



**The Maryland Insurance  
Administration's Study of Whether  
Chesapeake Employers' Insurance  
Company Should Be Subject to Title  
11 of the Insurance Article**

**October 1, 2012**

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## **Exhibit List**

- Exhibit 1      Senate Bill 745 (Chapter 570, 2012 Session)
- Exhibit 2      First Annual Report of the State Industrial Accident Commission of Maryland for the Year November 1, 1914 to October 31, 1915
- Exhibit 3      Executive Order 01.01.1999.16, The Governor's Task Force to Study the Injured Workers' Insurance Fund
- Exhibit 4      NCCI letter to The Honorable Therese Goldsmith, Commissioner, dated July 6, 2012
- Exhibit 5      AM Best, One Year Premium Loss and Market Share Study with Expenses, 2004
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## **I. Executive Summary**

Chapter 570 of the 2012 Laws of Maryland (SB 745)<sup>1</sup> provides for the conversion of the Injured Workers' Insurance Fund ("IWIF" or "the Fund"), the State's insurer of last resort for workers' compensation insurance since 1914, to Chesapeake Employers' Insurance Company ("Chesapeake"), a private, nonprofit, nonstock corporation that, with certain exceptions, shall be authorized, examined, and regulated by the Insurance Commissioner in the same manner and to the same extent as other authorized property and casualty insurers. As enacted, Chapter 570 provides that, unlike other workers' compensation insurers competing in the market, Chesapeake is not subject to Title 11 of the Insurance Article. Pursuant to Chapter 570, Section 5, the Maryland Insurance Administration ("the Administration") conducted a study, in consultation with IWIF and the National Council on Compensation Insurance, Inc. ("NCCI"), to determine whether Chesapeake should be subject to Title 11 of the Insurance Article, including whether Chesapeake should be a member of NCCI, the established rating organization in Maryland.

The Administration considered numerous arguments in favor of Chesapeake's Compliance with Title 11. First, such compliance would mean that premium rates for workers' compensation insurance would be developed in a similar fashion across all carriers in Maryland, and would require that Chesapeake's premium rates be subject the Insurance Commissioner's prior review and disapproval if the Commissioner finds that a proposed rate is excessive, inadequate, or unfairly discriminatory. As Maryland's largest workers' compensation insurer, and as a member of the Property and Casualty Insurance Guaranty Corporation, such regulatory oversight of Chesapeake's rates is appropriate to help ensure its ability to cover the claims of nearly a quarter of the workers' compensation market in the State. Second, as a private, authorized insurer, Chesapeake would be subject to the same regulatory requirements as other authorized insurers competing in the workers' compensation market, thereby helping to level the competitive playing field. Third, subjecting Chesapeake to Title 11 would ensure that NCCI could develop appropriate experience modification factors when insureds leave Chesapeake for a competitive carrier. Fourth, if Chesapeake were subject to Title 11, NCCI could incorporate all Maryland data in developing pure loss costs for use in the State. Fifth, ratemaking transparency and consumer assistance are served by requiring Chesapeake's compliance with Title 11.

Chesapeake will incur additional costs to become fully affiliated with the rating organization, and those costs may impact the premiums paid by Chesapeake's insureds; however, by fully affiliating and reporting all data to the rating organization, premiums may decrease for some employers and increase for others. Additionally, there would be options available to Chesapeake to mitigate the impact of any potential rate increases for its insureds, such as filing a merit rating plan with the Maryland Insurance Administration for approval.

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<sup>1</sup> Exhibit 1, also available at <http://mlis.state.md.us/2012rs/billfile/sb0745.htm>.

Accordingly, the Administration recommends:

1. Chesapeake should be subject to Title 11 of the Insurance Article, including becoming a fully affiliated member of the rating organization, and adhering to the rating organization's policy forms, uniform classification system and uniform experience rating plan;
2. Chesapeake must record and report its experience (policies issued, claims reported and losses paid) to the rating organization in the manner that the organization requires. It should adopt the point forward reporting approach, which can be phased in over a five-year period to minimize expenses and maximize the time allowed to program its systems; and
3. Chesapeake should develop a merit rating plan in consultation with NCCI and the Administration to lessen the impact of transitioning its insureds from the IWIF experience rating plan to NCCI's uniform experience rating plan and should file that plan with the Administration for approval.

## II. Legislative Study Charge

Chapter 570 of the 2012 Laws of Maryland (SB 745)<sup>2</sup> provides for the conversion of the Injured Workers' Insurance Fund ("IWIF" or "the Fund"), the State's insurer of last resort for workers' compensation insurance since 1914, to Chesapeake Employers' Insurance Company ("Chesapeake"), a private, nonprofit, nonstock corporation that, with certain exceptions, shall be authorized, examined, and regulated by the Insurance Commissioner in the same manner and to the same extent as other authorized property and casualty insurers. Beginning on or after October 1, 2013, Chesapeake will serve as the insurer of last resort for workers' compensation insurance in the State. As enacted, Chapter 570 provides that, unlike other workers' compensation insurers competing in the market, Chesapeake is not subject to Title 11 of the Insurance Article.

Pursuant to Chapter 570, Section 5, the Maryland Insurance Administration ("the Administration") is required to conduct a study, in consultation with IWIF and the National Council on Compensation Insurance, Inc. ("NCCI"), to determine whether Chesapeake should be subject to Title 11 of the Insurance Article, including whether Chesapeake should be a member of NCCI, the established rating organization in Maryland.

The law provides that when conducting the study, the Administration:

- may consult with any other person or entity that the Administration considers appropriate; and
- shall consider the impact on Chesapeake and its policyholders if the company is made subject to Title 11 of the Insurance Article, including the impact of the membership and transaction fees payable to the rating organization and additional administrative and system costs associated with complying with Title 11 of the Insurance Article.

Additionally, if the Administration determines that Chesapeake should be subject to Title 11 of the Insurance Article, the Administration is required to consider:

- the extent to which Chesapeake should be in compliance with the rating plan requirement under Title 11 of the Insurance Article; and
- an appropriate timeline for Chesapeake to phase in participation in the rating plan requirements to avoid disruption to its policyholders.

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<sup>2</sup> Exhibit 1, also available at <http://mlis.state.md.us/2012rs/billfile/sb0745.htm>.

### **III. Background**

The following provides historical context for IWIF's conversion to Chesapeake and summarizes certain requirements of Title 11 applicable to other competitive workers' compensation insurers in the marketplace.

#### **A. IWIF**

Pursuant to the Workmen's Compensation Act of 1914, the General Assembly created the State Accident Fund to insure employers against liability for occupational injuries. Initially the State Accident Fund was administered by the State Industrial Accident Commission ("SIAC"), the predecessor of the Workmen's (Workers) Compensation Commission ("WCC"). In its first annual report for the period November 1, 1914 to October 31, 1915, the members of the SIAC compared Maryland's fledgling system to those of other states:

The Compensation Acts of some jurisdictions, eight in number, do not require that compensation be insured. In six states, the law requires the insurance of compensation in a State Fund to the exclusion of all other methods. Of the remaining nineteen Compensation Acts, ten provide for insurance in private companies only, and nine, like the Maryland Act, provide for the operation of a State Fund (or a semi-mutual Association) in competition with private insurance companies.<sup>3</sup>

In 1987, the General Assembly enacted legislation (Chapter 585, 1987 Laws of Maryland) making the Fund an independent State agency and establishing a Task Force to study issues affecting the State Accident Fund and its place in the competitive market. The Task Force issued its report in January, 1988. Some of its recommendations were enacted by the General Assembly in 1990, including renaming the State Accident Fund the Injured Workers' Insurance Fund, mandating legislative audits of the Fund every three years, increasing the competitiveness of agents' commissions, expanding Fund marketing efforts, and removing Fund employees from classified service.

By a 1999 Executive Order of Governor Glendening, another Task Force was formed to study IWIF. The purpose of that Task Force was to conduct a thorough examination of IWIF considering the applicable laws; underwriting, accounting, management and marketing practices; tax exempt status; commissions; and overall mission of IWIF.<sup>4</sup> As a result of the work of the 1999 Task Force, legislation enacted during the 2000 Session granted the Administration certain regulatory authority over IWIF for the first time. Specifically, Chapter 567, 2000 Laws of Maryland made IWIF subject to the provisions of the Insurance Article relating to the examination of an

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<sup>3</sup> First Annual Report of the State Industrial Accident Commission of Maryland for the Year November 1, 1914 to October 31, 1915, at 5.

<sup>4</sup> Executive Order 01.01.1999.16, The Governor's Task Force to Study the Injured Workers' Insurance Fund.

insurer's affairs, transactions, accounts, records, and assets; required the Insurance Commissioner to examine the financial condition of the Fund to ensure it satisfied the solvency standards for a workers' compensation insurer in the State before the Fund could become a member of the Property and Casualty Insurance Guaranty Corporation; and otherwise clarified which provisions of the Insurance Article pertained to IWIF. Chapter 22, 2001 Laws of Maryland amended the previous year's legislation to ensure that the Fund satisfied the solvency standards for a workers' compensation insurer in the State and maintained adequate capital before the Fund could become a member of the Property and Casualty Insurance Guaranty Corporation by phasing in risk-based capital requirements.

In 2008, pursuant to Senate Bill 679 (Chapter 612, 2008 Laws of Maryland), the Administration conducted a study of IWIF to determine, among other things:

The impact of subjecting the Fund to the provisions of law regarding rate-making, rating, and rate review that are enforced by the Administration for other property and casualty insurers, including:

- an analysis of whether the Fund's current ratemaking practices produce actuarially sound rates;
- a determination of the cost impact to the Fund for the Fund to be required to file rates with a rating organization; and
- a comparison of the experience rating plan used by the Fund for small employers to the experience rating plan established by a rating organization for small employers.

At the conclusion of the 2008 study, the Administration issued a "January 2009 Report of the Maryland Insurance Administration on the Study of the Injured Workers' Insurance Fund." In that report, the Administration recommended that the General Assembly:

1. Clarify, in statute, the intended role of the Fund in the Maryland workers' compensation marketplace;
2. Make the Fund subject to Title 11, Subtitles 1, 2, and Sections 11-329 and 11-330, the Administration's ratemaking authority and require that it obtain prior approval of its rates;
3. Strike the language in the Labor and Employment Article, Section 10-125(b), that prohibits the Insurance Commissioner from requiring the Fund to increase its rates; and



4. Make the Fund subject to Title 10, Subtitle 1 of the Insurance Article (Insurance Producers).<sup>5</sup>

Many of the Administration's recommendations were implemented with the passage of Senate Bill 959 (Chapter 336, 2009 Laws of Maryland). The law clarified IWIF's role in the workers' compensation marketplace and expanded the Administration's regulatory authority over IWIF. IWIF would operate in a manner similar to an authorized domestic workers' compensation insurer; serve as a competitive insurer in the marketplace; guarantee the availability of workers' compensation insurance in the State; act as the workers' compensation insurer of last resort; and engage solely in the business of workers' compensation insurance. The Fund would be regulated by the Administration to the same extent as an authorized domestic workers' compensation insurer, except the provisions of Title 3, Subtitle 1, Title 6, Subtitle 1, Title 8 Subtitle 3, and Title 11 of the Insurance Article would not apply; therefore, the legislation continued to exempt IWIF from the provisions of Title 11 of the Insurance Article regarding ratemaking, rating and rate review. Now that Senate Bill 745 (Chapter 570, 2012 Laws of Maryland) provides for IWIF's conversion to a private, nonprofit authorized workers' compensation insurer, the Administration has been asked to study whether the new entity, Chesapeake, should be required to comply with Title 11 of the Insurance Article.

## **B. Workers' Compensation Ratemaking in Maryland**

### *1. Rating Organization*

Section 11-329 of the Insurance Article provides that each workers' compensation insurer must be a member of a rating organization and must adhere to the rating organization's policy forms, uniform classification system, and uniform experience rating plan. Further, each insurer must record and report its experience (policies issued, claims reported and losses paid) to the rating organization in the manner that the organization requires.

NCCI is the established rating organization in Maryland and in 39 other states. NCCI has been operating since 1922 on a not-for-profit basis and has been licensed as a rating organization with the Administration since 1946. It studies workplace injuries and other national and state factors impacting workers' compensation to analyze industry trends, prepare workers' compensation insurance rates and loss costs recommendations, determine the cost of proposed legislation, and provide a variety of data products to insurance companies and states. NCCI also provides "proof of coverage service" to the WCC by verifying that employers maintain the required workers' compensation insurance coverage.

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<sup>5</sup> The Maryland Insurance Administration's Study of the Injured Workers' Insurance Fund, January, 2009, at 20, available at [http://www.mdinsurance.state.md.us/sa/docs/documents/home/reports/mia\\_iwif\\_reportappendicesi-vii.pdf](http://www.mdinsurance.state.md.us/sa/docs/documents/home/reports/mia_iwif_reportappendicesi-vii.pdf)  
[http://www.mdinsurance.state.md.us/sa/docs/documents/home/reports/mia\\_iwif\\_appendixviii.pdf](http://www.mdinsurance.state.md.us/sa/docs/documents/home/reports/mia_iwif_appendixviii.pdf)  
[http://www.mdinsurance.state.md.us/sa/docs/documents/home/reports/mia\\_iwif\\_appendicesix-xviii.pdf](http://www.mdinsurance.state.md.us/sa/docs/documents/home/reports/mia_iwif_appendicesix-xviii.pdf)

NCCI collects five types of data to fulfill its duties as a rating organization: (1) policy data; (2) unit statistical data; (3) financial call data; (4) detailed claim information; and (5) medical call data. Each type of data is described briefly below.

First, policy data is recorded from the declarations pages, schedules and endorsements of the insurance policies issued by insurers. The purpose of collecting policy data is to provide the proof of coverage services to the WCC and also to verify the information contained in the unit statistical reports.

Second, unit statistical data includes audited exposure, premium and loss experience by classification code and by state for each workers' compensation policy issued by insurers.<sup>6</sup> NCCI has developed a classification system containing nearly 600 specific business exposure categories to which all member insurers adhere. According to NCCI:

Insureds are classified based on the nature of their business. They are assigned to the one classification that best describes the business of the employer. Each classification includes all of the various kinds of labor typically found in a business. The classification system places all employers conducting the same business in the same classification. This reflects the fact that employers engaged in the same business will have similar operations and exposure to loss.<sup>7</sup>

In NCCI's classification system, insureds are assigned to the four-digit basic "class" code that best describes their operations. The codes are published in manuals that are filed with and approved by the Administration. Thus, in Maryland, an employer should be assigned the same classification code by every authorized insurer offering to underwrite its workers' compensation insurance coverage. Strict adherence to the rating organization's classification system reduces the potential for unfair discrimination when underwriting and rating a risk.

Third, financial call data contains information on an insurer's overall financial performance, such as premium, losses and expenses. This information is collected from all insurers, aggregated, and used to determine the average rate of change in loss costs in the State. Unit statistical data is applied to determine how that average change will be allocated among the various classification codes.

Fourth, NCCI collects detailed claim information, describing the insured and injured claimant, the benefits and payments made, and the details of the lost wage (indemnity) payments. This information is analyzed after claims are paid to assist insurers in analyzing cost drivers and ways to control claim costs.

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<sup>6</sup> Exhibit 4, letter dated July 6, 2012 from NCCI to The Honorable Therese Goldsmith, Commissioner.

<sup>7</sup> Classification System, NCCI, *available at*

<https://www.ncci.com/nccimain/AboutNCCI/FactsInfo/NCCIServices/Pages/ClassificationSystem.aspx>

Finally, NCCI began collecting medical call data in 2010. According to NCCI, this information includes medical procedure and diagnostic information. The medical call data is used to perform studies and cost analyses. By obtaining, compiling and analyzing detailed claim and medical call data, NCCI can provide information and assistance to policy makers considering reforms to the workers' compensation system.

Unit statistical and financial call data are required for rate making; therefore, it is mandatory for all insurers to report these data types to NCCI for this purpose. NCCI has two data reporting options for rate making purposes: historical reporting and point forward reporting. Historical reporting requires insurers to extract unit statistical and financial call data from a number of prior policy years and provide it to NCCI up front. This can be difficult for insurers to accomplish, as data may not have been captured in the format the rating organization specifies. The costs of historical reporting, including labor, programming, and transaction fees, are greater at the outset. The second option, point forward reporting, provides an opportunity for the insurer to program its system to capture the unit statistical and financial call data in the required formats and to defer payment of a portion of the transaction fees. Unit statistical reporting begins twenty months after the policy effective reporting date. Financial data is reported once a year.

## 2. Rating Rules under Title 11

NCCI collects data from all insurers authorized to write workers' compensation insurance in Maryland (except IWIF) and aggregates it to develop "pure loss costs." Pure loss costs are the estimates, expressed on a per unit of exposure basis, of the monetary amount ultimately needed to pay workers' compensation claims. Loss costs do not include other costs of conducting business as an insurer, such as loss adjustment or claim management expenses, other operating expenses, assessments, taxes, profits or contingency allowances. NCCI files pure loss costs with the MIA on behalf of all insurers who write workers' compensation insurance in the State with the exception of IWIF. No insurer may use the NCCI's pure loss costs until those pure loss costs are approved by the MIA. The rating organization files the loss costs with the Administration for review and approval on an annual basis. Once approved, insurers adopt NCCI's loss costs and then file insurer-specific rate multipliers with the Administration. Rate multipliers are amounts by which the loss costs are multiplied to compensate the companies for the aforementioned costs. In the workers' compensation line of business, insurers that operate more efficiently can set lower rates than their competitors through their loss cost multipliers.

To calculate the policy premium for an employer, an insurer determines the appropriate class code, obtains the payroll for all workers, divides by 100 and multiplies that number by the product of the pure loss costs assigned to the class code and the multiplier. Employers who meet premium threshold requirements and whose loss experience is better or worse than the average of other similarly classified insureds are eligible for experience rating. Specifically, an insured is eligible for experience rating when the policy premium for the year under evaluation equals or exceeds \$10,000, or, if

two or more years are being evaluated, the average annual premium equals at least \$5,000. An employer who has experienced more claims within the past three years than others similarly classified likely will pose a greater risk for future claims; therefore, the insurer will apply an experience debit modification factor (greater than 1.0) in accordance with the experience rating plan developed by NCCI. Those employers with more favorable loss experience are eligible for an experience credit modification factor (less than 1.0).<sup>8</sup> NCCI develops the experience modification factors for employers based on information received through unit statistical data reports. The rating rules established by the rating organization are followed by all authorized insurers underwriting workers' compensation insurance policies in the State to foster fair competition in the market.

Insurers issuing workers' compensation policies in the State must follow NCCI's rating rules and also must bear the costs to do so as established by the rating organization. The rating organization's charges to each insurer are based on the amount of premiums written, as well as the number of transactions undertaken on behalf of an insurer. Full affiliation with the rating organization provides access and licensing to NCCI's products and services including:

- Infrastructure (includes use, license and maintenance of the experience rating plan)
- Classification System Plan, Statistical Plan, Large Account License and Policy Forms
- Filing Services (includes loss costs filing)
- Experience Rating Services
- Proof of Coverage
- Data Management Services
- Web Based Informational Tools
- Electronic Manuals and Circulars

### 3. IWIF Ratemaking

While IWIF has been subject to increasing regulatory oversight by the Administration in recent years, it has continued to be exempt from the requirements of Title 11 of the Insurance Article, including rating organization membership and compliance with the organization's rating plan. The Fund's rates, rating plan and rating rules are reviewed through the financial examination process to ensure they are actuarially justified. Financial examinations of Maryland domestic insurers are required at least once every five years. As such, IWIF's rates are reviewed less frequently than those of any other insurer writing workers' compensation insurance in the State.

IWIF has an actuary on staff and engages the services of a consulting actuary, Deloitte Consulting, LLP, to render an actuarial opinion regarding the adequacy of the

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<sup>8</sup> NCCI Experience Rating Plan, NCCI, *available at* <https://www.ncci.com/nccimain/AboutNCCI/FactsInfo/NCCIServices/Pages/NCCIExperienceRatingPlan.aspx>

Fund's loss reserves and to perform an annual rate and classification analysis. The Fund generally relies solely upon its own premium and loss data to develop its rates; however, if little credible data exists for a classification, IWIF can secure loss data from NCCI to complement its data. Upon completion of the annual rate and classification analysis, a report is provided to the Fund by its consulting actuary. Before any changes to the rating plan are implemented, the actuarial information is presented to an internal pricing committee and ultimately, to IWIF's Board of Directors for approval.

The Fund's stated pricing goals are to:

- Insure the financial integrity of the organization;
- Remain competitive in the marketplace; and
- Target opportunities through individual class modification.<sup>9</sup>

IWIF's rating plan differs from NCCI's in a number of ways. First, although the Fund largely adheres to NCCI's code classification system, it uses 28 codes not contained in NCCI's classification system.<sup>10</sup> IWIF created unique classification codes and developed rates for those codes because it possesses the actuarial data to do so. Employers classified in those codes may be offered insurance coverage at lower premium rates by IWIF than if coverage were purchased from authorized insurers adhering to NCCI's uniform classification system.

In addition, the Fund utilizes a predictive modeling component to assign policyholders with premiums of less than \$10,000 to one of seven tiers, whereas NCCI's plan does not incorporate tiering. IWIF's experience rating plan is structured differently from NCCI's. To qualify for IWIF's experience rating plan, there is a lower premium threshold: \$3,000 in base premium over three years. In contrast, under NCCI's experience rating plan, the premium threshold is \$10,000.<sup>11</sup> Thus, more insureds are eligible for premium credits under IWIF's plan than under NCCI's. IWIF also has developed a loss-free credit program for small policyholders ineligible for the experience rating program,<sup>12</sup> whereas NCCI's plan does not have such a program.

Furthermore, IWIF has a scheduled rating plan that allows the premium of an individual risk to be modified by an underwriter after "recognizing characteristics of the risk that are not reflected in its experience."<sup>13</sup> The characteristics include, but are not

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<sup>9</sup> IWIF PowerPoint: Base Rates and Pricing 2011 presented to the Board of Directors by Tom Phelan, CEO and Paige Beck, 2010

<sup>10</sup> In the Administration's 2008 study of IWIF, NCCI identified 98 IWIF-specific codes. In its response to the MIA for this study, IWIF reported only 28 non-NCCI codes are in use and a review of the Fund's Underwriting and Procedure Manual, at 54 and 55 confirms this.

<sup>11</sup> An insured is eligible for experience rating when the policy premium for the year under evaluation equals or exceeds \$10,000, or, if two or more years are being evaluated, the average annual premium equals at least \$5,000.

<sup>12</sup> Under IWIF's loss-free credit program, a five percent credit is applied to the policy not to exceed \$200.

<sup>13</sup> IWIF 2012 Rating Manual, at 15.

limited to: management stability, safety practices and procedures, and premises condition and care. The plan applies to risks with an annual premium in excess of \$10,000 and the maximum credit or debit cannot exceed 40% after consideration of the various characteristics. Lastly, the Fund has a number of association/safety group programs whereby members of participating organizations insuring with IWIF earn premium discounts ranging from five to fifteen percent.<sup>14</sup>

In connection with its 2008 study of IWIF, the Administration retained a consulting actuary, Merlinos and Associates, to review IWIF's rates to determine if IWIF's rate making practices produced actuarially sound rates. During the Administration's recently concluded financial examination of the Fund, another of its consulting actuaries, Lewis & Ellis, Inc. ("Lewis & Ellis"), reviewed the reasonableness of IWIF's loss and loss adjustment expense reserves and the rate level analysis performed by Deloitte Consulting, LLP to determine whether IWIF's ratemaking practices resulted in actuarially sound rates. In 2008 and again in 2011, the actuaries concurred that IWIF's rate making practices produced actuarially sound rates. Lewis & Ellis, however, concluded that while IWIF's base premium rates were actuarially sound, IWIF underwriters' implementation of IWIF's scheduled rating plan did not comply with the Fund's established guidelines. According to Lewis & Ellis, IWIF's underwriters had provided higher discounts to more insureds than may have been warranted. Based upon Lewis & Ellis' findings, the examiners commented in their financial examination report that implementation of the scheduled rating plan in that manner had resulted in and could continue to result in rate level inadequacy. IWIF's management acknowledged this in its response to the Administration and advised that procedures were changed as a result.<sup>15</sup>

As of December 31, 2011, IWIF reported \$170.6 million in earned premium and 20,189 active policyholders, representing \$6.65 billion of insured Maryland payroll.<sup>16</sup> IWIF's share of Maryland's workers' compensation market when measured by written premium totaled 22.5% in 2010, its lowest market share in the decade from 2001 through 2010. At its peak in 2004, IWIF commanded 33.9% of Maryland's workers' compensation market according to AM Best<sup>17</sup>. While IWIF remains the market leader with nearly double the market share of the insurer group with the next largest market share (12.5%), it has written less premium and lost market share every year from 2007 through 2010.<sup>18</sup> Much of the decline likely is attributable to the recession and slow recovery, as one of IWIF's targeted markets is building contractors.

While IWIF collected fewer premium dollars, its loss ratio climbed. A combined ratio in excess of 100% indicates that for every dollar an insurer earns, it pays out more than one dollar in claim payments, loss adjustment and operating expenses. If the

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<sup>14</sup> IWIF Underwriting and Procedure Manual, October 2011 and IWIF 2012 Rating Manual, January 2012 Edition.

<sup>15</sup> Injured Workers' Insurance Fund Examination: December 31, 2010, *available at* <http://www.mdinsurance.state.md.us/sa/documents/IWIF.10.pdf>.

<sup>16</sup> IWIF email from Paige Beck to Sandra Castagna dated 6/29/12 and IWIF 2011 Annual Report.

<sup>17</sup> Exhibit 5

<sup>18</sup> Maryland Insurance Administration 2011 Report on Workers' Compensation Insurance, Exhibit 2, *available at* <http://www.mdinsurance.state.md.us/sa/docs/documents/home/reports/workerscomp2011.pdf>.

combined ratio remains above 100%, this may indicate an insurer needs to increase its rates.

**IWIF'S Loss Ratios from 2006 through 2011<sup>19</sup>**

	2006	2007	2008	2009	2010	2011
Written Premium (000s)	316,513	272,523	225,915	167,234	166,820	176,521
Earned Premium (000s)	321,249	290,824	244,314	182,625	168,859	170,595
Loss and Loss Adjustment Expenses (000s)	296,259	273,926	234,549	202,752	186,171	178,878
Operating Expenses (000s)	51,744	49,930	48,075	36,955	35,699	41,405
Loss/LAE Ratio	92.2%	94.2%	96.0%	111.0%	110.3%	104.9%
Expense Ratio	16.3%	18.3%	21.3%	22.1%	21.4%	23.5%
Combined Ratio	110.3%	114.3%	118.3%	134.2%	132.2%	128.2%

**IV. Study Procedures**

In conducting this Study, the Administration reviewed and considered information from prior Administration studies, prior Administration reports to the General Assembly, and the Administration's recently concluded financial examination of IWIF. The Administration's 2008 study of IWIF and the Administration's recent financial examination of IWIF as of December 31, 2010 each included an actuarial analysis of IWIF's rating plan. In addition, the Administration conducted interviews with executives of IWIF and representatives of NCCI to gain their perspectives on the advantages and disadvantages of a requirement that Chesapeake comply with Title 11 of the Insurance Article. In response to subsequent Administration inquiries, IWIF provided certain classification, policy and premium data, copies of its underwriting guidelines and rating

<sup>19</sup> Exhibit 6, IWIF Annual Statements filed with the NAIC, 2006 through 2011. Combined Ratio equals Loss/LAE Ratio plus the Expense Ratio plus the Dividend Ratio.(Dividend ratio has not been included in the chart.).

manual and estimates of the costs to affiliate with NCCI. NCCI provided written comments, including estimates of the costs to Chesapeake of fully affiliating with the rating organization.

The Administration also solicited input from other interested parties including:

1. Industry associations representing insurers that write workers' compensation insurance in Maryland:
  - a. American Insurance Association ("AIA"); and
  - b. Property and Casualty Insurers Association of America ("PCI");
2. Agency associations whose members sell workers' compensation insurance:
  - a. Independent Insurance Agents of Maryland, Inc. ("IIAM"); and
  - b. Insurance Agents and Brokers ("IA & B");
3. Government and business associations whose members may purchase workers' compensation insurance from IWIF:
  - a. Maryland Municipal League ("MML");
  - b. Maryland Association of Counties ("MACO");
  - c. Maryland Retailers Association ("MRA");
  - d. Maryland Chamber of Commerce ("MCC"); and
  - e. National Federation of Independent Business ("NFIB"); and
4. The Property and Casualty Insurance Guaranty Corporation ("PCIGC").<sup>20</sup>

Responses were received from AIA, PCI, IIAM, and PCIGC.<sup>21</sup>

In addition, the Administration researched NCCI affiliation costs in another state where a state workers' compensation fund has converted to a private, competitive insurer.

## **V. Analysis**

### **A. Arguments in Favor of Chesapeake's Compliance with Title 11**

#### *1. Rate Adequacy*

The requirements of Title 11, including membership in a rating organization and adherence to that rating organization's uniform classification system, statistical plan, and experience rating plan are designed to help ensure that premium rates for workers' compensation insurance are developed in a similar fashion across carriers, taking into account Maryland's workers' compensation marketplace, the relative risks involved in different types of work, and the unique experience of particular employers. They also ensure that a proposed premium rate for workers' compensation insurance is subject to

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<sup>20</sup> Exhibit 7A

<sup>21</sup> Exhibit 7B



the Commissioner's prior review and disapproval if the Commissioner finds that a proposed rate is excessive, inadequate, or unfairly discriminatory.

With the exception of IWIF, other entities which serve as legislatively mandated property and casualty insurers in Maryland -- the Maryland Automobile Insurance Fund, the Joint Insurance Association, and Medical Mutual Liability Insurance Society of Maryland -- file their rates with the Administration. Likewise, with the exception of Chesapeake, under current law all other authorized insurers writing policies of workers' compensation insurance in the State are required to file their rates with the Administration.

In the examination report on the financial examination of IWIF as of December 31, 2010, the Administration's examiners concluded issues with IWIF's rate-setting process could result in inadequate rates over time. And IWIF's loss ratios indicate that it has been selling workers' compensation policies at a loss for the past several years. As Maryland's largest workers' compensation insurer, and as a member of the PCIGC, inadequate rates going forward could jeopardize Chesapeake's ability to cover the claims of nearly a quarter of workers' compensation insurance market in the State and could result in an assessment upon other property and casualty insurers to cover the shortfall. Every authorized insurer in Maryland is a member of the PCIGC and as such, has a vested interest in Chesapeake's ability to remain financially viable.<sup>22</sup>

## 2. Level Playing Field

As a state-run workers' compensation insurer of last resort, IWIF has been exempt from Title 11 requirements. According to PCI and AIA, as a private, authorized insurer, Chesapeake should be subject to the same regulatory requirements as other authorized insurers competing in the workers' compensation market. The PCIGC concurred that there is no public policy reason why Chesapeake should be exempt from Title 11 rating laws.<sup>23</sup> IIAM, too, supports a "level playing field" for competitive, private insurers in the State. Unless Chesapeake is subject to Title 11, it will continue to enjoy the following advantages over its competitors:

- development and application of its unique rating plan rather than the adoption of NCCI's;
- review of rates once every five years during the financial examination process instead of annually;
- lack of payment of full affiliation fees to NCCI.

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<sup>22</sup> Letter from Oyango Snell, State Government Relations Counsel, MD and Rita Nowak, Vice President Commercial Lines, PCI to Sandra Castagna dated August 2, 2012.

<sup>23</sup> Letter from Joseph R. Petr, President, PCIGC to Sandra Castagna dated August 30, 2012.

These advantages are in addition to Chesapeake's guaranteed business as insurer of last resort and maintenance of its federal tax exemption.<sup>24</sup> Based upon other states' residual market data, NCCI estimates the residual business in Maryland may represent four to five percent of the total industry workers' compensation written premium. As of 2010, in Maryland this would equal \$28.4 to \$35.5 million in written premium. That level of written premium alone affords Chesapeake the opportunity to remain one of the top eight workers' compensation insurers in the State in terms of market share.

### 3. Data Access

NCCI noted another disparity that exists when all insurers do not follow the same rating plan. IWIF insureds with poor claims histories subject to high experience modification debit factors may choose to leave IWIF for authorized insurers to reduce premiums. Unlike the case for all other authorized insurers, NCCI does not possess the requisite data for that insured, and cannot develop an appropriate experience modification factor. As a result, the insurer is unable to charge and collect a premium commensurate with the risk presented by the employer. This process is referred to as "mod-washing" and occurs solely due to other competitive insurers' lack of access to data. In contrast, IWIF can gain access to NCCI experience modification factors and take that information into account when developing its premiums. Unless Chesapeake is subject to Title 11, this disparity will continue.

### 4. Maryland-Specific Pure Loss Cost Data

To develop pure loss costs, NCCI currently relies on the data it receives from the 98 insurer groups writing workers' compensation in Maryland. Those groups account for 77.5% of the market share as measured by premium written. When it lacks adequate Maryland data to develop credible loss costs for particular classification codes, NCCI considers national data for those classification codes to complement the credibility of the Maryland data.

If Chesapeake were subject to Title 11, 100% of the workers' compensation data for the Maryland market would be reported to NCCI. NCCI would incorporate Chesapeake's data when developing Maryland loss costs, which may reduce the need to consider national data for particular classification codes and would allow a more comprehensive review of the Maryland market when developing pure loss costs. The results of NCCI's review and subsequent increases or decreases in pure loss costs would then be shared by all authorized insurers, and insured employers, in the market. NCCI noted that if Chesapeake maintains its exemption from Title 11 of the Insurance Article, "it will be the only private insurer in Maryland and in all other states where NCCI serves as the designated rating or advisory organization that is not required to report loss data to NCCI or use NCCI experience ratings."

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<sup>24</sup> Letter from Bruce C. Wood, Associate General Counsel and Director, Workers' Compensation, AIA to Sandra Castagna dated July 31, 2012.

## 5. Consumer Assistance

There also is a consumer service rationale for requiring Chesapeake's compliance with Title 11. If Chesapeake were to adopt NCCI's loss costs, file its rates and comply with NCCI's experience rating plan, the Administration could better assist consumers who file complaints against Chesapeake. If questions arise regarding an employer's classification, the Administration would simply request that NCCI review the class code assigned to determine its accuracy, just as it does when complaints of this nature are lodged against authorized insurers. And, if complaints are received regarding rate calculation, the Administration could rely on NCCI's and Chesapeake's filings to determine whether the rates were charged in accordance with the rating plan. Under the existing Title 11 exemption for Chesapeake, the Administration will not have ready access to classification and rating information to respond promptly to consumer inquiries and complaints. Instead, it would have to request the information from the insurer, review it and determine if the company complied with the requirements of its unique rating plan. Both NCCI's loss cost filing and an authorized insurer's rate multiplier filing are considered public records when filed with the Administration; therefore, they would be made available to the public upon request. If Chesapeake maintains its exemption from Title 11 of the Insurance Article, its rating plan, rates and rules would not be on file and thus, not available for public inspection.

### **B. Arguments Against Chesapeake's Compliance with Title 11**

IWIF executives raised concerns about (1) the cost of affiliating with NCCI; and (2) the time required to program IWIF's system to capture data in the format NCCI requires. They noted three separate actuarial firms have determined that IWIF's rates are actuarially sound, the Fund has competed successfully with authorized insurers and has operated as Maryland's workers' compensation insurer of last resort continuously since 1914; therefore, Chesapeake should not have to adhere to the rating organization's uniform classification system and uniform experience rating plan. Further, they question the need to incur any additional expenses to report data to NCCI for the rating organization to aggregate it with the industry's data. Finally, they stated there is nothing for Chesapeake, or its insureds, to gain by fully affiliating with NCCI. According to IWIF, affiliation would only benefit the rest of the insurance industry writing workers' compensation insurance in Maryland at Chesapeake's expense.

### **C. Potential Impact on Chesapeake Policyholders**

#### *1. Costs of Full NCCI Affiliation*

To comply with Title 11 of the Insurance Article, authorized insurers incur the costs associated with full NCCI affiliation. They also incur fees to file insurer-specific loss cost multipliers with the Administration, and any expenses associated with the Administration's review of those filings. These costs are reflected in insurer's loss cost multipliers, which means they ultimately are reflected in premium rates.

Currently, IWIF pays NCCI approximately \$175,000 annually for various items and services furnished by NCCI, including licensing of the classification plan<sup>25</sup>, proof of coverage service to the WCC, and secondary experience modification sales (this occurs when IWIF does not possess enough experience for a particular classification code and obtains NCCI's data to complement the credibility of its data for ratemaking purposes). NCCI estimates that it will cost Chesapeake an additional \$417,000 per year to become fully affiliated with NCCI, for an estimated total affiliation cost of \$592,000. That estimate is based on NCCI's 2012 affiliation pricing, IWIF's 2011 premium data and the number of insureds qualifying for NCCI's experience rating plan as stated in IWIF's 2010 annual report. It is subject to modification in the event that any of those variables change.

IWIF presented to the Administration its own cost estimate for full affiliation totaling \$629,253, based on 2011 data, inclusive of the amount it currently pays to NCCI for various services. IWIF's estimate is based totally on 2011 policyholder data, whereas NCCI's estimate combined policyholder data elements from 2010 and 2011. In addition, IWIF executives estimate that Chesapeake will require four additional employees -- an actuary/supervisor, financial analyst, underwriter and programmer -- at an annual cost of \$460,000, including benefits, to comply with all of NCCI's rating and reporting requirements. IWIF's analysis did not address the potential for any offsetting cost savings from full NCCI affiliation, such as any reduced actuarial expenses attributable to NCCI's development of the pure loss costs and the experience rating modification factors. IWIF also reported that it contacted another state insurer that affiliated fully with NCCI within the last six years to obtain a programming cost estimate. That insurer informed IWIF that it utilizes the services of an independent vendor for computer services at an annual cost of approximately \$500,000<sup>26</sup>. This expense estimate was confirmed by the Administration, but may be far more than any expense Chesapeake would incur since, unlike IWIF, the insurer IWIF contacted had no prior affiliation with NCCI; was converted from a monopolistic state plan to an NCCI affiliate in a very short period of time; and was required to convert all data in the formats NCCI requires. Moreover, the insurer IWIF contacted writes more premiums on an annual basis than IWIF. Since the vendor fees are based in part on the amount of premium written, we would expect such fees to be lower for IWIF. IWIF already reports policy data to NCCI to provide proof of coverage services to the WCC; therefore, those programming costs would not apply.

Thus, the estimated range of increased annual operating costs to Chesapeake is \$417,000 (additional fees to NCCI per NCCI's estimate) to \$1,414,253 (additional fees to NCCI, computer vendor and salaries per IWIF's estimate). Adding IWIF's high-end estimate of \$1,414,253 to its 2011 operating expenses of \$41,405,000 yields a 3.4% annual increase in operating expenses.<sup>27</sup> Because NCCI's transaction fees are based on the amount of premium written, the number of policies issued and the number of insureds

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<sup>25</sup> IWIF licenses NCCI's classification plan and follows its guidelines, with the exception of IWIF's development and use of the 28 unique IWIF classification codes.

<sup>26</sup> IWIF email from Paige Beck to Sandra Castagna dated September 18, 2012.

<sup>27</sup>  $\$41,405,000 + \$1,414,253 = \$42,819,253 / \$41,405,000 = 1.034$  or 3.4%

eligible for experience rating, the incremental rate of change to the expense ratio will vary based on those factors.

## 2. Potential Impact of NCCI Experience Rating and Classification

As of December 2011, IWIF had 20,189 policyholders. According to IWIF, of that number, 4,684 policyholders eligible for experience rating with IWIF would become ineligible for experience rating under the NCCI plan. Of those 4,684 insureds, IWIF reports that 4,324 will lose a credit modification factor (resulting in a rate increase), while 360 will no longer be subject to a debit modification factor (resulting in a rate decrease). Those policyholders paid \$10.7 million in premiums in 2011 or 6% of IWIF's total written premiums. Another 5,099 small policy holders could lose IWIF's loss-free credit. Those policyholders paid \$3.0 million in premiums or nearly 2% of IWIF's total written premium. The small policyholder loss-free discount is 5% of the policy premium, up to a maximum discount of \$200. Additionally, any insured currently classified in the IWIF-specific codes not recognized by NCCI may be impacted by Chesapeake's full affiliation with the rating organization. Government entities, including 106 municipalities and townships and 12 counties (including boards of education) were classified in IWIF-specific class codes. These policyholders paid \$20.4 million in premiums in 2011, or 12% of IWIF's total written premiums and may be subject to increased policy premiums once Chesapeake becomes fully affiliated with NCCI and subject to its rating plan. Combined, the three categories of policyholders identified above paid approximately 20% of the total premium written by IWIF in 2011.

It must be noted that if Chesapeake becomes subject to Title 11 of the Insurance Article, it could continue to maintain the differences in its rating plan, except for one: NCCI's experience rating plan. Section 11-329(b)(1) of the Insurance Article requires workers' compensation insurers to follow a uniform classification system and uniform experience rating plan; however, Section 11-329(b)(2) of the Insurance Article allows carriers to develop subclassifications of the uniform classification plan. Those subclassifications must be filed with and approved by the Administration. Additionally, Section 11-329(f)(2) allows an insurer to file a rating plan that provides for premium adjustments up to 25% based upon characteristics of a risk that are not reflected in the uniform experience rating plan. Thus, Chesapeake may file for approval a merit rating plan to maintain the loss-free credit program, the scheduled rating plan, and the association/safety group premium discount programs.

After NCCI has the requisite three years of Chesapeake ratemaking data, and files loss costs incorporating Chesapeake data, the potential exists for all of Chesapeake's insureds to experience a rate change; however, that change may be an increase or a decrease depending on the developed loss costs, rate multiplier, experience rating eligibility and modification factors. Once all financial and unit statistical data is reported and evaluated by NCCI, loss costs will be based on 100% of the Maryland market. Loss costs can increase or decrease. NCCI filed decreases to the pure premium loss costs for calendar years 2007 through 2009 (ranging from a low of -5.4% for 2009 to a high of -1.7% for 2008) and increases for calendar years 2010 through 2013 (ranging from a high

of 5.7% in 2011 to a low of 1.4% for 2012). Therefore, the impact on loss costs by the inclusion of Chesapeake's data with the remaining 77% of the Maryland market is not immediately quantifiable. Additionally, while NCCI's transaction fees can be estimated based on prior years' data, the actual cost depends on the data as it is being reported. Any changes to the amount of premium written, number of policies issued or number of insureds eligible for experience rating will also impact the transaction fees to be paid by Chesapeake. Since increases in fees will be included in Chesapeake's operating expenses, they ultimately will be reflected in its rate multiplier and thus, in the premium charged to its policyholders. The extent of this impact also is unknown. For these reasons, the cumulative effect of any increases or decreases to loss costs, the rate multiplier and experience modification factors on Chesapeake's insureds cannot be measured with any degree of accuracy at this time.

### *3. Timeline to Avoid Disruption to Policyholders*

NCCI's point forward reporting option would provide Chesapeake and its insureds an opportunity to defer a portion of its additional transaction fees. The transaction fees charged are associated with the amount of data provided; therefore, as more data is provided the fees will increase. Specifically, under point forward reporting, Chesapeake could begin reporting unit statistical data in 2015. Since three full years of unit statistical data are required by NCCI to be considered credible for loss cost and experience rating, the third year of Chesapeake's required unit statistical data would not be reported until 2018. At this point, Chesapeake would be considered fully affiliated, and would continue to report all data on the established schedules. Therefore, it would take nearly five years before Chesapeake is fully reporting to NCCI and paying all estimated increased fees. During that time, Chesapeake could more fully assess the most cost-effective means of satisfying NCCI-affiliation requirements, such as whether to hire a computer programmer to fulfill NCCI's reporting requirements or to contract with a vendor. From the fifth year and every year thereafter, Chesapeake would incur the full costs of NCCI affiliation.

Further, any impact from adopting NCCI experience rating and classifications would necessarily be phased in over a several-year period. First, with respect to the potential impact of NCCI experience rating, Chesapeake must report three years of unit statistical data to NCCI before the rating organization can develop the experience ratings for Chesapeake's insureds. Only after that three-year period would Chesapeake's insureds be rated in accordance with NCCI's experience rating plan rather than Chesapeake's. Second, with respect to IWIF-specific classification codes, NCCI asserts that once it has the opportunity to obtain and analyze three years of unit statistical data for the Chesapeake policyholders assigned to the non-NCCI classification codes, if the data is credible, it may be able to add IWIF's codes to its classification system. This has the potential to benefit not only the IWIF-insured employers currently classified in those codes, but also other employers in the State who may become eligible for classification in those codes.

Chesapeake would continue to use its experience rating plan until three full years of its rate-making data have been reported to NCCI for the organization to incorporate into its loss costs and experience rating. As stated above, it will take nearly five years before all of Chesapeake's required ratemaking data has been reported. To mitigate the impact of transitioning from one rating plan to the other, NCCI proposed that Chesapeake could increase the experience rating threshold incrementally over the five-year phase-in period. Chesapeake also could develop a merit rating plan designed to offer premium credits to insureds no longer eligible for experience rating under NCCI's plan and file it with the Administration for approval. The aggregation of Chesapeake's data with that of the industry may result in increased variability in the loss costs; however, NCCI also has proposed a number of alternatives to minimize the impact on insured employers, including considering data from a greater number of years to develop a longer term (lower) average of loss costs instead of the shorter term (higher) average, utilizing a longer term phase in period of the Chesapeake data or applying swing limits (e.g. limiting the increases or decreases to a certain percentage). Thus, by adopting the point forward reporting option, any changes in rates for Chesapeake's insureds would be gradually implemented over the transition period.

## **VI. Conclusions and Recommendations**

The arguments in favor of Chesapeake's compliance with Title 11 of the Insurance Article — rate adequacy, a level playing field, access to data, 100% of Maryland-specific loss cost data and improved consumer assistance — appear to outweigh those in opposition. If Chesapeake follows NCCI's uniform classification system and uniform experience rating plan, adopts NCCI's pure loss costs, reports all data as required and pays all fees to the rating organization, NCCI will be in a position to conduct a comprehensive review of the Maryland market. The results of NCCI's review and subsequent increases and decreases in pure loss costs would then be shared by all authorized insurers, and insured employers, in the market. All market participants would also apply the same experience rating modification factors for all eligible Maryland employers. Chesapeake's data reporting for all classification codes, including those that are company specific, will afford the rating organization the opportunity to add State-specific classification codes to its uniform classification system. This will allow other authorized insurers providing workers' compensation insurance in Maryland to compete for business, potentially lowering premiums for Maryland employers and government entities. While the potential exists for premium increases for some of Chesapeake's insureds, those increases can be implemented gradually and may largely be offset by the development of a merit rating plan if one is filed by Chesapeake and approved by the Administration.

If Chesapeake remains exempt from Title 11 of the Insurance Article, it will become the first and only authorized property and casualty insurer in Maryland to write a line of business for which rates are required to be filed with the Administration that is exempt from doing so. As the insurer of last resort, it will be guaranteed some level of written premium and will retain its federal tax exempt status. Chesapeake can charge and collect premiums commensurate with the risk presented by those insureds, through debit

modification factors if the insureds are eligible for experience rating, or if ineligible, through its rating plan filed with and approved by the Administration. And, if not required to fully affiliate with NCCI, Chesapeake avoids paying additional transaction fees, an option unavailable to other authorized insurers offering workers' compensation insurance in Maryland.

Based upon the foregoing analysis, the Administration recommends that:

1. Chesapeake should be subject to Title 11 of the Insurance Article, including becoming a fully affiliated member of the rating organization, and adhering to the rating organization's policy forms, uniform classification system and uniform experience rating plan;
2. Chesapeake must record and report its experience (policies issued, claims reported and losses paid) to the rating organization in the manner that the organization requires. It should adopt the point forward reporting approach, which can be phased in over a five-year period to minimize expenses and maximize the time allowed to program its systems; and
3. Chesapeake should develop a merit rating plan in consultation with NCCI and the Administration to lessen the impact of transitioning its insureds from the IWIF experience rating plan to NCCI's uniform experience rating plan and should file that plan with the Administration for approval.