STATE OF FLORIDA
DIVISION OF ADMINISTRATIVE HEARINGS

STATE FARM FLORIDA INSURANCE COMPANY,	)	
Petitioner,	)	
vs.	)	Case No. 08-4916
OFFICE OF INSURANCE REGULATION,	)	
Respondent.	)	

RECOMMENDED ORDER

Administrative Law Judge (ALJ) Daniel Manry conducted the final hearing of this case for the Division of Administrative Hearings (DOAH) on October 27 through 30, 2008, in Tallahassee, Florida.

APPEARANCES

For Petitioner: Cynthia S. Tunnicliff, Esquire
Brian A. Newman, Esquire
Pennington, Moore, Wilkinson,
Bell & Dunbar, P.A.
215 South Monroe Street, Second Floor
Post Office Box 10095
Tallahassee, Florida 32302-2095

C. Ryan Reetz, Esquire
Mia B. Fraser, Esquire
Squire, Sanders & Dempsey, LLP
200 South Biscayne Boulevard, Suite 4000
Miami, Florida 33131

Vincent J. Rio, Esquire
State Farm Insurance Companies
One State Farm Plaza, A-3
Bloomington, Illinois 61701-4300

For Respondent: S. Marc Herskovitz, Esquire
Elenita Gomez, Esquire
Office of Insurance Regulation
Legal Services Office
200 East Gaines Street
Tallahassee, Florida 32399-0333

STATEMENT OF THE ISSUE

The issue is whether Petitioner has shown by a preponderance of the evidence that an indicated rate increase of 67.0 percent, or, in the alternative, a requested rate increase of 47.1 percent, is not excessive, inadequate, or unfairly discriminatory within the meaning of Subsections 627.062(2)(b), paragraphs 1, 2, 5, 8, 10 through 12, and 14; 627.062(2)(e), paragraphs 1, 3, 6, and 10; 627.062(2)(j); 627.0628; 627.0629; and 627.06291, Florida Statutes (2008).[1]

PRELIMINARY STATEMENT

On July 16, 2008, Petitioner filed a request for rate increase with Respondent. By letter dated August 25, 2008, Respondent issued a Notice of Intent to Disapprove the rate request (the Notice of Intent). Petitioner timely requested an administrative hearing, and, on October 2, 2008, Respondent referred the dispute to DOAH to conduct the hearing.

At the hearing, Petitioner presented the testimony of seven witnesses, submitted 34 exhibits for admission into evidence, and re-called one witness in rebuttal. Respondent called one witness and submitted 32 exhibits.

The identity of the witnesses and exhibits and the rulings regarding each are reported in the seven-volume Transcript filed with DOAH on November 12, 2008. The ALJ gave the parties eight days after the date the Transcript was filed with DOAH to file their respective proposed recommended orders (PROs). The parties agreed to add the eight days they needed for preparation of their PROs to the statutory requirement for a recommended order no later than 30 days after the filing of the Transcript. The parties timely filed their respective PROs on November 20, 2008, and this Recommended Order must be issued no later than December 20, 2008.

FINDINGS OF FACT

1. The petitioner is State Farm Florida Insurance Company (State Farm Florida). Respondent is the state agency responsible for regulating insurance rates in the state.

2. State Farm Florida is a wholly-owned subsidiary of State Farm Mutual Automobile Company (State Farm Mutual). State Farm Mutual is the parent company of four wholly-owned subsidiaries. The four siblings are State Farm Florida; State Farm Fire and Casualty (Fire & Casualty); State Farm Lloyds, Inc. (Lloyds); and State Farm General Insurance Company (General). The parent and siblings are an affiliated group, for purposes of federal and state income taxes, and file a consolidated tax return.

3. State Farm Mutual writes property and casualty insurance, including homeowners insurance, through Fire & Casualty in 47 states. In Florida, Texas, and California, State Farm Mutual conducts the business of insurance through State Farm Florida, Lloyds, and General, respectively.

4. State Farm Florida filed a request for a rate increase of 47.1 percent (the requested rate). The request is a "rate filing" defined in Subsection 627.0621(1)(a). The rate filing is intended to be effective for new business on December 1, 2008, and for renewals on March 1, 2009.

5. The rate filing indicates that a rate increase of 67.6 percent is the actual rate indicated by the documentation in the rate filing (the indicated rate). However, State Farm Florida reduced the indicated rate during the administrative hearing to 67.0 percent to reflect approximately 7,000 policies that State Farm Florida renewed without wind coverage, so-called "ex-winded" policies. State Farm Florida reduced the indicated rate from 67.0 percent to the requested rate of 47.1 percent in an effort to obtain quick approval of the rate filing because State Farm Florida is allegedly, "Losing money every day."

6. The Notice of Intent states the grounds for denying the rate filing in 23 numbered paragraphs. Respondent dismissed the grounds stated in paragraph number 14. The Findings of Fact refer to the original numbers in the Notice of Intent but

address only paragraphs numbered 1 through 13 and 15 through 23. This Recommended Order makes no further reference to the grounds stated in paragraph number 14 of the Notice of Intent.

7. The Notice of Intent and the grounds stated therein constitute proposed agency action. This Recommended Order constitutes recommended agency action. Neither form of agency action may go beyond the powers, functions, and duties delegated by the Legislature in Chapter 627 without constituting an invalid exercise of delegated legislative authority defined in Subsection 120.52(8).[2] To that end, the ALJ required the witness for Respondent to identify the statutory authority that Respondent relies on for each numbered ground in the Notice of Intent. The ALJ also required each witness for Petitioner to specify the paragraph number of the ground in the Notice of Intent which his or her testimony addressed.

8. The Notice of Intent relies on Sections 627.062, 627.0628, 627.0629, and 627.06291 as statutory authority for the numbered grounds in the Notice of Intent. Each ground and the corresponding statutory authority is listed as follows:

Ground	Statutory Authority
1	§§ 627.062(2)(b)8., 627.0628, 627.0629, and 627.06291;
2	§ 627.062(2)(b)8.;
3	§ 627.062(2)(b)11. and 12.;

4-5 § 627.062(2)(b)11.;

6-8 § 627.062(2)(b)12.;

9-11 § 627.062(2)(b)2.;

12 § 627.062(2)(b)11.;

13 § 627.062(2)(b)2.;

15-16 § 627.062(2)(b)2.;

17 § 627.062(2)(b)10. and 11.;

18 § 627.062(2)(e)1.-3. and 10.;

19 § 627.062(2)(b)8.;

20 § 627.062(2)(b)5.;

21 § 627.062(2)(b)8. and 11.;

22 § 627.062(2)(b) and (2)(e)6.; and

23 § 627.062(2)(j).

9. Respondent has not determined that the rate filing is excessive, inadequate, or unfairly discriminatory within the meaning of Subsection 627.062(1). Rather, Respondent proposes final agency action determining that the information provided by State Farm Florida is insufficient for Respondent to independently determine whether either the indicated or requested rate in the rate filing is excessive, inadequate, or unfairly discriminatory.

10. Respondent asserts that the fact-finder's determination of the sufficiency of the evidence submitted by State Farm Florida is limited to the information that State Farm

Florida submitted with the initial filing. Respondent claims that the fact-finder may not rely on any information submitted by State Farm Florida during the final hearing if that information was not submitted with the initial filing. Respondent relies on the statutory requirement in Subsection 627.062(9)(a) for an insurer to certify, in relevant part, that the initial rate filing does not omit any material fact and fairly presents in all material respects the basis for the rate filing.

11. The ALJ rejects the agency's conclusion that the certification requirement in Subsection 627.062(9)(a) limits the evidence in the final hearing to the information that State Farm Florida submitted with the initial rate filing. Neither the Legislature nor Respondent has promulgated any explicit standards that prescribe the information that must be included in a rate filing. Other reasons for rejecting the agency's proposed interpretation of Subsection 627.062(9)(a) are discussed in the Conclusions of Law.

12. The fact-finder has weighed all of the evidence admitted during the final hearing, including information submitted after the initial filing (post-filing evidence). The Findings of Fact are based on evidence of circumstances as they existed through the conclusion of the final hearing.

13. A brief discussion of the history preceding the current rate filing provides context for this proceeding. State Farm Mutual incorporated State Farm Florida in 1998 with an initial capitalization of $607,500,000.00. The hurricanes of 2004 wiped out the surplus of State Farm Florida. In 2004, State Farm Mutual recapitalized State Farm Florida with a loan of $750,000,000.00 so that State Farm Florida could continue doing business in Florida.

14. State Farm Florida obtained an approval from Respondent for a prior rate filing of 52.7 percent. The rate increase became effective November 1, 2006.

15. In November and December 2006, premiums on renewals increased significantly. Beginning sometime in the middle of 2007, average premium began to decline.

16. The direct written premium for State Farm Florida that had been $1,889.00 in November and December 2006 declined to $1,350.00. In the first quarter of 2008 and the third quarter of 2008, direct written premium rose slightly to $1,399.00.

17. The decline in premium revenues is the moving force behind the current rate filing. The Legislature has found in Subsection 627.062(2)(e)3. that rates are inadequate if they are insufficient, together with investment income attributable to them, to sustain projected losses and expenses in the class of business to which the rates apply.

18. The reasons for the reduction in premium revenue are undisputed. State Farm Florida has non-renewed some policies; excluded wind from the covered risk of other policies, a process described by the parties as ex-winding; provided discounts to policyholders who improved covered property with wind-mitigation features identified in Subsection 627.0629(1), identified by the parties as wind-mitigation discounts; and allegedly incurred an increase in costs, not the least of which is the cost of reinsurance for excess losses.

19. State Farm Florida asserts that the decline in premium revenue caused by non-renewals, ex-winding, wind-mitigation discounts, and increased costs such as the cost of reinsurance justifies a rate increase equal to the indicated rate of 67.0 percent or the requested rate of 47.1 percent. The Legislature requires, in Subsection 627.062(2)(g), Petitioner to show by a preponderance of the evidence that either the indicated or requested rate is not excessive, inadequate, or unfairly discriminatory.

20. The fact-finder is unable to determine from a preponderance of the evidence that the indicated and requested rates are not excessive, inadequate, or unfairly discriminatory. This is not a finding that the indicated and requested rates are excessive, inadequate, or unfairly discriminatory. Rather, the evidence of circumstances as they existed through the final

hearing is either variable or ambiguous, and therefore neither credible nor persuasive to the fact-finder; or the evidence is insufficient for the fact-finder to make the findings statutorily required to approve either the indicated or requested rate.

21. A preponderance of the evidence does show that State Farm Florida determined the factors used in the rate filing in a manner that is consistent with standard actuarial techniques or practices and that those factors are based on reasonable actuarial judgment within the meaning of Subsection 627.0612(2)(a). However, a finding of actuarial reasonableness does not end the inquiry. The principal purpose of statutory review is to facilitate an independent determination of whether indicated or requested rates which are formulated in accordance with standard actuarial techniques are nevertheless excessive, inadequate, or unfairly discriminatory.

22. Several evidential issues of credibility or insufficiency prevent the fact-finder from determining from a preponderance of the evidence that the indicated and requested rates are not excessive, inadequate, or unfairly discriminatory. The relevant evidential issues are discussed in paragraphs 23 through 65.

23. Non-renewal of policies by State Farm Florida is one reason for a decline in premium revenue. State Farm Florida is

voluntarily limiting new property insurance business in the state to in-state transfers of business to inland locations (transfer business).

24. The fact-finder is unable to determine from a preponderance of the evidence whether the portion of the indicated or requested rate which is attributable to transfer business is excessive or reasonable. State Farm Florida has not quantified the number of policyholders that the transfer business entails.

25. For one year, beginning in March 2008, State Farm Florida will decline to renew (non-renew) policyholders. State Farm Florida will also ex-wind renewed policies.

26. The fact-finder is unable to determine from a preponderance of the evidence whether the portions of the indicated or requested rates which are attributable to non-renewal and ex-winding is excessive or reasonable. Evidence of the number of non-renewed and ex-winded policies is ambiguous. After Petitioner submitted the rate filing, the number of non-renewed and ex-winded policies increased from 50,000 to 85,000 through the administrative hearing. Such variability in the evidence is neither credible nor persuasive to the fact-finder.

27. The number of non-renewals and ex-winded policies is important because much of the requested rate increase is based upon forecasts of lower direct written premium. Fewer

policyholders and less coverage will naturally generate lower premium.

28. Another "significant contributing factor to the indicated rate need" is the number of policyholders receiving wind-mitigation discounts. Petitioner asserts that wind-mitigation discounts are greater than loss outputs.

29. The fact-finder is unable to determine from a preponderance of the evidence the amount of wind-mitigation discounts. The cross-examination of rebuttal testimony offered by State Farm Florida illustrates the evidential ambiguity.

> Q. Where in the filing or supplemental materials can I find that the discounts are greater than the loss output?
>
> A. Exhibit 5 develops the savings associated with the wind-mitigation discounts. They are part of our projected hurricane losses, and the premium savings are part of our projected premiums that were outlined in Exhibit 2.
>
> Q. Can I find them stated separately, or you are saying they are part of this exhibit and part of the other exhibit you mentioned?
>
> A. State separately?
>
> Q. That the discounts are greater than the losses. Can you show me a place where the discounts are greater?
>
> A. There is not a specific statement that says that. It does not say that premium – our premium decline is due to – it discusses several things with regard to wind mitigation discounts. . . . It is implied in the statement that premium is declining

> due to application of the mitigation discounts. If the reduction in losses were equivalent to the decline in premium, there wouldn't be a need to increase the premiums to reflect the fact that the savings do not match those discounts.

Transcript (TR) at 828-829.

30. As with non-renewals, evidence of the number of policyholders receiving wind-mitigation discounts and the dollar amount of the discounts is variable and less than credible and persuasive to the fact-finder.[3] Although State Farm Florida identified wind-mitigation discounts as the "primary cause of reduction in premium per policy," the evidence does not credibly quantify the discounts.

31. The fact-finder is unable to determine from a preponderance of the evidence whether the rate filing is based on a calculation of wind-mitigation for premiums that is different than the calculation of wind-mitigation discounts for losses. Wind-mitigation discounts must be equal for premiums and losses to avoid being unfairly discriminatory. State Farm Florida gives a discount of 65.0 percent for the hurricane portion of the premium but realizes only a 28.0 percent savings. State Farm Florida may be recovering what it claims to be losing on the wind-mitigation discounts by charging all policyholders equally even though a significantly larger portion of those policyholders do not qualify for the wind-mitigation discounts.

To raise rates for all policyholders may negate the savings the discounts were intended to create.

32. By Consent Order dated September 9, 2008, State Farm Florida conceded that it had failed to implement necessary procedures to comply with statutory and administrative rule requirements. State Farm Florida implemented refunds and credits to 98,000 current and former policyholders in the amount of $120 million and paid an additional $1.02 million to the Regulatory Trust Fund.

33. The fact-finder cannot determine from a preponderance of the evidence whether the cost of reinsurance is reasonable or excessive within the meaning of Subsection 627.0612(2)(c). State Farm Florida purchased reinsurance coverage for a probable maximum loss (PML) equal to the difference between $9.25 billion and a retained risk by State Farm Florida of $175 million.

34. Non-renewals, ex-winded policies, and loss savings from wind-mitigation improvements to covered property decreased the PML to $7.1 billion. However, State Farm Florida increased the amount of catastrophe reinsurance that it purchased to cover PML from $7.4 billion in the previous rate filing to $9.25 billion in the current rate filing. State Farm Florida is paying a significant portion of the PML premium to its parent, State Farm Mutual.

35. State Farm Florida retained approximately $175 million of the $9.25 billion in PML. State Farm Florida purchased reinsurance coverage for the remainder of the PML from State Farm Mutual, other private re-insurers, the Florida Hurricane Catastrophe Fund (the Cat Fund), and the temporary increase in coverage limit (TICL).[4]

36. State Farm Florida also paid State Farm Mutual $12.8 million for a credit risk provision. The credit risk provision will pay losses that the Cat Fund is contracted to pay but may be unable to pay.

37. The Cat Fund announced in October 2008 that it anticipated a bonding shortfall of $14.5 billion in the event the Cat Fund were called upon to pay all of its reinsurance obligations. State Farm Florida would receive only one-half of the reinsurance coverage it purchased from the Cat Fund in the event of a $14.5 billion bonding shortfall.

38. State Farm Florida paid $842 million for reinsurance coverage. State Farm Florida paid $142 million for reinsurance coverage from the Cat Fund and TICL layer provided by the state and paid approximately $700 million for reinsurance coverage by private re-insurers, including State Farm Mutual.[5]

39. Of the total $700 million paid to private re-insurers, State Farm Florida paid approximately $151 million to private

re-insurers other than State Farm Mutual. State Farm Florida paid $549 million to its parent company, State Farm Mutual.

40. It is undisputed that the $151 million State Farm Florida paid to private re-insurers other than State Farm Mutual is reasonable. Payments to unrelated private re-insurers represent arms-length transactions between a willing buyer and willing seller of reinsurance coverage. However, the fact-finder is unable to determine from a preponderance of the evidence whether either the cost of reinsurance purchased from State Farm Mutual or the cost of the credit risk provision purchased from State Farm Mutual is excessive or reasonable within the meaning of Subsection 627.0612(2)(c).

41. The economic reality is that State Farm Florida is merely the legal form in which State Farm Mutual chooses to do business in Florida. State Farm Mutual and its wholly-owned subsidiaries, including State Farm Florida, comprise a "group or combination" that the Legislature defines as a "person" in Subsection 1.01(3) or a joint underwriting association defined as a person in Section 624.04 (See 1976 Fla. Atty. Gen, Lexis 130).

42. Transactions between State Farm Mutual and State Farm Florida for reinsurance and credit risk provisions totaling approximately $561.8 million, when viewed in the light of economic reality, Subsection 1.01(3), or Section 624.04, may be

transactions which State Farm Mutual engages in with itself and which lack any independent economic significance.[6] Transactions with no independent economic significance would be sham transactions which may distort the economic costs of the reinsurance and credit risk provisions purchased from State Farm Mutual. Such economic distortions may enable the group to derive a rate advantage from the legal form in which State Farm Mutual chooses to do business in Florida.[7]

43. The reinsurance and credit risk provision which State Farm Florida purchased from State Farm Mutual for approximately $561.8 million may be the economic equivalent of a retained risk amount by State Farm Mutual or the group. The fact-finder cannot determine from a preponderance of the evidence whether the economic cost attributable to a retained risk by State Farm Mutual or the group is more or less than the amount State Farm Mutual charged State Farm Florida for the reinsurance and credit risk coverages.

44. Even if State Farm Florida and State Farm Mutual were distinct persons, State Farm Florida exists for the convenience of State Farm Mutual. State Farm Mutual conducted business in Florida, either directly or through some other member of the group, before State Farm Florida emerged from State Farm Mutual in 1998 with an initial capitalization of $607,500,000.00. State Farm Mutual re-capitalized State Farm Florida with

$750,000,000.00 in loans after the 2004 hurricane season. State Farm Mutual owns all of the stock of State Farm Florida. There is no economic, or legal, impediment to State Farm Mutual liquidating State Farm Florida at the convenience of State Farm Mutual and doing business in Florida as it did before it created State Farm Florida in 1998.

45. State Farm Mutual has sustained an annual loss from the reinsurance sold to State Farm Florida from 1998 through 2007. State Farm Mutual can easily end the losses, as well as the costs to State Farm Florida, by liquidating State Farm Florida and doing business in Florida directly.

46. Issues of variability, ambiguity, and credibility pertaining to the reasonableness of the cost of reinsurance is illustrated in testimony during cross-examination of one of the witnesses for State Farm Florida.

> Q. Am I assuming correctly, then, that, I mean, it's described on the page. But is there something in this page that indicates to you that it's a reasonable coverage limit, other than it's there?
>
> A. It would be other than that it's there, and State Farm [Florida] has chosen that level as a limit that they deem to be reasonable.
>
> Q. Okay. So your opinion that it's a reasonable coverage limit is informed by State Farm [Florida] believing it's a reasonable coverage limit?
>
> A. I suppose that's the way to say it, yes.

> Q. You don't have any independent reason to think it's either reasonable or unreasonable, other than State Farm [Florida] has it on the page that describes it such as it is?
>
> A. I would say that's correct.

TR at 555-556.

47. Another issue of variability, ambiguity, and credibility emerges from the hurricane models used by State Farm Mutual to project PML. State Farm Florida used hurricane models identified in the record as WORLDCAT™, RISKLINK™ and CLASIC™/2 to project both hurricane losses and PML.[8] Each model is approved by the Florida Commission on Hurricane Loss Projection Methodology (the Commission) pursuant to Section 627.0628. However, State Farm Florida projected hurricane losses using storm sets identified in the record as "cold water" or "long term" storm sets and projected PML using storm sets identified in the record as "warm water" or "short term" storm sets.

48. It is undisputed that the use of warm water storm sets increases the estimated storm frequency and risk. For example, State Farm Florida justified the requested rate of 47.1 percent, in relevant part, by using cold water storm sets to reduce stated PML by approximately $1.65 billion.

49. State Farm Florida utilized three hypothetical adjustments to reduce the indicated rate of 67.0 percent to the requested rate of 47.1 percent. First, State Farm Florida

calculated the impact on the cost of private reinsurance, including that provided by State Farm Mutual, based on the non-renewal and ex-winding activity. That adjustment reduced PML from $9.25 billion to $7.8 billion. Wind-mitigation discounts reduced PML another $700 million to $7.1 billion. The use of cold water, or long term, storm sets to project PML reduced PML another $1.65 billion to $5.45 billion.

50. State Farm Florida is actually purchasing $9.25 billion in re-insurance coverage, less the retained risk by State Farm Florida in the amount of $175 million. If the actual cost of private reinsurance were to justify an indicated rate of 67.0 percent, a requested rate of 47.1 percent would appear to be inadequate, and State Farm Florida would soon return with an additional rate filing.

51. State Farm Florida argues that the use of warm water, or short term, storm sets to determine the actual PML of $9.25 billion is appropriate. The evidence is clear that the global reinsurance market demands and uses warm water models to evaluate risk and to price reinsurance. Warm water storm sets may be the gold standard for re-insurers, but it is also axiomatic that use of the gold standard increases the price of re-insurance and the resulting profit to re-insurers. A preponderance of the evidence does not enable the fact-finder to independently determine that the use of warm water storm sets to

project PML is not excessive, inadequate, or unfairly discriminatory.

52. The issue of whether Florida is in a warm water cycle or cold water cycle is not resolved by a preponderance of the evidence. Moreover, State Farm Florida did not provide Respondent with the near term frequency storm set used by State Farm Florida to project PML. Respondent could not independently evaluate the storm sets utilized by State Farm Florida.

53. State Farm Florida argues, in relevant part, that the use of warm water models to estimate PML is justified because the Commission has previously evaluated hurricane models for the sole purpose of estimating hurricane losses, has never evaluated hurricane models for the purpose estimating PML, and legislative authority in Subsection 627.0628(3)(b) for the Commission to evaluate hurricane models used to project PML was not enacted until July 1, 2008.

54. Respondent has a different statutory interpretation. Respondent interprets its legislative authority to mean that the absence of the Commission's approval of a warm water model to project hurricane losses requires State Farm Florida to use cold water, or long term, storm sets to project PML.

55. Any doubt as to an agency's statutory authority to act in a manner that accepts warm water storm sets to project PML should be resolved in favor of refusing to exercise the

questionable authority. Moreover, the use of storm sets in hurricane models is a matter within the substantive expertise of Respondent. A statutory interpretation involving a matter within an agency's substantive expertise is entitled to great deference when, as in this proceeding, the agency explicates in the record reasons for such deference.

56. State Farm Florida includes an overall rate of return of 12.2 percent in the rate filing. The fact-finder is unable to determine from a preponderance of the evidence whether the factor used by State Farm Florida for underwriting profit and contingency is reasonable or excessive within the meaning of Subsection 627.0612(2)(b).

57. The Legislature gave the fact-finder authority in Subsection 627.0612(2)(b) to determine whether a factor for underwriting profit and contingencies (a profit factor) is reasonable or excessive. However, the evidence from State Farm Florida is expressed in terms of a rate of return rather than a statutorily authorized profit factor. The rate filing includes a profit of 5.0 percent, a contingency of 2.0 percent, and a retained risk factor of 9.0 percent for a total profit factor of 16.0 percent, but the rate filing uses a rate of return of 12.2 percent. Testimony elicited by counsel for State Farm Florida during the cross-examination of Respondent's witness

illustrates the variability between a 16.0 percent profit factor and 12.2 percent rate of return.

> Q. Whether it is called retained risk or it is included in profit and contingency, you get the same rate of return, isn't that correct?
>
> A. The rate of return – rate of return or rate indication –
>
> Q. Rate of return.
>
> A. Rate of return, I would say yes to that.
>
> Q. And the placement in the filing has no effect whether the rates are excessive, isn't that correct?
>
> A. That's correct.
>
> Q. The issue of excessiveness is determined by the overall rate of return, not the particular derivation of the 9 percent retained risk, isn't that right?
>
> A. That's one of the items.
>
> Q. Is that a yes?
>
> A. Yes.

TR at 793-794.

58. The profit factor contemplated by the Legislature and the rate of return utilized by State Farm Florida are distinct investment concepts. Paragraph 72 of the PRO filed by State Farm Florida states that when the income on investments is taken into account the rate of return is 12.2 percent, effectively amending the statutory reference to a profit factor in

Subsection 627.0612(2)(b), which is 16.0 percent in this case.[9] The Legislature has found in Subsection 627.062(2)(e)2. that rates are excessive if, among other things:

> [T]he rate structure established by a stock insurance company provides for replenishment of surpluses from premiums, when the replenishment is attributable to investment losses.

59. The retained risk of 9.0 percent by State Farm Florida is a "retained hurricane risk." State Farm Florida claims the retained risk is a necessary cost of writing homeowners insurance in Florida. However, State Farm Florida applies the 9.0 percent factor to the entire premium, not just the portion of the premium attributable to a retained hurricane risk. Moreover, legislation identified in the record as Senate Bill 2860 (SB 2860) removed from former Subsection 627.062(2)(b)11., now 627.062(2)(b)12., expresses authority for a "retained risk" provision.

60. The fact-finder is unable to determine from a preponderance of the evidence whether State Farm Florida passed along to policyholders premium savings attributable to an expansion of the Cat Fund from $16 billion to $28 billion. The Legislature intends in HB 1A that all premium savings resulting from the expansion of the Cat Fund are to be passed along to policyholders.

61. State Farm Florida assumed a zero net-cost of reinsurance purchased from the state. The net-cost of reinsurance, including previously discussed private re-insurance, takes into account the premium paid, the amount of coverage, and the expected recoveries.

62. State Farm Florida paid approximately $700 million for reinsurance from State Farm Mutual and private re-insurers and determined that expected recoveries would amount to slightly more than $106 million. The cost of coverage provided by the Cat Fund and the expected recoveries from the Cat Fund were not included in the determination of the net-cost of reinsurance.

63. The fact-finder is unable to determine from a preponderance of the evidence whether the failure to include the cost of coverage minus the expected recoveries from the Cat Fund led to a cost of that reinsurance which is greater than the services rendered in violation of Section 627.062. Because the Cat Fund makes no profit, has minimal expenses, and has a very large investment income credit due to its tax exempt status, recoveries may, in certain circumstances, be significantly higher than the premiums paid to the Cat Fund.

64. The fact-finder is unable to determine from a preponderance of the evidence whether expenses attributable to agent commissions are reasonable or excessive. State Farm Florida assumes a 13.0 percent commission based on historical

commission ratios. However, historical ratios may not accurately predict future costs because State Farm Florida is reducing business through non-renewals and reducing coverage through ex-winding and wind-mitigation discounts. Agent services are rendered either to obtain new business or to service existing policyholders. The voluntary limitation of new business to transfer business may reasonably be expected to reduce agent services attributable to new business.

65. The fact-finder is unable to determine from a preponderance of the evidence whether costs attributable to advertising and marketing are reasonable or excessive. State Farm Mutual advertises for "branding purposes" and allocates a portion of those costs to State Farm Florida. The benefit of advertising for "branding purposes" is the retention of business and the acquisition of new business. However, State Farm Florida is limiting new business to transfer business, and it is unclear what portion, if any, of the cost of branding incurred by State Farm Mutual is misallocated to new business that State Farm Florida is not creating.

66. State Farm Florida made adjustments to hurricane models including the averaging of three models. A preponderance of evidence shows that averaging, by itself, did not materially affect the rate filing because averaging reduced variability between the models.

67. The rate filing includes a factor identified in the record as a sinkhole presumed factor. State Farm Florida corrected a deficiency in the original filing by providing in Petitioner's Exhibit 11 the calculation required by Respondent.

68. The rate filing included a 10.0 percent loss adjustment factor for hurricane losses. The information included in the initial filing did not support the 10.0 percent factor, but the factor is supported by a preponderance of the post-filing evidence.

69. Respondent's PRO discusses several alleged violations of Florida Administrative Code Rules 69O-170.0135, 69O-170.014, and 69O-170.003. However, the ALJ concludes that Respondent has the burden of proving the affirmative allegation that State Farm Florida violated an administrative rule.[10] Respondent's insistence on confining the evidence to that submitted with the initial filing makes it unclear whether Respondent disputes the issue of whether the post-filing evidence cures any violations in the initial filing. The fact-finder cannot determine from a preponderance of the evidence as a whole whether Petitioner violated any administrative rule.

CONCLUSIONS OF LAW

70. DOAH has jurisdiction over the subject matter of and the parties to this proceeding. §§ 120.569 and 120.57(1) and

Ch. 627. DOAH provided the parties with adequate notice of the administrative hearing.

71. State Farm Florida has the burden of proof in this proceeding. State Farm Florida must show by a preponderance of the evidence that the rate filing is not excessive, inadequate, or unfairly discriminatory. § 627.062(2)(b) and (g).

72. State Farm Florida is not limited to information contained in the initial filing. State Farm Florida may rely on evidence of circumstances as they existed through the administrative hearing in order to satisfy the requisite burden of proof. Florida courts have long held that a proceeding conducted pursuant to Subsection 120.57(1) (a 120.57 proceeding) is a de novo proceeding in which:

> The [ALJ's] decision to permit evidence of circumstances as they existed at the time of hearing was correct. . . . Section 120.57 proceedings are intended to formulate final agency action, not to review action taken earlier and preliminarily.

McDonald v. Department of Banking and Finance, 346 So. 2d 569, 584 (Fla. 1st DCA 1977).

73. This proceeding is conducted to formulate final agency action. State Farm Florida is entitled to present new and additional information not contained in the initial filing. Florida Insurance Council, Inc. v. Office of Insurance Regulation, et al., DOAH Case No. 05-2609RP, 2006 Fla. Div. Adm.

Hear., aff'd, 951 So. 2d 833 (Fla. 1st DCA 2007)(rejecting as invalid the Respondent's proposed rule containing an evidentiary exclusion that was virtually identical to the one Respondent now advocates). See also Young v. Department of Community Affairs, 625 So. 2d 831, 838 (Fla. 1993); Hamilton County Board of County Commissioners v. Department of Environmental Regulation, 587 So. 2d 1378, 1378-88 (Fla. 1st DCA 1991); Beverly Enterprises-Florida, Inc. v. Department of Health and Rehabilitative Services, 573 So. 2d 19 (Fla. 1st DCA 1990).

74. After Florida Insurance Council, 951 So. 2d at 833, Respondent attempted to effectuate the exclusion of evidence not contained in an initial filing through a proposed 2007 amendment to Subsection 627.062(9). The Legislature chose not to adopt the exclusionary rule of evidence proposed by Respondent.

75. Respondent argues that the certification requirement in Subsection 627.062(9)(a)(the Certification Law) mandates that the evidence be limited to the information included in the initial filing. The Certification Law states, in pertinent part:

> The chief executive officer or chief financial officer of a property insurer and the chief actuary of a property insurer must certify under oath and subject to the penalty of perjury, on a form approved by the commission, the following information, which must accompany a rate filing:

> 1. The signing officer and actuary have reviewed the rate filing;
>
> 2. Based on the signing officer's and actuary's knowledge, the rate filing does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
>
> 3. Based on the signing officer's and actuary's knowledge, the information and other factors described in paragraph (2)(b), including, but not limited to, investment income, fairly present in all material respects the basis of the rate filing for the periods presented in the filing; and . . .

§ 627.062(9)(a).

76. The statutorily required certifications are fairly construed to be limited to knowing misstatements, or omissions that make a statement misleading or that result in unfair presentation of information. There is no language in Certification Law that could be reasonably interpreted as limiting the scope of this rate hearing before DOAH.

77. The exclusionary rule that Respondent proposes in this proceeding was previously rejected in another proceeding. Hartford Fire Ins. Co. et al. v. Office of Insurance Regulation, Case Nos. 07-5185 through 07-5188 (DOAH March 28, 2008). In Hartford, the ALJ concluded:

> 102. . . . OIR asserts that the amendments to Section 627.0[62] make it a requirement

> that all documentation must be included in the filing, and therefore there is no longer a place for a clarification letter in the rate review process.
>
> 103. . . . OIR bases its position on the addition of Subsection 627.062(9), Florida Statutes, . . .
>
> 104. Contrary to the OIR's assertions, nothing in this amendment requires that all documentation upon which an insurer might possibly rely must be included in the filing itself. The amendment does require that the insurer closely scrutinize its filings and insure that all factors identified in Section 627.062(2)(b) "fairly present in all material respect the basis for the filing." The filing cannot, by commission or omission, make any misleading or untrue statements. Florida Administrative Code Rule 69O-170.013(5) clearly makes it the insurer's responsibility to include all information it wants considered to support the rate filing, and this requirement is not new. However, other parts of Section 627.0[62] which the Legislature chose not to delete still clearly allow for additional information to be provided to the OIR upon request, and the OIR's rules still contemplate such a process. . . . (Emphasis added)

78. Respondent adopted the quoted conclusions of law in its May 30, 2008, Final Order in Hartford, Case No. 94940-08-FO. Respondent is bound by the doctrine of administrative stare decisis to follow its final orders in cases involving similar facts and law. Gessler v. Dept. of Business and Professional Regulation, 627 So. 2d 501 (Fla. 4th DCA 1993).

79. The Certification Law is not reasonably construed to amend Chapter 120 by implication. Amendment by implication is not favored by the courts. In State v. J.R.M., 388 So. 2d 1227 (Fla. 1980), the court stated:

> It is well established that amendment by implication is not favored and will not be upheld in doubtful cases. Miami Water Works Local No. 654 v. City of Miami, 157 Fla. 445, 26 So. 2d 194 (Fla. 1946). Amendment by implication occurs when it appears the latter statute was intended as a revision of the subject matter of the former or when there is an irreconcilable repugnancy between the two, so that there is no way the former rule can operate without conflicting with the latter."

80. For reasons stated in the Findings of Fact, State Farm Florida did not show by a preponderance of the evidence that the indicated and requested rates are not excessive, inadequate, or unfairly discriminatory. As explained in the Findings of Fact, a finding that State Farm Florida did not satisfy its burden of proof is not tantamount to a finding that either the indicated rate and requested rate is excessive, inadequate, or unfairly discriminatory.

81. The determination by Respondent that hurricane models used to project PML must use cold water, or long term, storm sets is entitled to great deference. The statutory interpretation is within the substantive expertise of the agency. The evidentiary record supports a finding that an

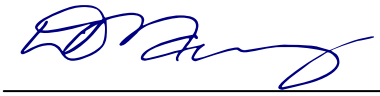
interpretation of statutory terms requires special agency insight or expertise. The agency has articulated in the record underlying technical reasons for deference to agency expertise, and the agency's interpretation is not clearly erroneous. Johnston, M.D. v. Department of Professional Regulation, Board of Medical Examiners, 456 So. 2d 939, 943-944 (Fla. 1st DCA 1984). Insurance rate-making is a technical, complicated, and involved process. Travelers Indemnity Company v. Williams, 190 So. 2d 27 (Fla. 1st DCA 1966); Mutual Insurance Rating Bureau v. Williams, 189 So. 2d 389, 390 (Fla. 1st DCA 1966); Nationwide Mutual Insurance Company v. Williams, 188 So. 2d 368, 372 (Fla. 1st DCA 1966).

RECOMMENDATION

Based on the foregoing Findings of Fact and Conclusions of Law, it is

RECOMMENDED that Respondent enter a final order determining that State Farm Florida did not show by a preponderance of the evidence that either the indicated rate or requested rate in the rate filing is not excessive, inadequate, or unfairly discriminatory.

DONE AND ENTERED this 12th day of December, 2008, in Tallahassee, Leon County, Florida.



DANIEL MANRY
Administrative Law Judge
Division of Administrative Hearings
The DeSoto Building
1230 Apalachee Parkway
Tallahassee, Florida 32399-3060
(850) 488-9675
Fax Filing (850) 921-6847
www.doah.state.fl.us

Filed with the Clerk of the
Division of Administrative Hearings
this 12th day of December, 2008.

ENDNOTES

[1/] References to subsections, sections, and chapters are to Florida Statutes (2008), unless otherwise stated.

[2/] Subsection 120.52(8) defines an "invalid exercise of delegated legislative authority" as "[agency] action which goes beyond the powers, functions, and duties delegated by the Legislature." The statute proceeds to describe circumstances in which agency action in the form of rulemaking goes beyond the powers, functions, and duties delegated by the Legislature. The statutory definition of agency action that goes beyond the power delegated by the Legislature is not confined to agency action in the form of rulemaking but also reaches agency action undertaken through the adjudication of individual cases. A contrary interpretation would effectively authorize an agency to accomplish through adjudication of individual cases that which the Legislature prohibits the agency from accomplishing through rulemaking. The powers that an agency exercises through either adjudication of individual cases or rulemaking must be coextensive with the powers, functions, and duties delegated by the Legislature in the terms of the enabling statute.

[3/] State Farm Florida claims that at the end of 2006, when the previous rate increase went into effect, 112,000 policyholders

qualified for wind-mitigation discounts, but by August 2008 the number of policyholders receiving the discounts rose to 264,000.

[4/] The TICL was authorized by the Legislature in Chapter 2007-1, Section 2(17)(d)4, at 17, Laws of Florida, which the parties refer to in the record as House Bill 1A (HB 1A). HB 1A is reported in its entirety in Respondent's Exhibit 11.

[5/] The respective amounts of reinsurance are summarized in Tab 17 of Petitioner's Exhibit 1.

[6/] The absence of any economically significant distinction between State Farm Florida, State Farm Mutual, and the other members of the affiliated group is illustrated in paragraph 70 of the PRO filed by State Farm Florida.

> The 5% profit is a typical profit that SFF [State Farm Florida] uses in most states [sic] and it is the profit needed for doing business in an average state.

State Farm Florida does not do business in "most states." It only does business in Florida. State Farm Mutual and Fire and Casualty are the members of the affiliated group that conduct the business of insurance in "most states."

[7/] The record does not disclose whether the annual loss experienced by State Farm Mutual resulted in a tax benefit, such as a reduction in taxable income, for purposes of the federal and state income tax. Federal tax law disregards certain transactions between members of an affiliated group so that a single company organized into separate divisions does not enjoy a tax advantage over an affiliated group organized into separate companies with a common parent. The state corporate income tax "piggybacks" the federal income tax. Similarly, state sales tax systems generally provide resale exemptions that, in relevant part, provide equal tax consequences for transactions between related entities within an affiliated group and divisions within a single corporation. An analogous argument can be made that State Farm Mutual should not enjoy a rate advantage from the legal form in which it chooses to do business in Florida. One way to determine whether State Farm Mutual enjoys a rate advantage by doing business in Florida through State Farm Florida is to compare the economic cost of a retained risk provision with the costs of reinsurance and the credit risk provision at issue in this proceeding.

[8/] The $9.25 billion reinsurance amount for PML represents State Farm Florida's estimate of the 1-250 year PML. The 1-250 year assumption does not assume that such an event will occur once every 250 years. Rather, the assumption is that a 1 in 250 year event has a 0.4 percent chance of occurring in any given year.

[9/] Some evidence suggests the actual rate of return may be 20.0 percent. See discussion in paragraph 54 of Respondent's PRO.

[10/] Florida Department of Transportation v. J.W.C., 396 So. 2d 778 (Fla. 1st DCA 1981).

COPIES FURNISHED:

Vincent J. Rio, Esquire
State Farm Insurance Companies
One State Farm Plaza, A-3
Bloomington, Illinois 61701-4300

S. Marc Herskovitz, Esquire
Elenita Gomez, Esquire
Office of Insurance Regulation
Legal Services Office
200 East Gaines Street
Tallahassee, Florida 32399-0333

C. Ryan Reetz, Esquire
Mia B. Fraser, Esquire
Squire, Sanders & Dempsey, LLP
200 South Biscayne Boulevard, Suite 4000
Miami, Florida 33131

Cynthia S. Tunnicliff, Esquire
Brian A. Newman, Esquire
Pennington, Moore, Wilkinson,
Bell & Dunbar, P.A.
215 South Monroe Street, Second Floor
Post Office Box 10095
Tallahassee, Florida 32302-2095

Kevin M. McCarty, Commissioner
Office of Insurance Regulation
200 East Gaines Street
Tallahassee, Florida 32399-0305

Steve Parton, General Counsel
Office of Insurance Regulation
200 East Gaines Street
Tallahassee, Florida 32399-0305

NOTICE OF RIGHT TO SUBMIT EXCEPTIONS

All parties have the right to submit written exceptions within 15 days from the date of this Recommended Order. Any exceptions to this Recommended Order should be filed with the agency that will issue the Final Order in this case.