The

PROCESS

OF

RATEMAKING

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doing business are higher than they in fact are. The amounts paid to the reinsurer reflect only the sharing of the costs and profits for the same risk for which the policyholder has once been charged. Unless the policyholder receives a benefit from reinsurance, the costs of reinsurance represent a double-charge for the risk of loss and the profit allowance.

An application of the above principle may be found in a recent homeowners case in Georgia,[1] where the insurer included substantial cost of reinsurance in its rates but at the same time used a premium-to-surplus ratio in excess of the 3:1 benchmark proposed in this work.[2] The Georgia insurer used an above average premium-to-surplus ratio of 3.177:1 (made available by the reinsurance) to convert an after-tax underwriting profit as a percent of surplus of 11.5 percent[3] into a profit as a percent of premiums of 3.6 percent (or 11.5% ÷ 3.177 = 3.6%).

Substituted rail for motor common carrier service. Long before the I.C.C. first adopted general regulations pertaining to substituted rail for motor service, a/k/a "piggyback service," the railroads handled motor trailers of freight at tariff rates published for entire loaded trailers moving as a freight commodity. In 1964 the I.C.C. formally provided that motor carriers might continue to substitute rail for motor service (so-called "Plan I" piggyback service) so long as shippers were notified that substitution might occur and were given the option of declining to allow substitution.[4] In the alternative, motor carriers and railroads would enter into formal through route, joint rate arrangements ("Plan V" piggyback).

When a motor carrier substituted rail service for its own over-the-road service, it charged the shipper the same motor carrier rate.[5] The I.C.C. saw no reason why the motor carrier should be barred under Plan I from using the rail rates published in open tariffs maintained by railroads when the rail carrier held out the same services to the public generally.[6] As for Plan V, the I.C.C. held it would not attempt to control the level of compensation to be received by the railroads under division agreements with trucking companies, since they were "by nature, private contracts negotiated by individual carriers."[7]

RETROACTIVE RATEMAKING. "Retroactive ratemaking" refers to an improper recovery of costs that were properly recoverable only in a past period or periods. In the absence of express statutory direction, it is unlawful for an agency to alter

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[1] Cotton States Mutual Ins.Co., Homeowners Program, dated May 22, 1996, filed May 23, 1996, Exh. 6, p. 3, Ga.Dept.Ins., Atlanta, Ga.

[2] For discussion of the proposed benchmark, *see* p. 681.

[3] The insurer derived the after-tax underwriting profit by subtracting the net of tax investment yield from a projected return on surplus of 15 percent. The insurer used a pre-tax investment yield of 5.4 percent and a tax rate of 34.9 percent. Thus, the after-tax profit equaled 15% – 5.4% × (1– 34.9%), or 5.4 percent.

[4] Substituted Service—Charges and Practices of For-Hire Carriers and Freight Forwarders, 322 ICC 301 (1964), aff'd *sub nom.* Am.Trucking Assns. v. Atchison, T.& S.F.R.Co., 387 U.S. 397 (1967), adopting 49 CFR Part 500. Later the I.C.C. totally exempted this service from its regulation in Improvement of TOFC/COFC Regulation, 364 ICC 731 (1981), adopting 49 CFR Part 1090.

[5] *See* 322 ICC at 310; and Substituted Freight Svc., 232 ICC 683, 687 (1939).

[6] 322 ICC at 335.

[7] *Id.* at 328.

the past legal consequences of past actions,[1] such as by awarding damages for past illegal conduct. An agency may, and indeed must in an appropriate case, affect the future legal consequences of past transactions. Such "secondary retroactivity" is an "entirely lawful consequence of much agency rulemaking and does not by itself render a rule invalid."[2]

The Indiana commission usefully summarized the three basic functions served by the rule against retroactive ratemaking:[3]

a) protecting the public by ensuring that current customers pay for their own service and not for past deficits;
b) preventing utilities from using future rates to protect the financial investment of their stockholders, *i.e.*, providing a guaranty, rather than opportunity, for a fair rate of return; and
c) requiring utilities to bear losses and enjoy gains that depend on their own managerial efficiency.

It is retroactive, and hence unlawful, ratemaking for a state agency engaged in a prior approval proceeding on application for a rate increase to approve the increase with an effective date prior to the issuance of its final order; the agency cannot, for example, make the approved increase effective as of the date of an earlier order in the proceeding.[4]

Retroactivity is particularly inconsistent with group ratemaking and could produce a "cost-plus" system of regulation. A uniform group rate for a class of companies requires each company to compete and control costs. If an agency had authority to make rates retroactive to any point in time, each company would have an "incentive to seek relief from the uniform rate, not to live within it."[5]

State insurance law is particularly insistent that rates shall not recover past, out-of-state losses. A Connecticut statute provides that no personal risk insurance rate shall be "designed to recover underwriting or operating losses incurred out-of-state," implying that past losses incurred within Connecticut in some circumstances may be recovered in a new rate filing.[6] A New York statute adopted in 1990 similarly provides that any rate affecting an effort on the part of an insurer to recoup losses incurred in another state, which requires a general reduction in rates, is "deemed unfairly discriminatory."[7]

Retroactive discounting is disapproved by insurance commissioners primarily to prevent rates from falling below approved minimum rates. The New York superintendent, for example, disapproved a proposed rebate of a group life or health insurance

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[1] Bowen v. Georgetown Univ.Hosp., 488 U.S. 204 (1988); American Min.Congress v. U.S. Environmental Protection Agency, 965 F.2d 759, 769 (9th Cir. 1992).

[2] National Medical Enterprises, Inc. v. Sullivan, 957 F.2d 664, 671 (9th Cir. 1992).

[3] Re Northern Indiana Pub.Svc.Co., 157 PUR4th 206, 228 (Ind.URC, 1994).

[4] Re Western Ky.Gas Co., 123 PUR4th 68, 71-72 (Ky.PSC, 1991).

[5] T.W.A. v. C.A.B., 336 U.S. 601, 606-07 (1949).

[6] Conn.Stats., C.G.S.A. §38a-686(c).

[7] 27 N.Y. Ins.Code, §2303 (1994 Pocket Part).