

ESTIMATING COSTS

ESTIMATING THE COST OF A WORKERS' COMPENSATION POLICY

There are eight steps in estimating the cost of workers' compensation insurance. Some policies will also include dividends or refunds that may impact the costs. Each of the steps and its special terminology will be explained in depth in the this section.

- STEP 1. Review classification codes and calculate the manual premium
- STEP 2. Adjust the manual premium for experience rating or merit rating
- STEP 3. Adjust the manual premium for schedule rating credit
- STEP 4. Adjust the manual premium for premium credits
- STEP 5. Adjust the manual premium for premium discounts
- STEP 6. Add the expense constant
- STEP 7. Calculate the final audited premium.
- STEP 8. Subtract dividends (or refunds).

Once the insurance company completes Steps 1 through 6, the business is billed for an estimated annual premium based on the estimated amount of payroll for the upcoming policy period. Generally, the business will pay a deposit of not more than \$2,500 or 25 percent of the estimated annual premium, whichever is greater. The rest of the premium is billed on a monthly, quarterly or semi-annual basis. STEPS 7 and 8 come after the end of the policy period.

STEP 1. REVIEW CLASSIFICATION CODES AND CALCULATE THE MANUAL PREMIUM

To set rates, workers' compensation insurance companies divide business activities into more than 400 different classifications, based on the principal duties involved. Each classification has its own rate of coverage, so the overall rate for a given policy will be a combination of rates for all employees in all classifications. All insurers use basically the same set of classification categories and occupations descriptions.

The employer and his/her insurance agent together determine the classifications that fit the specific business. Each employer must pay close attention to this aspect of the policy since the classifications used to calculate the premium are so critical in determining the ultimate cost of the policy. The carrier has the final word on how the policy is classified.

The employer should do the following:

- Insist that the workforce be accurately and fairly classified.
- Look over the list of classifications, which should be provided by the agent.
- Read the classification descriptions.
- Make sure the classifications fit the employees appropriately. Many carriers are willing to develop special class codes to reflect changes in technology and the workplace. The carrier may be contacted regarding its willingness to develop new codes.
- Obtain copies of the codes for company record keeping.

The few minutes a company official spends reading and understanding the classifications could save thousands of dollars on the cost of the premium.

Once the classifications are settled, the company and its agent estimate what the class-by-class payroll will be during the policy period. The estimated payroll in each class is multiplied by the rate for that class. This rate is referred to as the manual rate. The total for all classifications is your estimated annual manual premium. It functions as the starting point in calculating the premium cost.

The payroll can be divided for employees who perform work that falls into more than one classification if the company keeps detailed records. This can result in a savings on the manual premium. Most carriers will have specific guidelines and formats for dividing the payroll; the insurance agent should provide the details upon request. Also, there are three codes referred to as standard exceptions that cannot be split. They

are codes 8810 (clerical), 8742 (outside sales) and 7380 (drivers).

STEP 2. ADJUST THE MANUAL PREMIUM FOR EXPERIENCE RATING OR MERIT RATING

Experience rating is an essential building block for determining a policyholder's final premium. This step takes into account the company's safety record and allows the carrier to use the firm's actual performance to determine the amount of its policy. Each insurance company has its own experience rating formula or merit rating plan.

When computing a company's estimated premium for the coming year, an insurance carrier uses the loss experience for the three years preceding the most recent year. For instance, a 2005 policy will be based on the company's experience for 2001, 2002 and 2003. A 2006 policy will be based on 2002, 2003 and 2004.

If a firm's actual losses in the three-year rating period were lower than the expected statewide average for its classifications, the premium will be adjusted downward. If the losses were higher than average for the classifications, its premium will increase.

The exact amount of upward or downward adjustment is very subjective, based on the carrier's own formula. Differences in these formulas can sometimes cause substantial differences in the premiums a company is quoted. Thus, the same loss history can result in a different experience modification rating factor, depending on which insurance company is doing the calculating.

Most insurance carriers use an alternate formula for employers with smaller premiums. It is called a merit rating plan and is based on a more generic small business formula. For instance, an insurance company may use a merit rating plan for customers whose annual premiums are between \$1,000 and \$5,000 but use its experience rating formula for premiums above \$5,000. Merit rating plans are usually more beneficial for small employers.

STEP 3. ADJUST THE MANUAL PREMIUM FOR SCHEDULE RATING CREDIT

Carriers have the option of offering additional credits to select clients. One of these credits is known as a schedule rating credit and is offered strictly at the discretion of the carrier. The same holds true for the premium credit programs. These credits are figured after the carrier adjusts the manual premium to reflect a firm's specific loss history. The schedule rating credit can be up to 25 percent, and many carriers offer up to an additional 25 percent premium credit.

Schedule rating takes into account a business' characteristics, such as recent loss-control efforts and management practices that the insurance company believes can make a difference in reducing future losses. Schedule rating is subjective. Insurance companies use the flexibility of schedule rating discounts to attract or retain favored customers.

Employers should ask their insurance carriers if they could qualify for a schedule credit now or in the future. Employers should also ask for written documentation on the program.

STEP 4. ADJUST THE MANUAL PREMIUM FOR PREMIUM CREDIT

Premium credit plans are sometimes known by other names such as a work-safe safety program or cost-control program. It is important to note that this is not the same as a premium discount. Some of the criteria used for these programs include having pre-employment drug screening, a return-to-work program, use of a designated health care provider and an employee assistance program. Again, employers should ask for documentation on the carrier's program.

STEP 5. ADJUST THE MANUAL PREMIUM FOR PREMIUM DISCOUNT

The premium discount—not to be confused with the premium credit described in Step 4—is a non-negotiable, volume discount established by the insurance carrier. Each carrier’s manual rate includes allowances for administrative expenses. Since some expenses do not increase as premiums increase, insurers sometimes reduce large premiums by taking out some of these administrative charges, thus the premium discount. The allowed discount increases with the size of the premium. These premium discounts are not discretionary.

STEP 6. ADD THE EXPENSE CONSTANT

The expense constant is a charge added to every premium to cover certain expenses common to all workers’ compensation policies, regardless of the premium size. These include such things as auditing expenses and issuing and recording policies. This is a different factor than what is built into the basic manual rate to cover certain other administrative costs. Today, most companies’ expense constants range from \$150 to \$300.

STEP 7. CALCULATE THE FINAL AUDITED PREMIUM

After a firm’s policy has expired, it may be subject to further adjustments, either up or down. Since the manual premium is based on anticipated payroll, the insurance company can now audit the client’s actual payroll to determine how accurate that estimate was. The final audited premium will be based on the actual payroll. Classification codes may also be changed at audit.

If the company owes additional premium, it has at least 30 days from the date of notice to pay. If the insurer owes a refund, it must pay it within 60 days of the completed audit.

More information on refunds is provided in this booklet under the section titled *Your Rights Regarding Workers’ Compensation*—page 6.

STEP 8. SUBTRACT DIVIDENDS (OR REFUNDS)

The final cost of a workers’ compensation policy may be reduced even further if the carrier issues a dividend. A dividend is a refund of surplus profit and is paid after the close of the policy period. The amount of a dividend is decided by an insurance company’s board of directors. In recent years, dividends have been averaging approximately 10 percent of the premium. Under Michigan law, however, dividend amounts may not be guaranteed or even estimated at the time a dividend plan policy is sold. Also, dividends may not be held back if the firm changed carriers.

Before 1983 when all workers’ compensation insurance companies used the same rates, carriers competed for business primarily on the basis of their dividend plans. The open competition rating law has led to a greater emphasis on the front-end price of a policy and reduced the use of dividend plans to lure and keep customers.

Some employers prefer the more certain up-front savings that a low initial rate offers to the less predictable savings of a dividend plan because of the obvious cash-flow advantages of a policy with a lower initial price.

WORKSHEET FOR CALCULATING YOUR WORKERS' COMPENSATION INSURANCE PREMIUM

[SAMPLE CALCULATION]

1. To calculate the manual premium, first enter up to 5 Class Codes. Determine the proper codes with your insurance agent or carrier. A classification code manual may be found at <http://www.caom.com>
 - Enter payroll for all workers that fit each separate class code.
 - Payroll is divided by 100 because rates are charged per \$100 of payroll.
 - Enter manual rates for each code. Obtain code from agent or carrier. Prices vary among 300 Michigan insurance carriers.
 - Multiply the divided payroll by the manual rates and show the subtotals for each.
 - Add all subtotals for the manual premium.

2. Adjust for experience rating by multiplying the manual premium from Step 1 with the experience modification factor (mod factor). Consult the MI Experience Rating Form or consult with the agent or carrier regarding the mod factor. A company with an alternative merit rating should enter it here. Merit ratings usually apply to smaller businesses.

3. Adjust for the schedule rating credit by multiplying the adjusted manual premium with the schedule rating credit. A Schedule Rating may be a credit of up to 25% and, in some cases, may be a debit adjustment. A credit (or debit) reflects an employer's loss history, loss control efforts, and overall management practices that impact claims. Employers should consult with the agent or carrier regarding the criteria for the credit.

4. Adjust for the premium credit by multiplying the adjusted manual premium with the premium credit. Some insurance carriers offer a discretionary premium credit to reward an employer's loss control efforts and work-safety efforts. The credit may target specific programs like drug screening, return-to-work, designated physician and others. Employers should check with the agent or carrier regarding the availability of and criteria for a premium credit.

5. Adjust for the premium discount. The premium discount—not to be confused with the premium credit—comes from a table, is not negotiable, and is actually a volume discount. Usually an initial portion of the premium is not discounted. Employers must contact the agent or carrier regarding the premium discount schedule.

6. Add the expense constant, an administrative fee charged by the insurance carrier, to the adjusted manual premium. The agent or carrier can report the expense constant amount to the policyholder.

7. This is the estimated annual premium.

8. Final premium adjustments from payroll audits or dividends should be discussed with the agent or carrier.

1. CALCULATE THE MANUAL PREMIUM (Estimated annual payroll class codes x manual rate)

Est. Annual Codes	Payroll	Divide by \$100	x Manual Rates	Subtotals
3628	\$500,000	/\$100= \$5000	x 3.64	= \$18,200
8742	\$65,000	/\$100= \$650	x 0.80	= + \$520
8810	\$185,000	/\$100= \$1,850	x 0.41	= + \$759
				= +
				= +
Calculate the MANUAL PREMIUM				= \$19,479

2. ADJUST FOR EXPERIENCE RATING

Enter the **EXPERIENCE MODIFICATION FACTOR**

x 0.90

Calculate the **ADJUSTED MANUAL PREMIUM**

= \$17,531

3. ADJUST THE MANUAL PREMIUM FOR SCHEDULE RATING CREDIT (If any)

Enter the **SCHEDULE RATING CREDIT**(100% - Credit%)

x 0.95

Calculate the **ADJUSTED MANUAL PREMIUM**

= \$16,655

4. ADJUST THE MANUAL PREMIUM FOR PREMIUM CREDIT (If any)

Enter the **PREMIUM CREDIT** (100% - Credit %)

x 0.90

Calculate the **ADJUSTED MANUAL PREMIUM**

= \$14,990

5. REDUCE BY PREMIUM DISCOUNT

Enter the **PREMIUM NOT SUBJECT TO DISCOUNT**

- \$5,000

Calculate the **SUBTOTAL**

= \$9,990

Enter the **DISCOUNT** (100% - Discount %)

x 0.905

Calculate the **ADJUSTED MANUAL PREMIUM**

= \$9,041

Enter the **PREMIUM NOT SUBJECT TO DISCOUNT**

+ \$5,000

Calculate the **ADJUSTED MANUAL PREMIUM**

= \$14,041

6. ADD THE EXPENSE CONSTANT

Enter the **EXPENSE CONSTANT**

+ 150

Calculate the **ESTIMATED ANNUAL PREMIUM**

= \$14,191

7. CALCULATE FINAL AUDITED PREMIUM (Following a payroll audit after close of policy)

8. SUBTRACT DIVIDENDS (OR REFUNDS) (Should be discussed with agent or carrier)

WORKSHEET FOR CALCULATING YOUR WORKERS' COMPENSATION INSURANCE PREMIUM

- To calculate the manual premium, first enter up to 5 Class Codes. Determine the proper codes with your insurance agent or carrier. A classification code manual may be found at <http://www.caom.com>
 - Enter payroll for all workers that fit each separate class code.
 - Payroll is divided by 100 because rates are charged per \$100 of payroll.
 - Enter manual rates for each code. Obtain code from agent or carrier. Prices vary among 300 Michigan insurance carriers.
 - Multiply the divided payroll by the manual rates and show the subtotals for each.
 - Add all subtotals for the manual premium.

- Adjust for experience rating by multiplying the manual premium from Step 1 with the experience modification factor (mod factor). Consult the MI Experience Rating Form or consult with the agent or carrier regarding the mod factor. A company with an alternative merit rating should enter it here. Merit ratings usually apply to smaller businesses.

- Adjust for the schedule rating credit by multiplying the adjusted manual premium with the schedule rating credit. A Schedule Rating may be a credit of up to 25% and, in some cases, may be a debit adjustment. A credit (or debit) reflects an employer's loss history, loss control efforts, and overall management practices that impact claims. Employers should consult with the agent or carrier regarding the criteria for the credit.

- Adjust for the premium credit by multiplying the adjusted manual premium with the premium credit. Some insurance carriers offer a discretionary premium credit to reward an employer's loss control efforts and work-safety efforts. The credit may target specific programs like drug screening, return-to-work, designated physician and others. Employers should check with the agent or carrier regarding the availability of and criteria for a premium credit.

- Adjust for the premium discount. The premium discount—not to be confused with the premium credit—comes from a table, is not negotiable, and is actually a volume discount. Usually an initial portion of the premium is not discounted. Employers must contact the agent or carrier regarding the premium discount schedule.

- Add the expense constant, an administrative fee charged by the insurance carrier, to the adjusted manual premium. The agent or carrier can report the expense constant amount to the policyholder.

7. This is the estimated annual premium.

- Final premium adjustments from payroll audits or dividends should be discussed with the agent or carrier.

1. CALCULATE THE MANUAL PREMIUM (Estimated annual payroll class codes x manual rate)				
Est. Annual Codes	Payroll	Divide by \$100	x Manual Rates	Subtotals
_____	_____	/\$100=_____	x _____	= _____
_____	_____	/\$100=_____	x _____	= + _____
_____	_____	/\$100=_____	x _____	= + _____
_____	_____	/\$100=_____	x _____	= + _____
_____	_____	/\$100=_____	x _____	= + _____
Calculate the MANUAL PREMIUM				= _____

2. ADJUST FOR EXPERIENCE RATING	
Enter the EXPERIENCE MODIFICATION FACTOR	X _____
Calculate the ADJUSTED MANUAL PREMIUM	= _____

3. ADJUST THE MANUAL PREMIUM FOR SCHEDULE RATING CREDIT (If any)	
Enter the SCHEDULE RATING CREDIT (100% - Credit%)	X _____
Calculate the ADJUSTED MANUAL PREMIUM	= _____

4. ADJUST THE MANUAL PREMIUM FOR PREMIUM CREDIT (If any)	
Enter the PREMIUM CREDIT (100% - Credit %)	X _____
Calculate the ADJUSTED MANUAL PREMIUM	= _____

5. REDUCE BY PREMIUM DISCOUNT	
Enter the PREMIUM NOT SUBJECT TO DISCOUNT	- _____
Calculate the SUBTOTAL	= _____
Enter the DISCOUNT (100% - Discount %)	X _____
Calculate the ADJUSTED MANUAL PREMIUM	= _____
Enter the PREMIUM NOT SUBJECT TO DISCOUNT	+ _____
Calculate the ADJUSTED MANUAL PREMIUM	= _____

6. ADD THE EXPENSE CONSTANT	
Enter the EXPENSE CONSTANT	+ _____
Calculate the ESTIMATED ANNUAL PREMIUM	= _____

7. CALCULATE FINAL AUDITED PREMIUM (Following a payroll audit after close of policy)

8. SUBTRACT DIVIDENDS (OR REFUNDS) (Should be discussed with agent or carrier)