrative costs between Private Employers, Public Taxing Districts, Public State Agencies, Self-Insureds, and ancillary Funds for the 2003-2007 years; and
- Allocation of administrative costs between loss adjustment expense ("LAE") and general operating expenses from 2003 to 2008.

In addition, Deloitte Consulting researched peer and industry financial results, including the following:

- U.S. Competitive Funds
- U.S. State Funds

Review and Analysis

Historical Administrative Expenses and Allocation to LAE

Historical Administrative Expenses

The exhibit below displays the BWC's historical administrative expenses:

BWC Administrative Expenses by Employer Class

Employer Class	2007	2006	2005	2004	2003
BWC					
Private	222,005,249	208,484,222	210,228,596	217,820,582	224,839,810
Public - State	9,880,781	13,976,287	6,652,804	7,266,149	10,227,707
Public Taxing Districts	31,090,389	29,582,221	30,602,897	30,321,149	31,630,130
Self Insured	<u>20,954,070</u>	<u>24,168,481</u>	<u>18,627,850</u>	<u>17,755,628</u>	<u>18,681,492</u>
	283,930,489	276,211,211	266,112,147	273,163,508	285,379,139
Safety & Hygiene					
Private	20,441,620	15,008,094	12,710,985	10,289,650	16,973,619
Public - State	313,228	1,356,015	1,576,358	1,702,175	663,598
Public Taxing Districts	1,809,241	5,309,142	3,894,030	5,512,920	4,032,260
Self Insured	<u>811,120</u>	<u>1,310,048</u>	<u>3,120,763</u>	<u>3,772,446</u>	<u>2,461,344</u>
	23,375,209	22,983,299	21,302,136	21,277,191	24,130,820
DWRF					
Private	398,380	422,766	393,402	449,580	559,347
Public - State	15,595	15,725	14,549	16,744	20,596
Public Taxing Districts	50,842	52,897	48,768	58,167	71,779
Self Insured	<u>24,052</u>	<u>24,180</u>	<u>21,872</u>	<u>22,709</u>	<u>28,005</u>
	488,870	515,568	478,591	547,200	679,727
Black Lung	75,714	84,837	83,156	81,251	87,692
Marine Industry	52,337	53,186	52,476	51,456	51,144
IC					
Private	28,886,360	31,463,728	29,917,965	27,812,311	32,548,200
Public - State	1,862,353	1,910,396	1,700,124	1,498,777	1,657,630
Public Taxing Districts	5,388,546	5,472,432	5,110,898	4,761,116	5,589,266
Self Insured	<u>15,674,467</u>	<u>16,208,087</u>	<u>15,906,420</u>	<u>15,887,039</u>	<u>20,047,154</u>
	51,811,726	55,054,643	52,635,407	49,959,243	59,842,250
Total BWC	307,922,619	299,848,101	288,028,506	295,120,606	310,328,522

This table shows the BWC's expenses, as well as those of the IC, from 2003 to 2007. The vast majority of the expenses are related to the State Insurance Fund, with private insurers making up over two-thirds of the expenses. Expenses have been relatively stable over this period.

Allocation to LAE

The table below displays the BWC's allocation of administrative expenses to LAE and other operating expenses.

Fiscal Year	Expenses Allocated to LAE	Expenses Allocated to Other Operating Expenses
2003	74%	26%
2004	79%	21%
2005	66%	34%
2006	82%	18%
2007	82%	18%
2008	82%	18%
2003 - 2008	78%	23%

Industry LAE vs. Other Operating Expenses

The table below displays the industry workers compensation allocation of administrative expenses to LAE and other operating expenses.

Industry (From IIEE - Agency Companies)

Calendar Year	Expenses Allocated to LAE	Expenses Allocated to Other Operating Expenses
2003	72%	28%
2004	74%	26%
2005	76%	24%
2006	72%	28%
2007	67%	33%
2003 - 2007	72%	28%

Industry (From IIEE –Direct Companies)

Calendar Year	Expenses Allocated to LAE	Expenses Allocated to Other Operating Expenses
2003	74%	26%
2004	74%	26%
2005	78%	22%
2006	70%	30%
2007	71%	29%
2003 - 2007	73%	27%

These tables indicate that the industry has a lower percentage of expenses allocated to LAE as compared to the BWC. Similar results are seen for State Funds. Inclusion of HPP costs in the BWC figures would further increase the ratio of expense allocated to LAE, as these represent the costs of administrating the BWC's MCO programs, a cost that is associated with LAE. Thus, the disparity with the industry would be even larger if these costs were included. This suggests that the BWC should re-evaluate the process of allocating administrative expenses in the ACF between LAE and other operating expenses.

Conclusions

Findings

The administrative cost loading is not subject to actuarial estimates due to the pay-as-you-go nature of the ACF. Our findings are therefore focused on the allocation of expenses to LAE, which drive the actuarially estimated LAE liabilities in the ACF. LAE reserves are estimated to be approximately \$1.1 billion (discounted at 5%) as of June 30, 2008. Our comparison of the BWC's allocation indicates that the BWC has a higher percentage of administrative expenses allocated to LAE relative to the industry and other State Funds. This suggests a need to re-evaluate this allocation.

Performance Assessment

We assessed the performance of the Ohio workers' compensation system compared to these four overarching themes: Effectiveness & Efficiency; Financial Strength & Stability; Transparency; and Ohio Economic Impact. Each broad study element (Ohio Benefit Structure; Pricing Process; Cost Controls; Financial Provisions; and Actuarial Department Functions & Resources) is reviewed with these themes in mind to develop a performance assessment of the current state. Our performance assessment is made on each element in the context of its contribution to supporting the overarching themes.

For these performance assessments, the following scoring method applies:

	Strongly supports system performance
	Supports system performance
	Some support for system performance
	Some opportunity for system performance change/enhancement
	Significant opportunity for system performance change/enhancement

Based on this scoring method, the performance assessment for the ACF is as follows:

	Effectiveness & Efficiency	Financial Strength & Stability	Transparency	Ohio Economic Impact
Administrative Cost Calculation				

Peers and Industry Standards Considered
Other State Funds, Industry Averages

Recommendations

Our recommendation for the ACF is shown below:

- Evaluate the Allocation of Administrative Expenses Between LAE and Other Operating Expenses.** The BWC should evaluate this allocation. If it is determined that the allocation to LAE is too high, the likely impact would be a reduction to the actuarial LAE reserve estimate, which in turn would reduce the large deficit of the ACF.

Impact

The impact (high, moderate, or low) of these recommendations as they relate to the overarching themes is shown in the following table:

	Effectiveness & Efficiency	Financial Strength & Stability	Transparency	Ohio Economic Impact
Re-evaluate portion of Administrative Expenses allocated to LAE	↑	↑	↑	↑

Legend

High Impact	Moderate Impact	Low Impact	No Impact	Adverse Impact
↑	↑	↑		↓

The Deloitte Consulting team is available to clarify or amplify any issues raised in this report. We express our appreciation for BWC process constituents' time, effort, and guidance in completing this integral task of our comprehensive study.

Appendix A – Deliverable Matrix

Group 2 Study Elements

Ohio Benefit Structure
Award Categories
1) Compensation Types
2) Benefit and Compensation Levels
3) Number of Benefit Types

Pricing Process
Statewide Rate Level
1) Administrative Cost Calculation

Cost Controls
MCO Effectiveness
Medical Payments to Providers

Financial Provisions
Loss Reserves
1) Current Actuarial Audit Reserve Methodology
2) Independent Review
3) Expected Payments Established by Independent Actuarial Consultant
4) Loss Reserve Margins and Discount Factor
5) Performance Assessment Implications
Net Asset Level
1) Methods for Setting Net Asset Targets
2) Risk Margins
3) Disclosure
Excess Insurance and Reinsurance
1) Cost Effectiveness, Catastrophic Events, and Rate Stability

Ohio Benefit Structure Areas

Award Benefit Types	Tasks Involved
1) Compensation Types	23. Conduct a study of the benefits and compensation paid by the BWC compared to industry peers. This study would include an analysis of all compensation types and their application by the BWC.
2) Benefit and Compensation Levels	
3) Number of Benefit Types	

Pricing Process Areas

Statewide Rate Level	Tasks Involved
1) Administrative Cost Calculation	27. Conduct a study on the administrative cost calculation used in employer rates. This evaluation should include a review of the allocated and unallocated loss adjustment expenses of the BWC.

Cost Controls Areas

MCO Effectiveness	Tasks Involved
MCO Effectiveness	30. Conduct a study on the effectiveness of Managed Care Organizations (MCO) in the workers' compensation system. This analysis would include an evaluation of the effectiveness of the use of MCOs, the payments to MCOs relative to the benefits received, the advantages and disadvantages of the MCO approach, the medical cost trends since MCO implementation, and a comparison to industry standards.
Medical Payments to Providers	Tasks Involved
Medical Payments to Providers	25. Conduct a study on the medical payments to providers in Ohio and provide a comparison to industry peers. This study should recommend changes/improvements to BWC's medical payment structure in line with industry standards.

Financial Provisions Areas

Loss Reserves	Tasks Involved
1) Current Actuarial Audit Reserve Methodology	21. Review the actuarial audit reserves established by the BWC's independent actuarial consultant to establish objective quality management principles and methods by which to review the performance of the workers' compensation system.
2) Independent Review	
3) Expected Payments Established by Independent Actuarial Consultant	15. Evaluate the methodology and reasonability of the expected payments established by the BWC's independent actuarial consultant.
4) Loss Reserve Margins and Discount Factor	
5) Performance Assessment Implications	21. See above.

Net Asset Level	Tasks Involved
1) Methods for Setting Net Asset Targets	26. Conduct a study on the amount of surplus/net assets that should be held by the BWC. This study should compare the BWC to industry standards and recommend appropriate methods of setting target surplus for the BWC and the appropriate discount rate.
2) Risk Margins	
3) Disclosure	

Excess Insurance and Reinsurance	Tasks Involved
1) Cost Effectiveness, Catastrophic Events, and Rate Stability	31. Conduct an evaluation on the excess insurance or reinsurance requirements for the BWC including the need for excess coverage or reinsurance in the event of a catastrophic event. This evaluation should include the cost effectiveness of excess coverage or reinsurance, the ability of the BWC to handle a catastrophic event, and the stability in rates provided by excess insurance or reinsurance coverage. This study should include an evaluation of reinsurance requirements and a possible reinsurance program for the BWC.

Pricing Process Areas – continued

Ancillary Funds	Tasks Involved
1) Coal Workers Pneumoconiosis	7. Review and make written recommendations with regard to the Coal-Workers Pneumoconiosis Fund. This review would include a complete analysis of the rating program. This analysis should compare the methodology used in BWC's rating calculation to industry standards the actuarial standards of practice promulgated by the Actuarial Standards Board of the American Academy of Actuaries.
2) Marine Industry Fund	10. Review and make written recommendations with regard to the Marine Industry Fund. This analysis should compare the methodology used in BWC's rating calculation to industry standards and the Actuarial Standards of Practice promulgated by the Actuarial Standards Board of the American Academy of Actuaries.
3) Disabled Workers' Relief Fund	13. Review and make written recommendations with regard to the Disabled Workers' Relief Funds. This analysis would include a complete analysis of the funds including but not limited to the loss information, payroll information, and other rating calculations. This analysis should compare the methodology used in BWC's rating calculation to industry standards and the Actuarial Standards of Practice promulgated by the Actuarial Standards Board of the American Academy of Actuaries.

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