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FILED

AUG 8 2005

OFFICE OF
WORKER'S COMPENSATION JUDGE
HELENA, MONTANA

IN THE WORKERS' COMPENSATION COURT OF THE STATE OF MONTANA

CATHERINE E. SATTERLEE, et al. Petitioners, v. LUMBERMAN'S MUTUAL CASUALTY COMPANY, et al. Respondents/Insurers.	WCC No. 2003-0840 **AFFIDAVIT OF DANIEL GENGLER**

STATE OF MONTANA)
: ss.
County of Lewis and Clark)

DANIEL GENGLER, being first duly sworn upon his oath, deposes and says:

1. I am currently the Internal Actuary for the Montana State Fund ("MSF"). I have been employed with MSF since August 21, 1995.

DOCKET ITEM NO. 230

2. As the Internal Actuary, I am responsible for and have personal knowledge of MSF's policies and procedures regarding ratemaking, surplus, and dividends. I also have personal knowledge of MSF's financial condition and am familiar with the financial impact the recent common cases may have on MSF's viability. I am familiar with the pending litigation in the above-referenced matter and the related case of *Reesor v. Montana State Fund*, 2004 MT 370, 325 Mont. 1, 103 P.3d 1019. I understand that *Satterlee* and *Reesor* are collectively attempting to invalidate the provisions of Montana Code Annotated § 39-71-710 which allow an insurer to terminate a claimant's PTD benefits when those claimants become eligible to receive retirement benefits. I have analyzed the financial impact of *Satterlee* and *Reesor* on MSF's operations.

3. MSF has estimated the cost of benefits associated with a retroactive application of *Satterlee*. Excluding claims which are coded or otherwise identified as settled, for claims arising on or after October 1, 1981 through June 30, 1990, the increase in benefit costs against the Old Fund is estimated at $93,000,000 to $116,000,000. For non-settled claims arising on or after July 1, 1990 through December 22, 2004, the increase in benefit costs against the MSF is estimated at $135,000,000 to $186,000,000. In total, the benefit costs associated with retroactively applying *Satterlee* to PTD claims is estimated at $228,000,000 to $302,000,000. MSF's estimate is not a "best case/worst case" scenario but instead represents the "highly likely range" from an actuarial standpoint.

4. If *Satterlee* invalidates Montana Code Annotated § 39-71-710 as applied to PTD claims, the prospective application of *Satterlee* will result in an increase in benefit costs which would require rate increases ranging from 11% to 21% for MSF's policyholders. Based on annual premiums of approximately $200,000,000, this rate increase corresponds to an annual increase of approximately $21,600,000 to $41,400,000 for MSF's policyholders. This rate increase might be offset somewhat by future investment income that is earned pending payment of benefits at retirement age. This offset is known in the industry as "discounting" rates, in consideration of future investment income. The amount of offsetting discount is a business decision contingent upon an assessment of risk and market conditions each time rates are established.

A. <u>Depletion of Surplus Funds</u>

5. An insurance company's equity is known as "surplus" in the industry, that is, money available in excess of liabilities. Surplus is not excess, unnecessary funds. Because insurance liabilities are uncertain, surplus is a prudent measure of contingency against the financial failure of an insurance company. Reasonable surplus provides assurance that the insurance company's financial obligations to its policyholders will be

met. MSF is required by statute to maintain at least a minimal surplus to ensure financial solvency.

6. The amount of surplus that an insurance company needs is based on industry standards developed to provide reasonable but not certain assurance against financial failure. MSF is statutorily required by Montana Code Annotated § 39-71-2330(2) to maintain a minimum surplus of 25% of its annual earned premium. MSF is also statutorily required by Montana Code Annotated § 39-71-2311 to be self-supporting. Our analysis concludes that while the statutory minimums provide some protection against financial failure, it is at a level at which the MSF would be unacceptably vulnerable to financial failure.

7. Workers' compensation insurance differs from most other insurance lines in that benefits are open-ended and are not subject to a policy limit.

8. For a workers' compensation carrier like MSF, there are several characteristics that have the potential for a greater volatility of results than the norm in the property casualty industry and therefore require a stronger than average surplus to address these issues, including the following:

a. Extremely long-term obligations associated with claims in which actual costs are not known with certainty for decades.

b. MSF writes only one type of insurance in one state;

c. Courts are constantly changing the workers' compensation laws and benefits, making it difficult for MSF to accurately set premiums;

d. MSF provides the guaranteed market; and

e. Unlike a stockholder-owned insurance company, MSF cannot access additional capital to cover adverse financial results.

9. Ultimately, surplus is intended to assure that MSF will be able to fulfill its obligations to policyholders and injured employees.

10. A strong surplus, along with adequate loss reserves, protects injured employees, policyholders, and allows MSF to continue to operate as a strong and viable insurance carrier.

11. MSF's long-range target is to have a reserve-to-surplus ratio of 1.5-2.0 to 1. The higher the ratio, the less adequate the reserve. For 2004, the reserve-to-surplus ratio was 3.55 to 1. For 2003, the reserve-to-surplus ratio was 3.4 to 1. For 2002, the reserve-to-surplus ratio was 2.19 to 1. MSF's lowest reserve-to-surplus ratio has been 2.18 to 1.

12. The financial impact of retroactive application of *Satterlee* to MSF was not included in the rates for prior years and therefore such costs are not included in current reserves. The financial impact of retroactive application of *Satterlee* would reduce or eliminate current surplus. If the financial impact exceeds current surplus, liabilities would exceed assets and the MSF would be deemed financially insolvent.

13. MSF's surplus at the end of fiscal year 2004 was $127.5 million. As of March 31, 2005 and as presented to the MSF board of directors, MSF's projected surplus for the end of fiscal year 2005 is $141.8 million.

14. Assuming the midpoint of cost estimates, MSF's surplus would be eliminated as a result of the benefit costs associated with retroactively applying *Satterlee* to PTD claims. The elimination of MSF's surplus would result in a significant rate increase over many years in an attempt to restore surplus to target levels. The significant rate increase to restore surplus would, of course, be added to the other rate increases required as a result of prospectively applying *Satterlee* to PTD claims.

15. MSF would be severely crippled or insolvent if *Satterlee* applied retroactively. After analyzing the impact associated with retroactively applying *Satterlee* to PTD claims, our actuarial analysis arrived at the following conclusions:

a. A change in Montana's statutory benefits to pay lifetime benefits to injured employees with permanent total disability is estimated to cost Montana employers insured by MSF 15% more for their workers' compensation coverage, possibly offset by up to 7 percentage points in consideration of future investment income. We anticipate that other carriers and self-insured pools would see similar rate increases. Statewide, Montana employers would pay approximately $60 million more for their workers' compensation insurance each year;

b. The 15% estimate is a mid-range estimate. It is highly likely that actual results will vary. Slight variations in assumptions can swing the estimate by material amounts. One source of uncertainty is anticipating the incidence of PT claims. Lifetime

PT benefits will likely change the dynamics by which injured workers seek PT status. Another source of uncertainty is life expectancy. Life expectancy among this population is not well understood in the industry. In any event, given the relatively small numbers of PT claims, actual average life spans are subject to considerable variability. COLAs are another source of uncertainty. The number and amount of COLAs are unlimited under current law and therefore have a highly leveraged effect on cost estimates. By slightly varying our assumptions regarding the numbers of PT claims, life expectancies, and average annual COLAs, we derive indications of rate increases ranging from 11% to 21%;

c. The National Council on Compensation Insurance (NCCI) has provided a preliminary estimate of the rate impact of lifetime PT benefits, tentatively concluding an increase in rates of between 5% to 11% as a result of prospectively applying *Satterlee*. A copy of NCCI's estimate is attached hereto as Ex. "A." NCCI's estimate assumes that carriers will offset the increase in benefit costs in consideration of future investment income (discounting). But for the assumption of discounting, the MSF and NCCI estimates are consistent with one another.

d. Retroactive application of lifetime PT benefits from October 1, 1981 to June 30, 1990 is estimated to cost the Old Fund approximately $105 million. By varying our assumptions slightly, we derive indications ranging from $93 million to $116 million. The Old Fund is an obligation of the State's General Fund. Therefore, any cost impact to the Old Fund would not affect MSF rates;

e. Retroactive application of lifetime PT benefits from July 1, 1990 to June 30, 2005 is estimated to cost MSF approximately $161 million. By varying our assumptions slightly, we derive indications ranging from $135 million to $186 million. The MSF would very likely be insolvent, or at a minimum, its financial position severely crippled. Unlike private carriers who can access capital markets to raise additional funds, the MSF is solely reliant on premiums charged to employers for its capital needs. MSF would need to rebuild its equity by more aggressive pricing than would otherwise be the case. It is difficult to say precisely how much higher rates would be because of the many complex variables involved in pricing decisions. Such variables include competitive pressures in the market, adverse or favorable development on prior year claims, investment income, etc. However, absent another source of capital, it is certain that MSF rates would be higher than they otherwise would be for a very long time, perhaps decades;

f. While we might apply best available methods to best available data, any cost estimate of a benefit change of this magnitude is highly uncertain. Given the level of uncertainty in the cost estimates, it would only be prudent for MSF to consider adding a contingency provision in its rate structure, to protect against the risk that the 15% estimate is too low until sufficient loss experience is incurred to gain greater certainty of losses. A rough characterization is that, market conditions allowing, the MSF might look to maintain an additional five percentage points of rate increase over and above the 15% estimate in consideration of the uncertainty of the true costs of this benefit change; and

g. The MSF would need to add additional margin to its rates to restore prudent levels of financial equity. At a minimum, MSF would need to rebuild its surplus to the statutory minimum as quickly as possible. A one year recovery of the statutory minimum surplus would require an additional rate increase of about 60%. Such a rate increase is probably not sustainable as the MSF would likely lose a significant portion of its current market share. A three year recovery of surplus to the statutory minimum would require an additional rate increase of about 16%. The recovery period would be longer to the extent that the MSF loses market share due to the additional rate increase. In any event, because the statutory minimum represents a weak financial position, the MSF would need to maintain some additional margin in its rates for much longer, in order to rebuild to surplus levels that represent financial strength.

16. The Old Fund currently has an unfunded liability. At the end of fiscal year 2004, the Old Fund's liabilities exceeded its assets by $7,442,792. The financial impact

of retroactive application to the Old Fund will be paid out of the General Fund. The General Fund would be impaired as a result of the estimated $93,000,000 to $116,000,000 impact of retroactively applying *Satterlee* to PTD claims. Previously, the Old Fund received funding through a payroll tax, but the tax was terminated in 1998.

17. If the Old Fund is not adequately funded, any amount necessary to pay and administer claims must be transferred from the State of Montana General Fund to the Old Fund. An article addressing the Old Fund's 2003 financial condition and the interplay between the Old Fund and the General Fund is attached hereto as Ex. "B."

18. The insolvency of the Old Fund in the 1980s was the result of inadequate pricing and reserves and rate suppression. During that time, many private sector insurers left Montana.

19. In addition to the benefit costs and administrative efforts discussed above, the *Satterlee* decision will have a cost impact on policyholders and the MSF.

20. Workers' compensation ratemaking is prospective, as insurance rates are developed prior to the transfer of risk.

21. In accordance with Montana Code Annotated § 39-71-2330, MSF sets rates in a fashion similar to private carriers and consistent with actuarial principles.

22. Actuarial principles for determining property casualty insurance (inclusive of workers' compensation) establish this prospective approach for workers' compensation. *See* Statement of Principles Regarding Property and Casualty Insurance Ratemaking, attached as Ex. "C" and located at <<u>http://www.casact.org/standards/princip/sppcrate.pdf</u>>.

23. Ratemaking in the prior years did not take into consideration the potential increase in PTD benefits which may be due to affected claimants if *Satterlee* applies retroactively to PTD claims.

24. In fiscal year 2001, MSF increased its rates by 0.0%. In fiscal year 2002, MSF increased its rates by 2.7%. In fiscal year 2003, MSF increased its rates by 2.8%. In fiscal year 2004, MSF increased rates by 11.6%. In fiscal year 2005, MSF increased its rates by 9.5%. For fiscal year 2006 (July 1, 2005 through June 30, 2006), MSF increased its rates by 3.0%.

B. <u>Pending Common Fund Litigation</u>

25. If *Stavenjord* applies retroactively, MSF has estimated that the overall retroactivity benefit costs will amount to $14,000,000 to $19,000,000, with an additional benefit cost to the Old Fund of $5,000,000 to $7,000,000. If *Schmill* applies retroactively, MSF has estimated that the overall retroactivity benefit costs will amount to $1,400,000 to $1,900,000, with an additional benefit cost to the Old Fund of $800,000. If *Reesor* applies retroactively to PPD claims, MSF has estimated[1] that the overall retroactivity benefit costs will amount to approximately $2,000,000, with an additional benefit cost to the Old Fund of approximately $1,000,000. The cumulative benefit cost impact on MSF of retroactively applying *Reesor*, *Satterlee*, *Stavenjord* and *Schmill* ranges from $152,000,000 to $209,000,000, with an additional benefit cost to the Old Fund of $100,000,000 to $125,000,000. Further, retroactively implementing each decision involves significant claims-related and administrative expenses.

I declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge.

DATED this 8th day of August, 2005.

Daniel J. Gengler
DANIEL GENGLER

STATE OF MONTANA)
: ss.
County of Lewis & Clark)

Subscribed to and sworn to before me on the 8th day of August, 2005, by DANIEL GENGLER.

Kathleen G. Gowen
(Type or print name) Kathleen G. Gowen
NOTARY PUBLIC FOR THE STATE OF MONTANA
residing at Helena, Montana
My commission expires: April 1, 2006

KATHLEEN G. GOWEN NOTARIAL SEAL STATE OF MONTANA
KATHLEEN G. GOWEN
Notary Public for the
State of Montana
Residing at Helena, Montana
My Commission Expires
April 1, 2006

[1] MSF's estimate did not include claims with entitlement dates occurring on or after July 1, 1991 through June 30, 1995 because *Reesor* is inapplicable during that timeframe pursuant to the Montana Supreme Court's decision in *Russette v. Chippewa Cree Housing Authority* (1994), 265 Mont. 90, 92, 874 P.2d 1217.

CERTIFICATE OF MAILING

I, Kathleen G. Gowen, the undersigned, of Respondent/Insurer, Montana State Fund, hereby certify that on this 8th day of August, 2005, I mailed a copy of the foregoing *Affidavit of Daniel Gengler*, postage prepaid, to the following persons:

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Kathleen G Gowen

EXHIBIT "A" TO GENGLER'S AFFIDAVIT

NCCI National Council on Compensation Insurance, Inc.

Montana
Preliminary Evaluation of Satterlee v. Lumberman

NCCI was asked to provide a preliminary evaluation of one aspect of the Satterlee v. Lumberman case that is currently under review by the Montana Workers Compensation Court. Currently in Montana, when an employee receives retirement benefits or is eligible to receive full retirement benefits from Social Security, certain workers' compensation indemnity payments end (workers compensation statute 39-71-710, "Termination of benefits upon retirement"). To the extent that the Workers Compensation Court decision in the Satterlee vs. Lumberman case overrules the above-cited statute, the payment of Montana workers' compensation indemnity benefits while a workers compensation claimant is also receiving Social Security retirement benefits would be required. If the court ruling were to prevent the termination of PT benefits, the additional indemnity benefits would increase Montana workers compensation (WC) system costs by 5% to 11% ($13 M to $30M; after consideration of statutory discounting for indemnity benefits). Additionally, if an unfunded liability is created from the retrospective application of this change, it may be significant. For instance the unfunded liability for accidents that occurred in 2001-2003 may be over $55 million.

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EXHIBIT "B" TO GENGLER'S AFFIDAVIT

helenair.com
Independent Record

Wednesday, January 14, 2004

Montana News:

Report: Workers' comp fund in danger

By JENNIFER McKEE -IR State Bureau- 01/14/04

HELENA — The state's workers' compensation old fund account is in danger of running out of money again because lawmakers stripped more than $22 million from the account in the 2003 Legislature, state workers' comp officials say.

The account, which pays for medical bills and other expenses related to on-the-job injuries before 1990, is currently just breaking even, the Montana State Fund's latest financial report shows.

"This should cause concern if an adverse event occurs, as the remaining liabilities would be unfunded," the December report reads.

The Montana State Fund, the state's semi-public work-comp company, runs the old fund for the state government, said Matthew Cohn, a State Fund spokesman. But the State Fund is not responsible for paying for any of the liabilities of the old fund; if the old fund runs out of money, the difference will come from state coffers.

"Breaking even" might sound like a good place to be, Cohn said, but for an insurance company, it can spell disaster. Insurance companies don't know exactly how much they will have to pay on long-term medical bills; they can only offer an educated guess. In addition, Montana Supreme Court decisions and new laws can change how much workers' comp insurance companies have to pay injured workers.

To be safe, Cohn said, most insurance companies keep a little extra money in reserve.

"It's standard in the industry to have a cushion," he said. "This should come as no surprise."

The old fund used to maintain a cushion of 10 percent more than what insurance experts thought the account would need to pay out all the funds bills.

In the 2003 Legislature, House Majority Leader Roy Brown, R-Billings, sponsored a bill to do away with the mandated 10 percent reserve and transfer that money into the state's general fund. It was done as a measure to help balance the state general fund budget in the waning days of the session.

So far, $22.3 million has been transferred out of the old fund. That comes on top of $4 million that was skimmed from the fund during the 2002 special legislative session.

Now, the old fund has a reserve of around $600,000, Cohn said. It owes about $120 million in long-term medical bills and other obligations. If medical costs continue to rise, the $600,000 may not be enough to cover all the bills the old fund must pay, Cohn said.

The old fund has already run out of money once. In the 1980s, the account owed about $500 million more in future medical costs and other benefits to injured workers than it had in the bank. To pay it back, lawmakers enacted a "payroll tax" or a new tax on every employed person and employer. Lawmakers also created a totally new workers' compensation fund for the state — the Montana State Fund, which is designed to function more like a private business than any other arm of state government.

All claims from injuries before 1990 stayed in the old fund. Later claims are handled by the current State Fund.

The old account actually doesn't have enough money to pay all its bills right now. The account has about $91 million in it, Cohn said, and insurance officials estimated it still has about $120 million in obligations to pay. The difference, Cohn said, will come from money made by investing the $91 million.

The State Fund board of directors warned the governor and legislative leaders in April that HB363 could break the old fund's bank.

"The State of Montana will be responsible for any shortfalls in the system," read a letter sent by the board to Gov. Judy Martz on April 18.

The bill passed by wide margins only days later.

Brown could not be reached for comment Tuesday.

Only one person present in the Senate voted against the bill in its final form, Sen. Mike Cooney, D-Helena.

"I was real nervous about transferring money out of the old fund," he said Tuesday. "It concerned me that this would come back to haunt us."

So far, the old fund has not run out of money and even if it did, Cohn said, that doesn't mean injured workers or their doctors would not be paid. Being "unfunded" only means the fund couldn't pay back all its obligations if it had to; not that it is actually out of money.

"In that sense, it's not a panic," he said. "But it is a problem."

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EXHIBIT "C" TO GENGLER'S AFFIDAVIT

Attachment A

Statement of Principles Regarding
Property and Casualty Insurance Ratemaking

(Adopted by the Board of Directors of the CAS May 1988)

II. PRINCIPLES

Ratemaking is prospective because the property and casualty insurance rate must be developed prior to the transfer of risk.

Principle 1: A *rate* is an estimate of the expected value of future costs.

Ratemaking should provide for all costs so that the insurance system is financially sound.

Principle 2: A rate provides for all costs associated with the transfer of risk.

Ratemaking should provide for the costs of an individual risk transfer so that equity among insureds is maintained. When the experience of an individual risk does not provide a credible basis for estimating these costs, it is appropriate to consider the aggregate experience of similar risks. A rate estimated from such experience is an estimate of the costs of the risk transfer for each individual in the class.

Principle 3: A rate provides for the costs associated with an individual risk transfer.

Ratemaking produces cost estimates that are actuarially sound if the estimation is based on Principles 1, 2, and 3. Such rates comply with four criteria commonly used by actuaries: reasonable, not excessive, not inadequate, and not unfairly discriminatory.

Principle 4: A rate is reasonable and not excessive, inadequate, or unfairly discriminatory if it is an actuarially sound estimate of the expected value of all future costs associated with an individual risk transfer.