

# Essay

## Ending Public Utility Style Rate Regulation in Insurance

Daniel Schwarcz<sup>†</sup>

*Many property-casualty insurers are subject to an elaborate state-based regulatory regime that enforces prohibitions against “excessive” and “unfairly discriminatory” rates. Extensive economics research suggests that this regulation is not in the public interest. Building on this literature, this Essay suggests that insurance rate regulation evolved out of a set of market and regulatory conditions that no longer prevail in most property-casualty insurance markets. The persistence of traditional insurance rate regulation in many states thus represents a failure of these jurisdictions to evolve along with the markets they oversee. In developing this argument, the Essay shows how insurance rate regulation emerged out of the view that property-casualty insurance markets share key characteristics with natural monopolies. In both settings, unique market conditions were understood to “naturally” stymie socially-beneficial competition. And in both settings, states tolerated these naturally-occurring anti-competitive market conditions, but subjected firms in these markets to extensive rate regulation designed to prevent excessive or unfairly discriminatory rates. Despite these parallels in their development, modern-day insurance markets no longer resemble natural monopolies. Insurers can, and do, compete vigorously in ways that promote social welfare and do not rely on plausibly anti-competitive practices. Preserving public utility style insurance rate regulation makes little sense in light of these shifts in insurance market structure, even if insurance rate regulation oriented towards broader social goals like privacy and social mobility remain sensible.*

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<sup>†</sup> Professor of Law at the University of Minnesota Law School. For helpful comments and suggestions, I thank Kenneth Abraham, Peter Carstensen, Tom Cotter, Alex Klass, Robert Litan, Kyle Logue, William McCartney, Brett McDonald, Peter Molk, Justin Schardin, David Snyder, Jeffrey Stempel, Rick Swedloff, and participants in workshops at Vanderbilt Law School, Rutgers Law School, and the University of Minnesota Law School. For excellent research assistance, I thank Luke Wolf and Ellen Hunt.

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## Introduction

Insurance regulation has long been loosely associated with public utility regulation.<sup>1</sup> This association is particularly fitting when it comes to states’

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1. See generally Kenneth Abraham, *Four Conceptions of Insurance*, 161 U. PA. L. REV. 653, 669 (2013) (“In some significant ways the formal structure of insurance regulation in the United States conforms to [a] public utility/regulated industry conception.”).

regulation of property-casualty insurance rates. Like traditionally-regulated public utilities,<sup>2</sup> many property-casualty insurers are subject to an elaborate state-based regulatory regime that is designed to ensure that their rates are not “excessive.”<sup>3</sup> Rate regulation in both the insurance and public utility domains also prohibits “undue” or “unfair” discrimination. In both settings, this bar has little to do with discrimination against protected minority groups. Instead, it principally concerns the possibility that some subset of consumers might be served or covered at less than full cost, with other customers being forced to make up the difference.<sup>4</sup>

Extensive economics research suggests that these forms of insurance rate regulation are not in the public interest. In study after study, economists have documented that property-casualty insurance markets often flourish when states deregulate rates, and tend to experience limited success under many aggressive forms of rate regulation.<sup>5</sup> The reasons for these trends are hardly mysterious to economists: property-casualty insurance markets generally include numerous competing firms.<sup>6</sup> Relatedly, market entry is relatively easy in most cases: the inverted production cycle of insurance (wherein premiums are collected before claims are paid) means that market entrants do not generally need huge amounts

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2. See CHARLES F. PHILLIPS, PUBLIC UTILITIES IN THE AMERICAN ECONOMY (3d ed. 1993) (noting that the regulation of rates is the primary area of controversy and attention in public utilities regulation). A number of states have “deregulated” public utilities. See *id.*

3. See generally KENNETH S. ABRAHAM & DANIEL SCHWARCZ, INSURANCE LAW AND REGULATION 126-128 (6th ed. 2015). Rate regulation is also an increasingly prominent feature of some states’ health insurance regulation. See *State Effective Rate Review Programs*, CTR. MEDICARE & MEDICAID SERVS., [http://www.cms.gov/ccio/resources/fact-sheets-and-faqs/rate\\_review\\_fact\\_sheet.html](http://www.cms.gov/ccio/resources/fact-sheets-and-faqs/rate_review_fact_sheet.html) [<http://perma.cc/XUX9-UMWG>].

4. See Ronen Avraham, Kyle Logue & Daniel Schwarcz, *Understanding Insurance Antidiscrimination Laws*, 87 S. CAL. L. REV. 195, 203 (2014) [hereinafter Avraham et al., *Understanding Insurance Antidiscrimination*]; Ronen Avraham, Kyle Logue & Daniel Schwarcz, *Towards a Universal Framework for Insurance Anti-Discrimination Laws*, 21 CONN. INS. L.J. 1, 8-9 (2014) [hereinafter Avraham et al., *Universal Framework*]; see also *Prop. & Cas. Model Rating Law § 5 (A)(3)*, NAT’L ASS’N OF INS. COMM’RS (2010), <http://www.naic.org/store/free/GDL-1775.pdf> [<http://perma.cc/9K74-YDPY>] (“Unfair discrimination exists if, after allowing for practical limitations, price differentials fail to reflect equitably the differences in expected losses and expenses.”); C.O. Ruggles, *Discrimination in Public Utility Rates*, 32 J. POL. ECON. 191, 194 (1924).

5. See, e.g., Stephen P. D’Arcy, *Insurance Price Deregulation: The Illinois Experience*, in DEREGULATING PROPERTY-LIABILITY INSURANCE 248 (J. David Cummins ed., 2002); Martin F. Grace, Robert W. Klein & Richard D. Phillips, *Auto Insurance Reform: Salvation in South Carolina*, in DEREGULATING PROPERTY-LIABILITY INSURANCE, *supra*, at 148-49; Sharon Tennyson, *The Impact of Rate Regulation on State Automobile Insurance Markets*, 15 J. INS. REG. 502, 516 (1997). For a systematic description of many of these studies, see *Analysis of Property-casualty Insurance Rate Regulatory Laws*, PROP. CASUALTY INSURERS OF AM., Appendix 3 (2011), <https://www.leg.state.nv.us/Session/76th2011/Exhibits/Assembly/CMC/ACMC279L.pdf> [<https://perma.cc/L649-QR1Q>]. One controversial potential exception is California, where there is some strong evidence that rate regulation has proven to be relatively effective. See Dwight M. Jaffee & Thomas Russell, *The Regulation of Automobile Insurance in California*, in DEREGULATING PROPERTY-LIABILITY INSURANCE, *supra*, at 195; J. Robert Hunter, *State Automobile Insurance Regulation: A National Quality Assessment and In-Depth Review of California’s Uniquely Effective Regulatory System*, CONSUMER FED’N AM. 23-24 tbl.1 (2008), [http://consumerfed.org/wp-content/uploads/2010/08/state\\_auto\\_insurance\\_report.pdf](http://consumerfed.org/wp-content/uploads/2010/08/state_auto_insurance_report.pdf) [<http://perma.cc/36DJ-MJL7>].

6. See SCOTT E. HARRINGTON, INSURANCE DEREGULATION AND THE PUBLIC INTEREST 16 (2000).

of capital.<sup>7</sup> Consistent with these facts, property-casualty insurers in most markets generally earn reasonable—and certainly not excessive—levels of profit compared to firms in other industries.<sup>8</sup> Meanwhile, rate regulation is often politicized, ineffective, cyclical, and, in the worst cases, can affirmatively undermine competitive market conditions by discouraging market entry and causing existing firms to seek exit.<sup>9</sup>

Even for those who believe that robust regulation of insurance markets is often necessary (a camp in which I firmly belong), the evidence against the regulation of “excessive” or “unfairly discriminatory” rates in property-casualty insurance (rather than health insurance)<sup>10</sup> is powerful.<sup>11</sup> And yet, such regulation remains a key feature of many states’ regulatory regimes. One recent assessment approximates that, as of 2015, half of all states employed strict rate review systems for many forms of property-casualty coverage.<sup>12</sup> These consist either of a requirement that all changes in rates receive prior approval by the regulator, or else a requirement that rates be filed before use, coupled with a relatively strong possibility that those rates may be disapproved.<sup>13</sup> A less recent but more fine-grained survey found that, as of 2007, markets for automobile insurance,

7. Paul L. Joskow, *Cartels, Competition, and Regulation in the Property-Liability Insurance Industry*, 4 BELL J. ECON. & MGMT. SCI. 375, 381 (1973).

8. See INS. INFO. INST., THE INSURANCE FACT BOOK 39 (2011). Admittedly, measures of property-casualty insurers’ profitability are not fully transparent because of the relatively opaque nature of property-casualty statutory accounting, which gives insurers substantial discretion in setting reserves. See William H. Beaver et al., *Management of the Loss Reserve Accrual and the Distribution of Earnings in the Property-casualty Insurance Industry*, 35 J. ACCT. & ECON. 347, 348 (2003). But this discretion applies more to the reserves that are set in individual years than to persistent measures of profitability over a sustained period of time.

9. Martin F. Grace & Robert W. Klein, *The Perfect Storm: Hurricanes, Insurance and Regulation*, 12 RISK MGMT. & INS. REV. 81, 105 (2009); Fed. Ins. Office, *How to Modernize and Improve the System of Insurance Regulation in the United States*, U.S. DEP’T TREASURY 54 (Dec. 2013), <http://www.treasury.gov/initiatives/fio/Documents/How%20to%20Modernize%20and%20Improve%20the%20System%20of%20Insurance%20Regulation%20in%20the%20US.pdf> [<https://perma.cc/J3QJ-PVJU>]; see also Richard Derrig & Sharon Tennyson, *The Impact of Rate Regulation on Claims: Evidence from Massachusetts Automobile Insurance*, 14 RISK MGMT. & INS. REV. 173, 174 (2011); Lauren Regan et al., *The Relationship Between Auto Insurance Rate Regulation and Insured Loss Costs: An Empirical Analysis*, 27 J. INS. REG. 23, 27 (2009); Mary Weiss et al., *The Effect of Regulated Premium Subsidies on Insurance Costs: An Empirical Analysis of Automobile Insurance*, 77 J. RISK & INS. 597, 599 (2010); Sharon Tennyson, *The Long-Term Effects of Rate Regulatory Reforms in Automobile Insurance Markets*, INS. RES. COUNCIL 17 (2012), [http://www.namic.org/pdf/13memberAdvisory/131113\\_IRC\\_Tennyson\\_Long-TermEffectsRateRegulatoryReforms.pdf](http://www.namic.org/pdf/13memberAdvisory/131113_IRC_Tennyson_Long-TermEffectsRateRegulatoryReforms.pdf) [<http://perma.cc/5LXZ-5X2C>].

10. Rate regulation in health insurance markets is also not uncommon, though the nature of this regulation varies significantly by state even after the Affordable Care Act. Health insurance markets raise a variety of distinct issues from property-casualty insurance markets, not the least of which is that there are very few competing carriers in many health insurance markets. For these reasons, rate regulation in health insurance markets is not addressed in this Essay. Life insurers’ rates are not generally subject to public utility style rate regulation.

11. See Abraham, *supra* note 1, at 673; Daniel Schwarcz, *Transparently Opaque: Understanding the Lack of Transparency in Insurance Consumer Protection*, 61 UCLA L. REV. 394, 398 (2014) (criticizing rate regulation).

12. See R.J. Lehmann, *2015 Insurance Regulation Report Card*, R STREET 27 (Dec. 2015), <http://www.rstreet.org/wp-content/uploads/2015/11/RSTREET46.pdf> [<http://perma.cc/UQ3J-FGMD>].

13. See *id.*

homeowners' insurance, and medical malpractice insurance are each regulated through prior approval rate regulation in approximately twenty states, with the precise mix of states employing such regulation varying by coverage line. That study also found that almost forty states require workers' compensation insurers to receive prior approval of their rates.<sup>14</sup>

Despite this dramatic disconnect between economists' views and regulatory reality, the legal academic literature has paid limited attention to the regulation of "excessive" or "unfairly discriminatory" rates in property-casualty insurance.<sup>15</sup> Consequently, this Essay explores such insurance rate regulation from a legal and historical perspective. It argues that insurance rate regulation emerged out of the view that property-casualty insurance markets share key characteristics with natural monopolies. In both settings, unique market conditions were understood to "naturally" stymie socially-beneficial competition. And in both settings, states tolerated these naturally-occurring anti-competitive market conditions, but subjected firms in these markets to extensive rate regulation designed to prevent excessive or unfairly discriminatory rates. Despite these parallels in their development, modern-day insurance markets no longer resemble natural monopolies. Insurers in most property-casualty insurance markets can, and do, compete vigorously in ways that promote social welfare and do not rely on plausibly anti-competitive practices.<sup>16</sup> Preserving public utility style insurance rate regulation in these insurance markets makes little sense in light of the shifts in their structure.<sup>17</sup>

Although the Essay relies heavily on the economics literature evaluating insurance rate regulation, it also advances that literature in several ways. First, it explains how, as a historical matter, legal and political forces produced the public utility oriented system of insurance rate regulation that still prevails in many

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14. See Sharon Tennyson, *Efficiency Consequences of Rate Regulation in Insurance Markets* (Networks Fin. Inst. Policy Brief No. 2007-PB-03, 2007), <http://ssrn.com/abstract=985578> [<http://perma.cc/Q6XM-8DQD>]. For a third compilation of state laws governing insurance rate regulation, see Angelo Borselli, *Insurance Rates Regulation in Comparison with Open Competition*, 18 CONN. INS. L.J. 109, 119-27 (2011).

15. Law review articles addressing this issue can be counted on one hand, and most of them date back multiple decades and do not seriously engage with the emerging economic evidence regarding the impact of rate regulation in insurance. See Spencer Kimball & Ronald Boyce, *The Adequacy of State Insurance Rate Regulation: The McCarran-Ferguson Act in Historical Perspective*, 56 MICH. L. REV. 545, 556 (1958); Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U. L. REV. 13, 80-87 (1993); Harvey Rosenfield, *Auto Insurance: Crisis and Reform*, 29 U. MEM. L. REV. 69, 104-05 (1998). For one more recent addition to the literature, see Borselli, *supra* note 14, at 128-36.

16. Some specialized insurance markets, such as title insurance markets, remain relatively concentrated due to distinctive market conditions. See *infra* note 166. For these reasons, rate regulation in title insurance markets is excluded from the scope of this Essay.

17. For a similar argument in a completely different context, see W. Nicholson Price II & Arti Rai, *Manufacturing Barriers to Biologics Competition and Innovation*, 101 IOWA L. REV. 1023, 1029-30 (2016) (arguing that the "proactive approach that some countries use [to regulate large molecule "biologic" drugs] -- government-imposed price regulation of originator products--misses the mark . . . [because it] mistakenly views the problem as one of natural monopoly").

states.<sup>18</sup> Second, it demonstrates that this regulatory system was indeed sensible at that time of its origin, but that changes in both the structure of property-casualty insurance markets and related features of insurance regulation ultimately undermined the economic rationale for traditional insurance rate regulation.<sup>19</sup> The persistence of such regulation in many states is thus an example of regulatory systems failing to evolve with the markets they regulate.<sup>20</sup> Third, it clarifies that eliminating public utility style rate regulation in insurance does not necessarily mean eliminating all insurance rate regulation.<sup>21</sup> To the contrary, insurance rate regulation designed to promote broader social values such as equality, privacy, and social mobility may well be eminently sensible. But those goals have virtually nothing to do with the rationale and operation of traditional public utility style rate regulation in insurance.

These arguments unfold in three Parts. Part I traces the legal and regulatory history of rate regulation in insurance, showing how it emerged during the early- to mid- twentieth century from an understanding that property-casualty insurance markets are comparable to natural monopolies. Although many insurers sold coverage across the country, they collectively set their rates and designed their coverage. Lawmakers generally understood such collusion to be “natural” and “desirable” in insurance markets, given that collective rate setting and product design were necessary for insurers to accurately predict losses and avoid “ruinous competition.” Even so, the law would only permit this collusion if it were subject to the same types of rate regulation that had recently emerged in the public utilities arena, another setting where robust competition was understood to be structurally impossible. In both the insurance and public utility domains, rate regulation would ensure that firms’ rates did not require some customers to cross-subsidize others or result in firms making an “excessive” profit.

After tracing this history, the Essay argues in Part II that, whatever force the historical vision of insurance as a type of public utility had, it no longer comports with modern-day insurance markets. Although industry intermediaries continue to pool insurers’ loss data and draft model policy forms, they do so under an extensive regulatory regime that prohibits them from setting advisory rates or engaging in any other plausibly anticompetitive activities, such as requiring that carriers use specific policy forms. In fact, industry data-sharing operates principally to lower costs for small firms and limit barriers to entry. By contrast, it is no longer necessary, or even particularly helpful, for many large or

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18. See *infra* Section I.B.

19. See *infra* Part II.

20. See generally Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 N.C. L. REV. 1629, 1625-46 (2011). For an analogous failure of state insurance regulation to fail to keep up with market developments, see Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI L. REV. 1263, 1345-46 (2011) (exploring how regulation of insurance policy contract terms is implicitly structured on the outdated assumption that policy forms are completely homogeneous across firms).

21. See *infra* Part III.

medium size insurers to operate in most markets. And it certainly no longer prevents competition among insurers with respect to rates or policy forms. For these reasons, the varied forms of collaboration that do continue in certain property-casualty insurance markets are generally consistent with broad antitrust principles.<sup>22</sup> In sum, both the historical rationale for public utility style rate regulation in insurance and the basic bargain pursuant to which it was implemented and subsequently entrenched no longer have any purchase.

Having demonstrated the inapplicability of historical rationales for public utility style rate regulation in insurance, Part III reviews the robust insurance economics literature to reject alternative justifications for the regulation of “unfairly discriminatory” or “excessive” insurance rates. Readers who are familiar with this insurance economics literature on rate regulation may therefore choose to skim Part III. For other readers, though, Part III represents a key component of the Essay’s larger policy conclusion. In particular, it shows that, while property-casualty insurance markets are indeed subject to a broad range of potential market failures, they are generally well structured to promote price competition. Consumers are well aware of the rates they pay for coverage in most markets, and have numerous tools available to determine how much competing carriers would charge for coverage on roughly similar terms. Although such comparison shopping is complicated by the increasing heterogeneity of carriers’ coverage terms and the opacity of insurers’ claims paying practices, these market failures create only a limited risk of “excessive” or “unfairly discriminatory” premiums. The one potential exception to this conclusion—insurers’ pricing of coverage based on predictions of individual customers’ price sensitivity, a practice termed “price optimization”—should be addressed, if at all, by rules that are tailored to that specific issue and not confined to the insurance domain.

The Essay concludes by suggesting that eliminating public utility style insurance rate regulation could improve the efficacy of more justified forms of insurance regulation, including modernized insurance rate regulation. As I have argued extensively elsewhere, there is good reason to regulate insurers’ rates—as well as their underwriting and marketing—to limit discrimination against historically disadvantaged groups (rather than to prevent “unfair discrimination” in the public utility sense of the term).<sup>23</sup> Eliminating public utility style rate

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22. This Essay takes no explicit position on whether the McCarran Ferguson Act’s limited antitrust exemption should be repealed. See generally Robert H. Jerry, *The Antitrust Implications of Collaborative Standard Setting by Insurers Regarding the Use of Genetic Information in Life Insurance Underwriting*, 9 CONN. INS. L.J. 397 (2002). On one hand, a central justification for this antitrust exemption was that insurers’ collaboration in sharing data needed to be shielded from federal antitrust laws. To the extent that insurers’ collaboration is, in fact, consistent with modern antitrust laws, then this rationale for the exemption is no longer relevant. On the other hand, though, the exemption can also be justified as a necessary tool to protect state insurance regulation against federal encroachment under the guise of antitrust enforcement. From this perspective, the exemption’s merit is not impacted by the topic of this Essay, but instead depends on a broader assessment of the merits of state-based insurance regulation.

23. See Avraham et al., *Understanding Insurance Antidiscrimination*, *supra* note 4, at 214-21.

regulation would facilitate the reallocation of regulatory resources to this endeavor. More directly, it would clarify that insurance discrimination that disproportionately harms historically disadvantaged groups should not necessarily be tolerated even if it can be actuarially justified or occurs outside of insurers' rating processes.

## I. The Historical Origins of the Public Utility Style Insurance Rate Regulation

This Part details the historical linkages between public utility regulation and insurance rate regulation. The historical origins of insurance rate regulation are an essential building block in this Essay's normative argument for ending such regulation. Only by appreciating these origins does the normative force of Part II—which demonstrates that modern-day property-casualty insurance markets no longer tolerate or facilitate collective rate setting—come into focus. Similarly, the inapplicability of historical rationales for insurance rate regulation casts in a new light the insurance economics literature demonstrating the perverse public policy consequences of such regulation.

Section I.A begins by briefly overviewing the evolution of public utility rate regulation. Section B then shows how, between the late-nineteenth century and mid-twentieth century, policymakers concluded that property-casualty insurance markets are comparable to natural monopolies because insurers must rely on a centralized and collectively maintained system for setting rates to avoid "ruinous competition." Rather than resist this "natural" structure of property-casualty insurance markets, policymakers affirmatively tolerated industry collusion, but subjected it to a scheme of rate regulation drawn from contemporaneous regulatory approaches to natural monopolies. In both settings, independent regulators and commissions would directly review the cost calculations on which firms premised their rates to ensure that—notwithstanding the absence of ordinary competitive conditions—individual firms did not earn an excessive profit or charge rates that unfairly departed from the true cost of serving individual customers.

### *A. A Brief History of Public Utility Rate Regulation*

Historically, the term "public utility" referred to a constellation of industries—including power, telecommunications, water, and common carriers—that tended towards natural monopoly conditions.<sup>24</sup> A natural monopoly exists when "the entire demand within a relevant market can be

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24. See *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 314-15 (1989) ("[U]tilities are virtually always public monopolies dealing in an essential service, and so relatively immune to the usual market risks."); SIDNEY SHAPIRO & JOSEPH TOMAIN, *REGULATORY LAW AND POLICY: CASES AND MATERIALS* 101 (3d ed. 2003) ("[P]ublic utilities are the best example of a natural monopoly.")



satisfied at lowest cost by one firm rather than by two or more.”<sup>25</sup> In such settings, robust competition among competing producers is generally not a stable long-term outcome, leading to a single firm naturally emerging as the dominant, if not sole, source of the underlying service. The classic public utility industries often satisfy this definition of a natural monopoly because the fixed costs associated with developing and maintaining the infrastructure necessary to support the provision of services are immense, leading to economies of scale over the entire range of output.

Like all monopoly firms, natural monopolies left to their own devices will generally maximize profit by charging higher prices and serving fewer consumers relative to the equilibrium price and quantity levels that competitive market conditions would produce.<sup>26</sup> Natural monopolies may also be more likely to discriminate against consumers by charging them rates that do not reflect the costs of providing the underlying service; unlike in ordinary markets, such discrimination is not checked by the presence of competitors who can offer consumers a better deal. Finally, natural monopolies may provide sub-par levels of quality or service due to the relatively limited competitive pressures they face.<sup>27</sup>

Even when two or more firms are willing to serve natural monopoly markets, it is hardly clear that this result promotes the public interest. Competing firms in such settings would be required to charge higher rates than a single firm could, because they would have fewer customers over which to spread the fixed costs of developing their infrastructure. Additionally, the infrastructure that each firm would develop could produce externalities to third parties by taking up physical space with unsightly development, like electric transmission and distribution lines.<sup>28</sup>

Before the twentieth century, local governments generally attempted to manage natural monopolies through long-term contracts that allowed a particular company (or, in some cases, companies) to develop the necessary infrastructure to provide the services in question, in exchange for concessions such as nominal price ceilings and minimum service thresholds.<sup>29</sup> But these contract-based approaches to natural monopolies often proved problematic due to unanticipated

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25. See Richard A. Posner, *Natural Monopoly and Its Regulation*, 21 STAN. L. REV. 548, 548 (1969).

26. Demsetz emphasizes that natural monopolies need not provide monopoly prices and services to the extent that there is a competitive bidding process to provide the public utility and the inputs required to enter production are available to all entrants. See Harold Demsetz, *Why Regulate Utilities?*, 11 J.L. & ECON. 55, 56-57 (1968).

27. See A. Michael Spence, *Monopoly, Quality, and Regulation*, 6 BELL J. ECON. 417, 417 (1975).

28. See LINCOLN DAVIES ET AL., ENERGY LAW AND POLICY (2014).

29. Werner Troesken, *Regime Change and Corruption: A History of Public Utility Regulation*, in CORRUPTION AND REFORM: LESSONS FROM AMERICA’S ECONOMIC HISTORY 259, 260 (Edward Glaeser & Claudia Goldin eds., 2006). Although a few states experimented with creating public utility commissions during this time period, these commissions generally were advisory bodies with limited authority. See PHILLIPS, *supra* note 2, at 132.

economic conditions after contract formation and hold-up problems at the completion of the contract term.<sup>30</sup>

Throughout the first couple of decades of the twentieth century, states gradually replaced their contract-based approach to public utilities with the basic elements of traditional public utility regulation.<sup>31</sup> Initially, these efforts consisted principally of state statutes that empowered local municipal commissions to directly regulate the rates charged by public utilities.<sup>32</sup> States thereafter increasingly implemented state-wide commissions with broad regulatory authorities over the relevant industries; indeed, in the “years between 1910 and 1920 . . . twenty-nine states introduce[ed]” independent regulatory commissions tasked with overseeing industries that had been deemed to operate as natural monopolies.<sup>33</sup> However, in many ways, the logic of contract continued to operate as a rationale for this regulation: the state granted public utilities government-protected monopolies in exchange for their submission to extensive public utility regulation.<sup>34</sup>

State-wide public utility regulation was generally intended to promote four basic goals: “that all must be served, adequate facilities must be provided, reasonable rates must be charged, and no discriminations must be made.”<sup>35</sup> State regulatory commissions were granted a wide range of powers to achieve these objectives. For instance, they typically exercised broad oversight over firms’ services to ensure that they met minimal quality requirements and that all members of the public could access these services. State commissions also had direct oversight over market entry and the internal operations of public utilities, including their accounting, contracting, financing, and management/personnel ad practices.<sup>36</sup> However, the most important and distinctive power of state

30. Troesken, *supra* note 29, at 260-61.

31. Although traditional public utility regulation remains largely intact in many states, some states have deregulated their public utility markets in recent decades. These reforms have generally focused principally on generating markets through which competing firms can buy and sell at the wholesale level. But even in these states, cost of service ratemaking is common.

32. Troesken, *supra* note 29, at 262.

33. *Id.*

34. See SHAPIRO & TOMAIN, *supra* note 24, at 106.

35. PHILLIPS, *supra* note 2, at 118 (describing the “four major obligations or responsibilities imposed on” public utilities to consist of the obligation “to serve all who apply for service,” “to render safe and adequate service,” to “serve all customers on equal terms,” and to “charge only a just and reasonable price the services rendered.”); BRUCE WYMAN, *THE SPECIAL LAW GOVERNING PUBLIC SERVICE CORPORATIONS AND ALL OTHERS ENGAGED IN PUBLIC EMPLOYMENT*, at xi (1911). In exchange for submitting to these extensive forms of regulation, public utilities were generally permitted to operate as monopolies without fear of running afoul of federal Antitrust law. This result was a product of the “state-action” doctrine in antitrust law, under which activities are exempt from scrutiny if they are a result of the state actively deciding to displace competition with regulation. See *Cal. Retail Liquor Dealers Ass’n v. Midcal Aluminum*, 445 U.S. 97, 105 (1980); *Parker v. Brown*, 317 U.S. 341, 350-51 (1943). The setting of monopoly rates via a public utility commissions is a classic application of this doctrine. See *Columbia Steel Casting Co. v. Portland Gen. Elec. Co.*, 111 F.3d 1427, 1436 (9th Cir. 1996); *Jeffrey v. Sw. Bell*, 518 F.2d 1129, 1134 (5th Cir. 1975).

36. See Posner, *supra* note 25, at 592-93.

regulatory commissions was their authority to set the rates charged by public utilities.<sup>37</sup>

In exercising this authority, state commissions were supposed to allow the utility to make a fair but not excessive level of profit, using a rate structure that did not unfairly discriminate against subsets of the population.<sup>38</sup> To accomplish these goals, regulatory commissions would carefully scrutinize firms' rates to ensure that they were justified by their operating expenses and provided only a reasonable rate of return on the capital invested in the business.<sup>39</sup> This type of review would often require commissioners to review firms' expenses to determine whether any were imprudently incurred and to assess the amount that must be paid to lenders and owners in order to attract and retain sufficient investment in the industry.<sup>40</sup>

Cost of service rate regulation not only directly limited the prospect of "excessive rates," but also helped to protect against "undue" discrimination.<sup>41</sup> Unlike modern conceptions of discrimination—which tend to focus on firms targeting discrete and historically disadvantaged groups—"undue" or "unjust" discrimination in the public utilities setting concerned the possibility that some consumers might be served at less than full cost, with other customers being forced to make up the difference.<sup>42</sup> Examples of such discrimination included "(i) free or preferential rates to cities and to public or quasi-public institutions of one sort or another, (ii) contract rates with certain consumers, [and] (iii) [] the simultaneous use of flat and metered rates" for customers.<sup>43</sup> The goal of preventing such discriminatory pricing derived, in part, from the historic concept of a "just price."<sup>44</sup> Under this conception, goods and services had an objectively correct price based on their cost of production and the economic status of the producer, which existed independently of the amount that a good or service might fetch in the market.<sup>45</sup>

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37. See PHILLIPS, *supra* note 2, at 171 (noting that "in most of the industries under consideration, rate regulation has occupied most of the commissioners' time and has been the subject of continuous controversy").

38. See *Fed. Power Comm'n v. Nat. Gas Pipeline Co. of Am.*, 315 U.S. 575, 584 (1942).

39. See PHILLIPS, *supra* note 2, at 176.

40. See Posner, *supra* note 25, at 592-93.

41. See PHILLIPS, *supra* note 2, at 172.

42. See Ruggles, *supra* note 4, at 194.

43. *Id.* at 191.

44. See William Boyd, *Just Price, Public Utility, and the Long History of Economic Regulation in America*, 35 *YALE J. ON REG.* 721 (2018).

45. *Id.*

*B. The Emergence of Public Utility Style Insurance Rate Regulation*

The evolution of modern property-casualty insurance regulation was substantially impacted by the broader tradition of public utility regulation.<sup>46</sup> These linkages are at least partly attributable to the fact that key moments in the evolution of insurance regulation occurred during the emergence of the public utility regulatory model. At the same time, they were undoubtedly influenced by the view throughout the first half of the twentieth century that the insurance industry in fact possessed some of the features of natural monopolies.

*1. The Nineteenth Century Pre-Cursors of Public Utility Style Insurance Rate Regulation*

As with the regulation of natural monopolies, insurance regulation was generally limited and highly variable across the states prior to the twentieth century. New York was the first state to codify its insurance laws in 1849, with additional states gradually following New York's lead over the coming decades.<sup>47</sup> These state statutes might require that insurance companies acquire a license to do business in the state, file or make publicly available their financial records, pay taxes in connection with the sale of insurance, maintain minimum amounts of capital, or perhaps deposit a bond in support of their capacity to pay claims.<sup>48</sup>

Not only were these state statutes limited and variable, they were also the sole source of insurance regulation: In the 1868 case *Paul v. Virginia*, the U.S. Supreme Court held that the Commerce Clause was not implicated by a Virginia statute regulating out-of-state insurers because “issuing a policy of insurance is not a transaction of commerce.”<sup>49</sup> At the time, *Paul* was understood to mean that insurance was the sole regulatory province of the states, because the federal government could not reach the industry under its power to regulate interstate commerce.<sup>50</sup> In the wake of *Paul v. Virginia*, state insurance regulators devoted increased attention to coordinating their efforts by forming the National Association of Insurance Commissioners (NAIC). The NAIC promulgated several model laws and developed a uniform annual statement form that states

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46. See Abraham, *supra* note 1, at 668 (describing the historical importance of a conception of insurance as a public utility, which is based on the view that “insurance is affected with the public interest” and “operates under cartel-like market conditions”).

47. See Dalit Baranoff, *Fire Insurance in the United States*, ECON. HIST. ASS'N (Mar. 16, 2008), <http://eh.net/encyclopedia/fire-insurance-in-the-united-states> [http://perma.cc/JL7J-8AVQ].

48. See *Paul v. Virginia*, 75 U.S. 168, 181 (1868); MICHAEL S. BARR ET AL., *FINANCIAL REGULATION: LAW AND POLICY* 340 (2016); KENNETH MEIER, *POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE* 51-54 (1988); *id.*

49. The plaintiffs in *Paul* were a coalition of New York insurers. These insurers argued that the Privileges and Immunities Clause of the U.S. Constitution prohibited Virginia from requiring that the insurers' agent (Paul) first acquire a state license before selling coverage within that state. See *Paul*, 75 U.S. at 183.

50. See Kimball & Boyce, *supra* note 15, at 553.

could require insurers to fill out.<sup>51</sup> But its role and prominence during this period was limited.<sup>52</sup>

Throughout this time-period, fire insurers collaborated via national and regional organizations, often labeled “rate-making bureaus.” Committees of underwriters from competing insurers would meet under the auspices of these bureaus, and would set rates that they—on the basis of their underwriting experience—deemed appropriate. They would then either encourage or require member insurers to charge these rates.<sup>53</sup> In order to ensure that the agreed upon rates referred to the same insured risk, these bureaus also developed standardized policies for use among their members. Although these collaborative rate and form setting practices dated back to the 1800s, they were most clearly first formalized in the mid-1860s by the National Board of Fire Underwriters. When national control of rates and forms proved too difficult for the National Board to control, it delegated this responsibility to a variety of regional rate-making bureaus.<sup>54</sup> However, these regional efforts to coordinate competitors’ rates also frequently failed, most commonly because rate-making bureau members cheated or individual carriers refused to join these associations.<sup>55</sup>

Starting in the late 1800s, and corresponding with a larger national movement towards “trust busting,” many states passed “anti-compact laws” that outlawed insurers’ efforts to collaborate in setting rates.<sup>56</sup> These statutes were generally based on the assumption “that a combination of fire insurance companies was exactly like a trust, that there was no internal competition among its members.”<sup>57</sup> Yet the newly enacted federal antitrust laws of the time, like the Sherman Antitrust Act, could not be applied to insurance as a result of *Paul v. Virginia*. State anti-compact laws thus reflected an attempt to apply at the state level the same trust-busting strategy that had been implemented at the federal level, by simply prohibiting competing insurers from collaborating in their rate setting efforts. At this point in the history of insurance regulation, insurance was viewed more as an unlawful monopoly than as a type of public utility, and so the blunt tools of antitrust regulation—the outright prohibition on competitors

51. MEIER, *supra* note 48, at 54.

52. See Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625, 648 (2014).

53. See generally Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI. L. REV. 1263, 1271 (2011).

54. Kimball & Boyce, *supra* note 15, at 549.

55. See BARR ET AL., *supra* note 48, at 342.

56. See Marc Schneiberg & Tim Bartley, *Regulating American Industries: Markets, Politics, and the Institutional Determinants of Fire Insurance Regulation*, 107 AM. J. SOC. 101, 113 (2001) (“From 1885 to 1910, 24 states passed anticomcompact laws that made cooperative rate making in insurance illegal, creating a band of anticomcompact states in the Midwest and South.”).

57. STATE OF N.Y., REPORT OF THE JOINT COMMISSION OF THE SENATE AND ASSEMBLY OF THE STATE OF NEW YORK, S. Doc. No. 30, at 66 (1911) [hereinafter *Merritt Committee Report*].

agreeing to set their rates—were accordingly brought to bear on insurance companies.

## 2. The Emergence of Public Utility Style Insurance Rate Regulation in the Early Twentieth Century

Just as with the state regulation of natural monopolies, it was not until the early 1900s that the public utility conception of insurance regulation clearly emerged. Although states continued to pass anti-compact laws leading into the early years of the 1900s, these laws were increasingly viewed as ineffective by state legislatures. Insurers side-stepped these prohibitions by calculating and publishing rates outside of rating bureaus using ostensibly independent raters who published “advisory rates.”<sup>58</sup> Rather than target such evasion of anti-compact laws, some states—starting with Kansas, and followed shortly thereafter by the influential state of New York—imported into the insurance domain the same basic principles and techniques of rate regulation that were emerging at the same time in the public utility space.

### a. The Kansas and New York Models

Citizen protest of insurers’ collaborative rate setting was particularly pitched in Kansas, where farmers organized mutual insurance companies to bypass stock insurers and outraged citizens publicly voiced their discontent with fire insurance rates.<sup>59</sup> In response to these pressures, Kansas became the first state to pass legislation creating a rate regulatory regime for insurers in 1909.<sup>60</sup> Given the timing and the basic conceptualization of the fire insurance industry as a type of trust, it is perhaps not surprising that Kansas’s regulatory regime for insurers largely mirrored the key elements of the emerging public utility regulatory regime. Like regulated public utilities, the state insurance commissioner was tasked with reviewing insurers’ proposed rates to assess whether they were “excessive or unreasonably high” or resulted in “unjust discrimination” by charging different rates to policyholders who posed “risks of a like kind and hazard under similar circumstances and conditions.”<sup>61</sup> In the next

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58. *Id.* at 43.

59. See ROGER H. GRANT, INSURANCE REFORM: CONSUMER ACTION IN THE PROGRESSIVE ERA (1979) (quoting a Kansas drugstore owner as saying “That bastard Fetter is ruining me! I have to have fire insurance . . . . How can I pay this kind of rate when nobody has money?”); *Our History*, FARMERS’ ALLIANCE, <http://www.fami.com/our-history> [<http://perma.cc/2Y4T-GR5X>].

60. See An Act Relating to Fire Insurance, and to Provide for the Regulation and Control of Rates of Premium Thereon, and to Prevent Discriminations Therein, 1909 Kan. Sess. Laws 279.

61. *Id.* The statute also required the regulator to assess whether the rates were “adequate to the safety or soundness of the company.” *Id.*

several years, three additional states—Texas, Louisiana, and Missouri—passed laws that partially or fully mirrored Kansas’s proposals.<sup>62</sup>

Prompted by these developments, as well as the high-profile revelations of a state-coordinated investigation of the life insurance industry,<sup>63</sup> New York tasked a legislative committee—the “Merritt Committee”—with investigating the fire insurance industry.<sup>64</sup> The Merritt Committee produced a highly influential report that ended up playing a pivotal role in the development of property-casualty insurance regulation over the coming decades. It concluded that the key public policy issue in fire insurance stemmed from the prospect of “ruinous competition:” a process whereby insurers underpriced their policies in response to competitive pressures, causing them to be unable to pay claims in the wake of a large disaster.<sup>65</sup> This conclusion was not just theoretical: the previous century had witnessed this pattern several times over, most recently in the wake of the 1906 San Francisco Earthquake.<sup>66</sup>

Such ruinous competition, the Merritt Committee concluded, stemmed from two unique features of fire insurance markets. First, unlike in most industries, insurers’ costs (in the form of policyholder claims) are undetermined at the time rates are set. Rate setting thus requires insurers to predict future claims from past experience. But “it is impossible to make rates properly on the basis of a single company’s experience,” because the experience of even the largest company “is not extensive enough to insure the proper working of the law of averages on all classes” of policyholders.<sup>67</sup> This was because fire risk was ever changing and the risk of massive “conflagrations” of entire cities could not be easily assessed. Second, in the face of uncertainty about future costs, individual

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62. Schneiberg & Bartley, *supra* note 56, at 138. This sentiment is well reflected in a quotation from a 1911 Supreme Court opinion rejecting a constitutional objection to an Alabama statute that penalized fire insurers who collaborated in rate setting:

We can well understand that fire insurance companies, acting together, may have owners of property practically at their mercy in the matter of rates, and may have it in their power to deprive the public generally of the advantages flowing from competition between rival organizations engaged in the business of fire insurance. In order to meet the evils of such combinations or associations, the state is competent to adopt appropriate regulations that will tend to substitute competition in the place of combination or monopoly.

German All. Ins. Co. v. Hale, 219 U.S. 307, 316 (1911).

63. The New York legislature established the 1906 “Armstrong Committee” to investigate allegations that a high-profile life insurance executive had charged the company’s accounts for the costs of a private party. The committee uncovered a much broader set of scandals and improprieties throughout the life insurance industry, most of which involved the redirection of policyholder premiums for executives’ private gain. In the wake of these revelations, New York implemented many of the key precursors to modern insurance solvency rule, including review of companies’ investments and expenditures. MEIER, *supra* note 48, at 57-58.

64. *Merritt Committee Report*, *supra* note 57, at 3.

65. The report concluded that fire insurance markets were not subject to the same regulatory problems as life insurance, because the annual policy periods that typified fire insurance did not result in the aggregation of large reserves that could be misdirected by insurers or their officers. *Id.* at 103-106.

66. See D’Arcy, *supra* note 5, at 251; Kimball & Boyce, *supra* note 15, at 548.

67. *Merritt Committee Report*, *supra* note 57, at 40.

insurers often had an incentive to base their rates on optimistic expectations of future claims in order to underprice their competitors. In the event that these optimistic estimates were accurate, the insurer would profit. And to the extent that large losses did occur and costs substantially exceeded expectations—particularly in the event of a conflagration—it was the policyholders of the company who principally bore the loss in the form of unpaid claims.<sup>68</sup>

According to the Merritt Committee, the inverse production cycle of insurance not only led to ruinous competition, but to unfair discrimination as well. As it explained “the man of influence, whose patronage is desired, will get his insurance too cheaply, as against the small man who is not in a position to drive a sharp bargain.”<sup>69</sup> As in the case of ruinous competition, this risk of unfair discrimination stemmed from the lack of clear cost-based criteria for pricing coverage, which allowed other factors to influence the price that insurers charged. These included the desire to secure future business,<sup>70</sup> the ability of some to “drive a sharp deal,” the willingness to accommodate “men of influence,” and the fact that competitive forces (at least according to the Committee) tended to make it easier for insurers to over-charge less risky insureds and under-charge more risky insureds.<sup>71</sup> Not only was discrimination “controlled by competition, and not entirely by the hazard” unfair “against the small man,”<sup>72</sup> it was also inefficient: properly priced insurance—which reflected the actual risk associated with property—could indirectly promote fire prevention by causing insureds to take prudent safety measures that would lower their premiums.<sup>73</sup>

In response to the threats of ruinous competition and unfair discrimination, the Merritt Committee deemed it “natural” and “desirable” that competing insurers coordinate in setting their rates through industry run, rate-making bureaus.<sup>74</sup> Ideally these bureaus could pool competing insurers’ loss data and, on that basis, make projections about future costs.<sup>75</sup> At the same time, the Merritt Committee concluded that “*if companies are to be allowed to combine then it must be only on the assurance that the rates will be equitable.*”<sup>76</sup> To accomplish this, the Merritt Committee suggested that New York require insurers to file their rates and schedules with the insurance department for review. That review, the Merritt Committee concluded, should focus on ensuring that there was no unfair

68. *See id.* at 42.

69. *Id.* at 41.

70. *Id.* The insurer “secure business even at a loss in the hope that when normal rates again prevail the patronage won will remain and the loss will be made good.”

71. *See id.* at 63-64. This last conclusion, at least, seems plainly inconsistent with modern insurance theory, which suggests that competition among carriers will tend to limit cross-subsidization of high-risk policyholders by low risk policyholders.

72. *Id.* at 64.

73. *Id.* at 49.

74. *Id.* at 40 (emphasis added).

75. In most instances, insurers at that time did not pool their loss data through rate making bureaus, though they started to do so in an effort to develop more accurate rates after the Merritt Committee Report.

76. *Merritt Committee Report, supra* note 57, at 65-66 (emphasis in original).



discrimination in the rate schedules, with rates being fixed on the basis of the actual hazards to which policyholders were exposed. The Merritt Committee also recommended that insurers continue to collaborate in their drafting of policy forms, but that individual companies be permitted to change portions of their policy via endorsement if such changes were filed with and approved by the Department.

However, the members of the Merritt Committee disagreed regarding whether New York, like Kansas, should also assess whether insurers' rates were "excessive." According to the majority of the committee's members, such regulation was not necessary, because stock insurance companies were subject to competition from other forms of insurers like mutuals, which did not need to set their rates in collaboration with stock insurers because they could compete simply by setting premiums higher than expected costs and issuing dividends in the amount by which premiums exceeded losses.<sup>77</sup> Moreover, insurers in recent decades enjoyed a reasonable, and non-excessive, rate of return.<sup>78</sup> Meanwhile, rate regulation invited a host of potential problems, including politicization of the regulatory process and the consumption of regulatory resources. However, two members of the committee dissented from these conclusions, recommending that the Department of Insurance be empowered to modify insurers' rates if they were found to be "unreasonable" or "excessive," in light of the fact that rate-making bureaus "are in the nature of monopolies."<sup>79</sup>

New York promptly adopted the suggestions of the Merritt Committee's majority, embracing a rate regulatory regime that focused on preventing unfair discrimination but not "excessive" rates.<sup>80</sup> In the next several years, eight states followed New York's lead.<sup>81</sup> This spread of New York's model was based not just on the state's reputation as a leader in insurance regulation, but also on its efforts to recommend its approach to other states via the NAIC in 1914, with the NAIC drafting several model laws for states to adopt.<sup>82</sup> However, after an initial wave of states adopting New York's model, a number of states chose the more aggressive regulatory model first passed in Kansas and preferred by the dissenting members of the Merritt Committee, which included regulatory review for excessive rates.<sup>83</sup> But whichever model states preferred, the pre-cursors to modern rate regulation were clearly established. Between 1909 and 1924, nearly thirty states implemented either the Kansas or the New York model of rate regulation for fire insurers.<sup>84</sup>

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77. See Kimball & Boyce, *supra* note 15, at 545-46.

78. *Merritt Committee Report*, *supra* note 57, at 65-66.

79. *Id.* at 131.

80. See Frederick G. Crane, *Insurance Rate Regulation: The Reasons Why*, 39 J. RISK & INS. 511, 513 (1972).

81. Schneiberg & Bartley, *supra* note 56, at 138.

82. MEIER, *supra* note 48, at 73-74.

83. Schneiberg & Bartley, *supra* note 56, at 138.

84. See Baranoff, *supra* note 47.

b. Early Parallels Between Public Utility Rate Regulation and Insurance Rate Regulation

The parallels between the evolution of rate regulation of insurance and public utilities are manifold. With the Merritt Committee's report, the insurance industry began to be viewed less as a monopoly inimical to the public interest, and more as a special type of public utility at the exact same time that regulatory review of natural monopolies was first emerging.<sup>85</sup> Insurance markets, the committee emphasized, were subject to unique market conditions that required competing firms to share key infrastructure—the aggregation of common data, the generation of sustainable rates on that basis, and the drafting of common policy forms to facilitate these activities. This infrastructure had to be shared and actively maintained by the collective as a matter of economic necessity. Like natural monopolies, then, the public interest demanded that the state confer upon the industry special permission to engage in seemingly anti-competitive activities. And like natural monopolies, this special permission came with a trade-off: that firms submit to a special and intrusive form of rate regulation by a public authority.<sup>86</sup>

In addition to these similarities in the basic rationales for rate regulation in insurance and public utilities, the regulatory program to be adopted in insurance would mirror the public utility model that had emerged in the prior two decades. First, the prohibition against “excessive” insurance rates drew directly from public utility regulation. In both settings, the perceived risk of excessive rates stemmed from a lack of competition among firms, which resulted from distinctive features of the underlying markets. By contrast, the states that rejected prohibitions on “excessive” rates, such as New York, did so precisely because they believed that colluding stock insurers were indeed subject to competitive restraints in the form of mutual insurers.<sup>87</sup>

Second, a central goal of insurance rate regulation—preventing “unfair discrimination”—also matched a core principle of public utilities rate regulation. In both settings, such discrimination referred to the risk that any one group of customers would receive preferential rates that could not be justified by cost-based considerations. This, in turn, would result in non-favored customers

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85. Indeed, at one point in the committee report, it noted that fire insurers are subject to “difficult[] and peculiar[]” rate considerations that are not present in ordinary businesses, with the potential exception of “public utilities” where (as in insurance) “the fixing of rates is more difficult; more elements enter into the cost and more factors must be given consideration.” *Merritt Committee Report*, *supra* note 57, at 38-39.

86. To be sure, even this historical view did not equate property-casualty insurance markets with natural monopolies. Unlike natural monopolies, the reason that robust competition was understood to be impossible stemmed from the risk of ruinous competition rather than the existence of high fixed costs and low marginal costs.

87. See *id.* at 66 (emphasizing that “It has generally been assumed that a combination of fire insurance companies was exactly like a trust, that there was no internal competition among the members of the combination.”).

implicitly cross-subsidizing favored customers.<sup>88</sup> These concepts of discrimination drew implicitly from the antecedent concept of a “just price,”<sup>89</sup> which itself assumed that a firm incurred a specific and identifiable cost from serving each individual customer. By contrast, in neither setting did unfair or unjust “discrimination” focus explicitly on protecting historically disadvantaged subsets of the population.

Finally, in both the insurance and public utility settings, the core goals of rate regulation—preventing “unfair discrimination” and “excessive” rates—would be policed by a state-based regulatory body. Firms would regularly submit proposed rate changes to these state-based regimes for review. And in both settings, this review would focus on ensuring that the proposed rates were consistent with the true cost to the firm of providing the underlying service, along with a reasonable allowance for a profit.

These parallels between insurance regulation and public utility regulation were further buttressed by the Supreme Court’s 1914 opinion in *German Alliance Ins. Co. v. Lewis*, which affirmed the constitutionality of Kansas’s insurance regulatory scheme.<sup>90</sup> The court reasoned that fire insurance markets are “affected with a public interest,” a fact which “justifies regulatory legislation.”<sup>91</sup> Although the court considered a number of factors in reaching this conclusion—many of which are not plausibly limited to traditional natural monopolies<sup>92</sup>—it also echoed the Merritt Committee’s conclusion that the collective rate making activities of insurers justified a public utility style regulatory scheme:

[T]he price of insurance is not fixed over the counters of the companies by what Adam Smith calls the haggling of the market, but formed in the councils of the underwriters, promulgated in schedules of practically controlling constancy which the applicant for insurance is powerless to oppose, and which, therefore,

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88. Compare Ruggles, *supra* note 4, at 198, with *Prop. & Cas. Model Rating Law § 5 (A)(3)*, NAT’L ASS’N OF INS. COMM’RS (2010), <http://www.naic.org/store/free/GDL-1775.pdf> [<https://perma.cc/9K74-YDPY>] (“Unfair discrimination exists if, after allowing for practical limitations, price differentials fail to reflect equitably the differences in expected losses and expenses.”).

89. See Boyd, *supra* note 44.

90. *German All. Ins. Co. v. Lewis*, 233 U.S. 389, 417-18 (1914).

91. *Id.* at 406.

92. *Id.* at 413. For instance, the court emphasized that “a large part of the country’s wealth, subject to uncertainty of loss through fire, is protected by insurance” and that fire insurance is a practical “necessity to business activity and enterprise.” The court’s test for what industries were “affected with a public interest” and hence could be regulated without violating the Due process clause, reduced to industries that (i) served an important human need and (ii) were subject to sufficiently large market imperfections. Thus being a natural monopoly was not a necessary condition for being affected with a public interest. Indeed, the Supreme Court held that a broad number of industries that are not plausibly natural monopolies -- including banking, housing interests, stockyards and mines—are “affected with a public interest.” See Nicholas Bagley, *Medicine as a Public Calling*, 114 MICH. L. REV. 57, 59 (2015). Although this caselaw became legally obsolete with the end of the *Lochner* Era, it helped to justify and shape the structure of the applicable regulatory regime in a number of different industries that were not natural monopolies. See *id.*

has led to the assertion that the business of insurance is of monopolistic character and that “it is illusory to speak of a liberty of contract.”<sup>93</sup>

In sum, the origins of insurance rate regulation in the United States were deeply intertwined with the nearly contemporaneous development of public utility rate regulation. Throughout the first several decades of the twentieth century, both the rationales for insurance rate regulation and the basic structure of such regulation drew directly from public utility regulation. However, it was not until the middle of the twentieth century, with the passage of the McCarran Ferguson Act, that the public utility conception of insurance rate regulation became firmly entrenched.

### 3. The Solidification of Public Utility Style Rate Regulation

By 1944, thirty-three states had passed statutes that permitted collective insurance industry rate setting, subject to regulation of rates by the insurance commissioner.<sup>94</sup> However, the actual enforcement of these regimes was highly variable. According to a Department of Justice report at the time, policyholders in many of these states were left “virtually at the mercy of the combinations of fire-insurance companies which fix and maintain the rates to be charged by their members.”<sup>95</sup> As two leading commentators concluded in 1958, “[i]t might be a reasonably accurate generalization to say that in 1944, though ostensibly there was control in two-thirds of the states, insurance rate making was as yet largely uncontrolled in the United States.”<sup>96</sup> Motivated both by the perception of inadequate state regulation and the expanding scope of the Supreme Court’s Commerce Clause jurisprudence after the New Deal, the Department of Justice prosecuted a coalition of approximately 200 fire insurers for violations of the Sherman Antitrust Act.<sup>97</sup>

In *U.S. v. South-Eastern Underwriters Ass’n*,<sup>98</sup> the Supreme Court upended conventional wisdom in the insurance industry by holding both that the federal government could indeed regulate fire insurers under its Commerce Clause power, and that it in fact had already done so through antitrust statutes like the

93. *German All. Ins. Co. v. Lewis*, 233 U.S. 389, 416-17 (1914).

94. Kimball & Boyce, *supra* note 15, at 552.

95. *Joint Hearing Before the Subcomms. of the Comms. on the Judiciary on S. 1362, H.R. 3269, and H.R. 3270*, 78th Cong. 55–57 (1943).

96. Kimball & Boyce, *supra* note 15, at 552; *see also* MEIER, *supra* note 48, at 73 (cataloging some of the limits of rate regulation statutes before passage of the McCarran Ferguson Act).

97. Operating through the South-Eastern Underwriting Association (SEUA), these insurers did not just set premium levels for their member insurers, which included approximately 90% of the fire insurers in a six state region. They also actively attempted to coerce non-member insurers to comply with their rates, by cutting non-complying insurers off from reinsurance markets, penalizing independent agents who continued to sell coverage through them, and refusing to cover individuals who previously or concurrently secured coverage through a non-complying insurer. *See United States v. S.-E. Underwriters Ass’n*, 322 U.S. 533, 535-36 (1944).

98. *Id.*

Sherman Act. *Paul v. Virginia*, the court explained, merely held that the U.S. Constitution did not deprive states of the power to regulate insurance; it did not affirmatively hold that the federal government could not regulate the industry under its Commerce Clause power. In fact, the Court held, the ordinary meaning of the phrase “interstate commerce”—even at the time of the Constitution’s drafting—plainly encompassed fire insurance, which operated as an integrated and national industry. Moreover, the scope of broadly-worded antitrust laws like the Sherman Act was to broadly regulate all forms of interstate commerce that implicated concerns of unfair competition and monopolization, a scope that clearly covered fire insurance markets.<sup>99</sup>

*South-Eastern* set off a flurry of federal lobbying activity among both fire insurers and state insurance regulators. State regulators worried that the continued existence of state insurance regulation and taxation were in danger, in part as a result of the dissenting opinion in the case which suggested as much.<sup>100</sup> Meanwhile, stock fire insurers focused their concerns on the prospect that federal antitrust laws could undermine collective rate making, which could produce the very type of ruinous competition that had been the focus of the Merritt Committee report.<sup>101</sup> Seeking to leverage the support of these two coalitions, the NAIC proposed a bill in 1944 that would both clarify that state regulation and taxation of insurance were permissible under the Commerce Clause, and exempt the insurance industry from various federal antitrust laws so as to preserve its collective rate-setting practices.<sup>102</sup>

In 1945, Congress passed a version of the proposed NAIC legislation, known as the McCarran Ferguson Act. The antitrust provisions in the Act explicitly exempted “the business of insurance” from a number of federal antitrust laws, including the Sherman Act, Clayton Act, and Federal Trade Commission Act.<sup>103</sup> The goal of these provisions, as the Supreme Court put it, “was that cooperative ratemaking efforts be exempt from the antitrust laws” in light of “the widespread view that it is very difficult to underwrite risks in an informed and responsible way without intra-industry cooperation.”<sup>104</sup>

However, the Act also provided that this antitrust exemption shall be applicable to the business of insurance “only to the extent that such business is [] regulated by state law.”<sup>105</sup> President Roosevelt explained these provisions in his signing statement by noting that “Congress did not intend to permit private rate fixing which the Anti-Trust law forbids, but was willing to permit actual

99. *Id.* at 539.

100. *Id.* at 590.

101. MEIER, *supra* note 48, at 67.

102. *Id.* at 69.

103. Notwithstanding this broad exemption, the Sherman Act does continue to be applicable to “any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation.” The Supreme Court has interpreted this exception to the Antitrust exemption narrowly. *See Hartford Fire Ins. Co. v. California*, 509 U.S. 764, 779-80 (1993).

104. *Grp. Life & Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 221 (1979).

105. McCarran Ferguson Act, 15 U.S.C. § 1012 (2018).

regulation of rates by affirmative action of the states.”<sup>106</sup> Both Congress and the President were willing to tolerate fire insurers’ practices of collective rate setting under these regulated conditions only because of the “virtually unchallenged” claim of fire insurers at the time that “free competition would be a disaster for the industry.”<sup>107</sup>

In other words, the legislative bargain was clear, and tracked exactly the bargain that had long been understood in the public utility arena: the peculiar features of the insurance industry necessitated collective action with respect to rates, but such anti-competitive conduct would only be tolerated by the law if it were affirmatively regulated by state officials who ensured that the resulting rates ultimately served the public interest. As stated perhaps most clearly by Attorney General Biddle:

The view we hold toward insurance is not unlike our policy toward railroad rates, that the fixing of rates by private groups . . . without active and definite state approval, is a clear contravention, not only of the [Sherman] act, but of the whole theory that underlies the act, the theory that competition should be free unless it is specifically regulated by the appropriate body.<sup>108</sup>

Reflecting this bargain, state insurance regulators organized via the NAIC and under the leadership of New York Insurance Superintendent Robert Dineen to affirmatively implement public utility style rate regulation. The resulting “All-Industry Bills” accomplished this in two primary ways. First, it extended the goals of insurance rate regulation to include both the prohibition of “unfairly discriminatory” and “excessive” rates. This, of course, represented a substantial expansion of regulatory authority for those states that had adopted the earlier New York model, which focused solely on rooting out “unfair discrimination” in the regulatory rate review process.

Second, the “All-Industry Bills” established a detailed set of procedures by which state regulators would implement their rate regulation. Insurers—either individually, or through a rating bureau to which they belonged—would be required to file their proposed rates 15 days prior to their use. These rates would be deemed to be approved if the state did not affirmatively disapprove them within this time frame.<sup>109</sup> To disapprove a rate, the state commissioner would hold a hearing—thus further paralleling the rate hearings that typified the public utility arena.<sup>110</sup> Within the next several years, every single state passed a version of these laws.<sup>111</sup>

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106. MEIER, *supra* note 48, at 70.

107. *Id.* at 72.

108. Kimball & Boyce, *supra* note 15, at 570-71.

109. MEIER, *supra* note 48, at 75.

110. *Id.*

111. *Id.* at 76.

In addition to extending the scope and enforcement of insurance rate regulation, the All-industry Bills added a new, ultimately short-lived, goal to insurance rate regulation. Not only would rate regulation serve the traditional goals of preventing “excessive” or “unfairly discriminatory” rates, but it would also seek to insure that carriers’ proposed rates were not “inadequate.”<sup>112</sup> This provision was designed to ensure that industry coordination on rates accomplished its basic goal of preventing “ruinous competition.” In that sense, rate regulation was to be thought of as a new form of solvency regulation, intended to ensure that insurers charged sufficient rates to pay out the claims they might ultimately owe.

#### 4. Modern Insurance Regulation and the Continued Vitality of Public Utility Style Rate Regulation

Over the decades since passage of the All-Industry Bills, states have diverged greatly in their continued reliance on public utility style rate regulation in property-casualty insurance markets. Many states have substantially deregulated rate regulation in property-casualty insurance markets, with the precise details of such deregulation varying by state. Illinois, for instance, failed to reauthorize its rate regulatory regime in 1971. The effect of this inaction was to eliminate the Insurance Department’s authority to review rate filings.<sup>113</sup> Various other states also deregulated their rates during this timeframe, though none have gone as far as Illinois. For instance, a number of states enacted file and use regimes, wherein insurers could alter their rates without waiting for regulatory action, thus potentially creating a presumption in favor of market-set rates.<sup>114</sup> Many other states exempted from rate regulation various property-casualty market segments that catered to relatively sophisticated policyholders.<sup>115</sup>

Yet as suggested above, numerous states resisted these trends, particularly after a series of perceived insurance-market crises in the 1970s and 1980s.<sup>116</sup> In some states, regulation of insurers’ rates was affirmatively increased from the baseline regime reflected in the “All Industry” laws. For instance, California adopted via proposition an extensive rate regulatory regime for auto insurance in 1988 that affirmatively limited the criteria on which insurers could base their rates, and created a wide-ranging regime for regulatory review and public

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112. See *id.* at 75.

113. See D’Arcy, *supra* note 5, at 257.

114. See ABRAHAM & SCHWARCZ, *supra* note 3, at 127.

115. See *Analysis of Property-casualty Insurance Rate Regulatory Laws*, PROP. CASUALTY INS. AM. (2011), <http://www.leg.state.nv.us/Session/76th2011/Exhibits/Assembly/CMC/ACMC279L.pdf> [<http://perma.cc/L649-QRJQ>].

116. See Tom Baker, *Medical Malpractice and the Insurance Underwriting Cycle*, 54 DEPAUL L. REV. 393, 393 (2005).

contestation of rate changes.<sup>117</sup> Other states, such as North Carolina, affirmatively required all property-casualty insurers in specified industries (i.e. auto and homeowners) to collectively file their rates through a state-wide rating bureau, and only thereafter allowed individual companies to deviate from the collectively approved rates.<sup>118</sup> Meanwhile, even among the states that deregulated large segments of the property-casualty market, many retained rate regulation for workers' compensation insurance markets, where rates increased substantially during the 1980s due to increased losses.<sup>119</sup>

In addition to these changes in the legal regimes governing insurance rate regulation, the actual processes and intensity of public utility style rate regulation continues to vary substantially by state and across time. For instance, the California Department of Insurance ("CDI") rigorously reviews most, if not all, insurers' rate change filings, and frequently negotiates reduced rate increases directly with the carrier during conference calls and in-person meetings.<sup>120</sup> When such negotiations fail, CDI can initiate a public administrative hearing regarding the proposed rate increase. Perhaps even more importantly, public interest groups can directly request a public hearing in response to an insurer's proposal to increase rates and can receive compensation for their efforts for participating in that hearing.<sup>121</sup> The number of public hearings on insurers' rate increase requests has ranged from a mere handful in some years, to over a dozen in other years.<sup>122</sup> In many instances, the difference between the rate finally approved at the administrative hearing and insurers' requested rate is more than ten percent, and in at least some cases it has been more than thirty percent.<sup>123</sup>

By contrast, other states more sporadically examine or challenge insurers' rate filings, notwithstanding their legal authority to do so. For instance, Texas regulators infrequently deny rate change requests and rarely hold hearings to consider these filings. Indeed, from 2007 to 2009, the Office of Public Insurance Counsel (OPIC)—which plays a central role in reviewing rate change applications in Texas—formally objected to less than three percent of the rate change applications that it reviewed, and more than half of these objectives did not result in any rate change.<sup>124</sup> At the same time, even Texas regulators do occasionally deny rate change requests in certain cases. In total, these denials

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117. Jaffee & Russell, *supra* note 5, at 197-201; Hunter, *supra* note 5, at 23-29; Stephen D. Sugarman, *California's Insurance Regulation Revolution: The First Two Years*, 27 SAN DIEGO L. REV. 683, 692-96 (1990).

118. ABRAHAM & SCHWARCZ, *supra* note 3, at 131.

119. See HARRINGTON, *supra* note 6, at 8.

120. See Daniel Schwarcz, *Preventing Capture Through Consumer Empowerment Programs: Some Evidence From Insurance*, in PREVENTING CAPTURE: SPECIAL INTEREST INFLUENCE AND HOW TO LIMIT IT (Daniel Carpenter & David A. Moss eds., 2013)

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*



have, according to OPIC, resulted in hundreds of millions of dollars of savings for Texas consumers.

In large part, these variations in the intensity and processes of insurance rate regulation are simply a result of politics: insurance commissioners are either appointed (typically, but not always, by the Governor) or else directly elected, meaning that their inclinations with respect to the role of regulation vary substantially with political cycles.<sup>125</sup> It is thus no surprise that insurance rate regulation in California—a traditionally pro-regulatory state—is more intensive than insurance rate regulation in Texas. But even in these states, political factors can substantially influence the insurance rate regulation. For instance, California regulators were much less proactive in challenging rate increases during the years that the insurance commissioner was a Republican, while Texas had a relatively robust system of insurance rate regulation before an anti-regulatory political movement in the state, during the early 2000s.

Even apart from these political issues, different states have quite different procedures for determining whether a rate increase is excessive. For instance, some states focus only on underwriting profits in their review, evaluating the loss and expense elements of insurers' filings to ensure that profits fall within specific ranges.<sup>126</sup> Other states also take into account insurers' investment income in setting rates. Still other states more formally pattern their rate review procedures on public utility rate regulation, by including within that process an assessment of the appropriate rate of return on invested capital.<sup>127</sup>

States have been more consistently impacted by two developments in insurance rate regulation over the last several decades. First, the prohibition against "inadequate" rates in insurance is now a dead letter in virtually all states.<sup>128</sup> Recall that the rationale for this element of rate regulation was to help ensure insurers' solvency and limit the risk of "ruinous competition." But the modern tools of insurance solvency regulation—including rules governing financial reporting, reserves, capital, investments, affiliate transactions, state guarantee funds, and the like—developed dramatically in their sophistication in the later decades of the twentieth century. These have eliminated the need for regulators to attempt to ensure solvency by evaluating whether insurers' rates are sufficiently high.<sup>129</sup> Second, the industry's exemption from most forms of federal antitrust law does not meaningfully vary by state. Although this exemption only applies to the extent that there is state "regulation" of the business of insurance

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125. See Martin F. Grace & Richard D. Phillips, *Regulator Performance, Regulatory Environment and Outcomes: An Examination of Insurance Regulator Career Incentives on State Insurance Markets*, 32 J. BANKING & FIN. 116 (2008).

126. HARRINGTON, *supra* note 6, at 9.

127. See *id.* For an example of some of the difficulties this approach creates, see *Comm'r of Ins. v. N.C. Rate Bureau*, 124 N.C. App. 674 (1996). For a more extensive overview, see KENNETH ABRAHAM, *INSURANCE LAW AND REGULATION* (2d ed. 1995).

128. See ABRAHAM & SCHWARCZ, *supra* note 3, at 117 ("Historically, the core tool of solvency regulation was the mandate that insurance rates be "adequate." Today, that is a historical relic.").

129. See *id.* at 118-23.

under the McCarran Ferguson Act, courts have read this requirement sufficiently loosely that it applies to virtually every issue concerning the business of insurance within virtually every state.<sup>130</sup>

## II. The Antiquated Assumptions of Public Utility Style Insurance Rate Regulation

As Part I makes clear, public utility style rate regulation in insurance is firmly rooted in the view that property-casualty insurance markets are comparable to natural monopolies because they require competitors to collaborate with respect to the pricing and design of their products. But much has changed with respect to competing insurers' collaboration since the 1940s, when the McCarran Ferguson Act embedded this public utility model into the fabric of insurance regulation by conditioning the industry's partial immunity from federal antitrust law on state rate regulation. Some of these changes—particularly the industry's agreement to abandon the development of advisory rates—are well appreciated in the literature, although they have generally been linked to the industry's antitrust immunity rather than to the rationale for state rate regulation.<sup>131</sup> Other important changes to the industry's collaboration—including the elaborate infrastructure for regulating the generation of aggregate data and the decreasing importance of this data for many large insurers—are less well documented. Section II.A thus describes the modern-day property-casualty industry's reliance on, and mechanisms for producing, information regarding the design and pricing of their products. It also describes insurers' replacement of advisory rates with historical loss data, as well as the elaborate regulatory system that has developed to limit the risk of industry collusion with respect to rates.

Having laid these foundations, Section II.B argues that the basic assumptions undergirding public utility style insurance rate regulation are no longer accurate.<sup>132</sup> In fact, modern-day industry data production does nothing to undermine robust competition among competing insurers with respect to their product design or pricing decisions. To the contrary, such collaboration enhances competition by facilitating market entry and allowing small insurers to compete

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130. See *id.* at 159 (noting that this requirement is met in most cases “if the state has enacted a statute authorizing regulation of insurance and regulatory authorities have not totally ignored the general class of activities into which that activity falls. It is not necessary to point to a state statute that approves or disapproves a particular practice; as long as there is a state regulatory scheme that has jurisdiction over the challenged practice then the regulation requirement is satisfied”).

131. See, e.g., JONATHAN R. MACEY & GEOFFREY P. MILLER, *COSTLY POLICIES: STATE REGULATION AND ANTITRUST EXEMPTION IN INSURANCE MARKETS* 103-06 (1993); Mark F. Horning, *Antitrust Immunity for the Insurance Industry Repeal, Safe Harbors, or Status Quo?*, 8 *ANTITRUST* 14, 18 (1994).

132. To be sure, I am not the first to question the continuing applicability of the public utility model of insurance. Perhaps most notably, Kenneth Abraham has suggested in one recent article that the rationale for regulating insurance “is less like the rationale for regulating public utilities and more like the rationale for regulating food and drugs, whose dangers are difficult to detect, but which are essential for individual well-being.” Abraham, *supra* note 1, at 669-70.

against larger carriers by mimicking some of the key economies of scale in the industry. And it certainly does nothing to prevent robust price and product competition among insurers. For these reasons, modern-day industry collaboration in property-casualty insurance markets would almost certainly pass muster under federal antitrust law principles, were they to apply to the industry. In light of these realities, modern-day collaboration within the industry cannot—as it historically did—justify public utility style rate regulation in insurance.

### *A. Modern-Day Collaboration in Property-Casualty Insurance Markets*

#### 1. The End of Advisory Rates

Historically, public utility style insurance rate regulation was premised principally on insurers' collective setting of advisory rates. That practice ceased in the early- to mid- 1990s. With the sole exception of North Carolina,<sup>133</sup> every state now bans by statute or regulation any insurer, or organization that provides support to an insurer, from calculating or publishing advisory rates.<sup>134</sup>

These laws prohibiting advisory insurance rates date back to the early 1990s. During the mid-1980s, many property-casualty insurance markets experienced perceived crises in the availability and affordability of insurance coverage.<sup>135</sup> Some federal lawmakers who linked these crises to anti-competitive practices among insurers introduced proposed legislation that would repeal the industry's antitrust exemption.<sup>136</sup> Meanwhile, a coalition of nineteen states sued large segments of the insurance industry for a wide-ranging conspiracy to restrict the terms and conditions of Commercial General Liability policies.<sup>137</sup>

Prompted by these developments, state insurance regulators called for an end to the industry's production of advisory rates.<sup>138</sup> Although regulators continued to acknowledge insurers' legitimate interest in sharing historical loss data so as to predict future losses, they also recognized that this interest did not require insurers to collaboratively set their rates.<sup>139</sup> In part, this was because

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133. North Carolina relies on advisory organizations to develop baseline rates, and then requires insurers who want to deviate from these rates to make a separate filing. ABRAHAM & SCHWARCZ, *supra* note 3, at 131.

134. *NAIC Loss Cost Bulletins*, NAT'L ASS'N OF INS. COMM'RS, [http://www.naic.org/industry\\_rates\\_forms\\_loss\\_cost.htm](http://www.naic.org/industry_rates_forms_loss_cost.htm) [<http://perma.cc/7QTE-XZZX>].

135. See Baker, *supra* note 116, at 415.

136. Insurance Competitive Pricing Act of 1993, H.R. 9, 103d Cong. (1993); Insurance Competitive Pricing Act of 1993, S. 84, 103d Cong., (1993).

137. Hartford Fire Ins. Co. v. California, 509 U.S. 764, 778 (1993).

138. Kevin Thompson, *McCarran-Ferguson Repeal and ISO'S Advisory Rate Ban: A Chance for Compromise?*, 17 N. KY. L. REV. 373, 383 (1989) (“We think at a minimum, companies need to factor in their own figures for profit and their own experience to calculate expenses.” said Nebraska Insurance Director William H. McCartney.”).

139. See Horning, *supra* note 131, at 15 (lawyer for the insurance industry acknowledging that “In contrast to the pooling of loss data, where there is a strong justification for industry cooperation, there is no similar efficiency rationale for cooperation between competitors on the expense and profit components of their rates”).

insurers' rates were impacted not just by their claims experiences, but also by their targeted level of profit and non-claims based expenses, such as overhead and marketing. Perhaps even more importantly, any individual company's rates should also reflect differences between that company's claims experiences and the claims experiences of the industry as a whole. A competitive insurer could pay less in claims by engaging in superior underwriting, rooting out fraud more effectively, or inducing higher levels of care among its policyholders. But advisory rates could blunt insurers' incentives to compete along these dimensions, or else limit the extent to which competitive advantages redounded to the benefit of policyholders in the form of lower premiums.

Starting in 1991, states began to formally prohibit insurers or the organizations that supported them from developing or publishing advisory rates. The NAIC first developed these limitations in a 1991 sample bulletin, which many states promptly adopted. Over time, portions of this bulletin were incorporated into model NAIC rating laws as well as an updated NAIC loss cost memorandum.<sup>140</sup> Over the next several years, individual states codified or incorporated relevant portions of these bulletins and/or model laws into their own laws and regulations.<sup>141</sup>

## 2. Modern Data Collection and Dissemination

Although insurers no longer publish or develop advisory rates, the industry does continue to collect massive amounts of statistical data on losses, premiums, and exposures, which is then made widely available to industry participants. But these data collection efforts are now facilitated by various insurance intermediaries that operate in a highly-regulated and coordinated environment to produce only specifically-authorized forms of data.<sup>142</sup>

Over the last several decades, a roughly uniform regulatory scheme has evolved to facilitate and oversee the industry's collection and publication of historic loss and premium data. Every state in the country requires property-casualty insurers to collect reams of statistical data regarding their premiums, costs, and claims experiences. This data must then be reported to insurers' state regulators in a standardized format based on specific definitions and procedures.<sup>143</sup> In practice, insurers outsource this reporting function to

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140. *NAIC Loss Cost Bulletins*, NAT'L ASS'N OF INS. COMM'RS, [http://www.naic.org/industry\\_rates\\_forms\\_loss\\_cost.htm](http://www.naic.org/industry_rates_forms_loss_cost.htm) [<https://perma.cc/7QTE-XZZX>].

141. *See, e.g.*, VA. CODE ANN. § 38.2 (1991); NEB. REV. STAT. § 44-7522 (1991); *see also* Horning, *supra* note 131, at 15 (noting that a "number of states have prohibited development of end rates in favor of prospective loss costs").

142. *See generally* *Statistical Handbook of Data Available to Insurance Regulators*, NAT'L ASS'N OF INS. COMM'RS (2012) [http://www.naic.org/documents/prod\\_serv\\_statistical\\_sta\\_zu.pdf](http://www.naic.org/documents/prod_serv_statistical_sta_zu.pdf) [<http://perma.cc/QNC3-CVUB>] [hereinafter *Statistical Handbook*].

143. This obligation was originally contained in the All-Industry Laws that every state passed in the wake of the McCarran Ferguson Act. Even states that altered the role of rate regulation generally kept these reporting requirements. For the current version of the NAIC model Law on point, *see Model Regulation to Require Reporting of Statistical Data by Property and Casualty Insurance*

“statistical agents.”<sup>144</sup> There are numerous statistical agents, including organizations such as the Insurance Services Office (ISO), the American Association of Insurance Services (AAIS), the National Independent Statistical Association, and the General Insurance Statistical Association.<sup>145</sup>

Statistical agents use insurers’ data to generate publicly-available, “annual statistical compilations” that match insurers’ aggregate premiums and losses for each line of insurance.<sup>146</sup> The data is detailed by coverage type and policyholder class, allowing regulators and insurers to evaluate historic loss ratios, claims costs, and claims frequencies.<sup>147</sup> There is generally a time lag of between one and three years (depending on the line of coverage) between the actual experience year on which reports are based and publication of annual statistical compilations, reflecting the fact that it takes time for losses in a given year to be processed and result in final resolution of claims.<sup>148</sup>

With some important adjustments often referred to as “loss development” and “loss trending,” insurers can use the historic data contained in the annual statistical compilations to generate reliable expected loss costs, even if they have limited company-specific data regarding the particular coverage line in the region where they are writing coverage. To do so, insurers must first fill in gaps in the historic loss cost data that result from the fact that some claims during the reporting period may not have been finally settled at the time of report publication. This process is referred to as “loss development,” and generally involves estimating the final costs of reported but unpaid claims based on similar claims in the past. Once these gaps in the data are limited, insurers must then engage in loss trending by adjusting loss expenses forward in time to account for inflation or shifts in claim frequency or severity.<sup>149</sup> This process can require adjustments over several years, depending on the time gap between the actual experience year on which reports are based and publication of the annual statistical compilation. Finally, loss cost data may need to be adjusted to spread out the costs of catastrophe events over multiple policy years.<sup>150</sup>

Insurers who would prefer not to perform these calculations in house can outsource them to “advisory organizations,” which are authorized to generate “advisory prospective loss costs” that incorporate these various adjustments.<sup>151</sup>

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*Companies*, NAT’L ASS’N OF INS. COMM’RS (2004) <http://www.naic.org/store/free/MDL-751.pdf> [<http://perma.cc/7CKT-HJNG>].

144. See, e.g., *Prop. & Cas. Model Rating Law (prior approval version)* § 2 (N) NAT’L ASS’N OF INS. COMM’RS (2009), <http://www.naic.org/store/free/GDL-1780.pdf> [<http://perma.cc/GN93-JLY5>].

145. For a more complete list, see Appendix A of *Statistical Handbook*, *supra* note 142.

146. PROP. & CAS. MODEL RATING LAW (PRIOR APPROVAL VERSION), *supra* note 144,

§ 17.

147. *Statistical Handbook*, *supra* note 142, § 3.3.

148. See *id.* § 3.5.

149. See ABRAHAM & SCHWARCZ, *supra* note 3.

150. See *Statistical Handbook*, *supra* note 142, §§ 3.6.4-3.6.5.

151. See Mark A. Geistfeld, *Legal Ambiguity, Liability Insurance, and Tort Reform*, 60

DEPAUL L. REV. 539, 550 (2011).

The major advisory organizations—ISO and AAIS—are also statistical agents, though not all statistical agents are advisory organizations. In addition to providing their subscribers with advisory prospective loss costs, advisory organizations provide a host of additional data-related services to their insurer-subscribers. These include drafting model policy forms and developing various tools that allow insurers to effectively discriminate among low-risk and high-risk policyholders.<sup>152</sup>

Irrespective of whether an insurer develops loss cost estimates on its own or relies on advisory prospective loss costs produced by an advisory organization, it does not receive any industry data bearing on considerations other than average loss costs. Thus, none of the data generated by either statistical agents or advisory organizations include non-loss adjustment expenses facing insurers, including the costs of acquisition, field supervision, collection expenses, general expenses, taxes, licenses, and fees.<sup>153</sup> Nor does this data include any indication of the expected or appropriate level of profit earned by carriers.<sup>154</sup> Additionally, because the data is aggregated across carriers, it generally does not provide any insight regarding individual carriers' loss expenses or pricing strategies.

Advisory organizations and statistical agents are prohibited from mandating the use of any particular data in the rate making process, or facilitating an agreement about this data use among insurers. Thus, not only do advisory organizations and statistical agents no longer generate advisory rates, they also cannot require their members to incorporate into their rates any particular loss projections, rating plans, rating schedules, or rating rules.<sup>155</sup> Ultimately, each insurer must “individually determine and file the rates it will use as a result of its own independent company decision-making process.”<sup>156</sup> Similarly, advisory organizations are forbidden from requiring their members to use their policy forms.<sup>157</sup>

Compliance with these rules is monitored and enforced by the states. In general, both advisory organizations and statistical agents must be licensed by the states in which they operate, and they are subject to periodic on-site exams. The NAIC operates an Advisory Organization Examination Oversight Working Group that coordinates state exams, limiting the risk that they will prove

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152. Advisory organizations can also develop rules, relativities, and supplementary rating information, which allow insurers to translate their individually chosen rate into premiums for individual insureds, depending on their individual risk levels. See Tim Wagner, *Insurance Rating Bureaus*, 19 J. INS. REG. 189 (2000).

153. See *id.*

154. *Id.*

155. See PROP. & CAS. MODEL RATING LAW (PRIOR APPROVAL VERSION), *supra* note 144, §§ 4-5.

156. NAIC Loss Cost Memorandum – Other than Workers' Comp, *Prospective Loss Costs Procedures*, NAT'L ASS'N OF INS. COMM'RS (Nov. 7, 2008), [http://www.naic.org/documents/industry\\_rates\\_loss\\_cost\\_other\\_memo.pdf](http://www.naic.org/documents/industry_rates_loss_cost_other_memo.pdf) [<https://perma.cc/CBQ5-9544>].

157. See *id.*

duplicative or ineffective.<sup>158</sup> The results of these exams are generally made public.<sup>159</sup>

Not only have the substance and mechanics of insurance industry data sharing changed dramatically since the McCarran Ferguson Act, so too has the significance of this data sharing. Many large and even medium sized carriers no longer extensively rely on historical loss data or the various data services offered by advisory organizations. Instead, their scale, along with obvious advances in modern technology, now allows many insurers to reliably anticipate loss expenses solely from their own historical claims data.<sup>160</sup> In fact, company-specific loss data is often more accurate and reliable predictor of future loss experience than industry aggregated data, because each company's pool of policyholders and claims-paying practices are distinctive.<sup>161</sup>

### *B. The Impact of Modern-Day Data Sharing in the Insurance Industry on Competition*

Insurers' historical practice of collaboratively devising their policy forms and rates clearly limited product and price competition among different carriers. By contrast, the various data sharing practices that prevail in modern-day insurance markets do not, in fact, limit competition among insurers with respect to either pricing or product design among carriers. To the contrary, they promote competition by reducing barriers to entry and limiting the advantages that large carriers have over smaller carriers resulting from economies of scale.

#### 1. Modern Data Sharing and Explicit Price-Fixing Schemes

There is essentially no risk that insurers' modern data-sharing practices could result in an explicit price-fixing scheme among competitors of the sort that prevailed historically. Perhaps the most obvious reason for this is that such an agreement would directly violate the law,<sup>162</sup> and there is every reason to believe that this prohibition is reasonably well enforced: unlike almost any other industry where price fixing might occur, insurers and advisory organizations are proactively examined by regulators whose primary mandate involves affirmatively searching for these types of explicit agreements.

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158. See Advisory Org. Examination Oversight (C) Working Grp., *2018 Charges for the NAIC*, NAT'L ASS'N INS. COMM'RS, [http://www.naic.org/cmte\\_c\\_aosp.htm](http://www.naic.org/cmte_c_aosp.htm) [<http://perma.cc/2WLW-U39Q>].

159. For the report of a recent examination of the ISO that extensively discusses its compliance with these rating rules, see *Report of Examination of Insurance Services Office, Inc. and ISO Data, Inc.*, NAT'L ASS'N OF INS. COMM'RS (Dec. 31, 2011), [http://www.naic.org/documents/committees\\_c\\_aosp\\_exposure\\_iso\\_report.pdf](http://www.naic.org/documents/committees_c_aosp_exposure_iso_report.pdf) [<http://perma.cc/M3JP-TAM5>].

160. Paolo Neirotti & Emilio Paoucci, *Assessing the Strategic Value of Information Technology: An Analysis on the Insurance Sector*, 44 INFO. & MGMT. 568, 573 (2007).

161. Schwarcz, *supra* note 53, at 1275.

162. Horizontal price fixing is the paradigmatic antitrust violation. See *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 551 U.S. 877, 886 (2007).

Even if some subset of firms attempted to circumvent this enforcement scheme to fix insurance prices, such a conspiracy could not be maintained using the data that is now shared across the industry. Recall that this data—even when it consists of prospective loss costs—excludes both a variety of insurer expenses as well as any profit component. There is no conceivable way for competing insurers to agree to incorporate this data into their pricing models, because there would be no way for conspiring insurers to ensure compliance with this agreement. That is because insurers cannot observe their competitors' loss cost assumptions, but only the end prices that are charged to consumers. It would therefore be impossible for any firm within the conspiracy to know whether any other firm was in fact cheating when it charged consumers lower prices, or was instead simply using different profit targets or non-claims-based expenses.

Insurers contemplating a price fixing conspiracy might attempt to overcome this difficulty by agreeing to set their prices using a formula that incorporated prospective loss costs to generate end prices that could be observed by fellow members of the conspiracy. But such a conspiracy would be relatively easy for regulators to spot. First, it would require members of the conspiracy to explicitly negotiate and set the terms of the formula to be used, and presumably to update that formula on an ongoing basis. These communications and negotiations would obviously substantially increase the likelihood of detection by regulators. Second, even if regulators somehow failed to spot these explicit agreements in their examinations, they could identify them from price quotes that ordinary consumers received, as the underlying loss data on which such a conspiracy would be based would be familiar to regulators. As such, regulators could effectively derive the terms of the hypothetical conspirators' formula by using the underlying loss data and several price quotes.<sup>163</sup>

## 2. Modern Data Sharing and Tacit Collusion with Respect to Prices or Product Design

There is also little risk that insurers' data sharing practices could undermine competition by producing anti-competitive tacit coordination among competitors. In *United States v. Gypsum*, the Supreme Court explained that “[t]he exchange of price data and other information among competitors does not invariably have anticompetitive effects; indeed such practices can in certain circumstances increase economic efficiency and render markets more, rather than less, competitive.”<sup>164</sup> To determine whether the sharing of data among competitors is pro- or anti-competitive, courts should examine “the structure of

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163. See *Todd v. Exxon Corp.*, 275 F.3d 191, 213 (2d Cir. 2001) (recognizing that a conspiracy based on the production of shared data is harder to maintain when the data is publicly available).

164. 438 U.S. 422, 441 (1978).



the industry involved and the nature of the information exchanged,” the court explained.<sup>165</sup>

Consideration of these factors clearly favors a conclusion that the modern-day data sharing practices of insurers are indeed pro-competitive. Turning first to the market structure inquiry—which generally focuses on market concentration—most property-casualty insurance markets are characterized by robust competition among dozens of competing firms.<sup>166</sup> It is relatively easy to define the relevant markets in this setting: property-casualty insurance products are generally only interchangeable within an individual state over relatively well-defined lines of coverage. Using this definition of property-casualty markets, Table 1 reports the market share of the top 4 insurance groups and the number of competing insurers in each state for the three lines of coverage that are most commonly subject to public utility style rate regulation.

The numbers in Table 1 demonstrate that almost all property-casualty insurance markets are reasonably competitive.<sup>167</sup> Although the top four insurers in many property-casualty insurance markets often do control a substantial amount of the business across the state—ranging from thirty percent to sixty-five percent for most markets—dozens of competing insurance groups operate in almost all of these markets. The HHIs in these markets also suggest that they are generally reasonably competitive.<sup>168</sup> Most property-casualty markets have HHIs ranging from 700 to 1500. Only a small number of these markets have HHIs between 1,500 and 2,500 points, a level which the Justice Department considers to be “moderately concentrated.” None of the markets have HHIs in excess of 2,500 points, which corresponds to a “highly concentrated” market under Department of Justice guidelines.<sup>169</sup>

165. *See id.*; *Todd*, 275 F.3d at 213.

166. To be sure, some specialized property-casualty insurance markets are indeed relatively concentrated, such as the title insurance market. *See*, 2015 *Title Insurance Industry Book*, AM. LAND TITLE ASS'N 12-13 (2015), <http://www.alta.org/industry-research/data-book/2015-title-industry-data-book.pdf> [<http://perma.cc/CM4R-LA23>] (reporting that, in most states, the top three title insurers typically write at least 60% of direct premiums). Moreover, the title insurance market, in particular, is subject to a number of distinctive anti-competitive forces, as most consumers do not actively shop for title insurance, but instead select their insurer based solely on the recommendation of an intermediary, such as a mortgage provider or real estate agent. This effectively results in a “situational monopoly.” *See* Tom Baker & Peter Siegelman, “*You Want Insurance with That?*” *Using Behavioral Economics to Protect Consumers from Add-on Insurance Products*, 20 *CONN. INS. L.J.* 1, 6-9 (2013). Whether rate regulation of title insurance markets, as well as similar specialized property-casualty insurance markets, is sensible is thus a more complicated issue than in the case of the core personal lines insurance markets that are the focus of this Essay.

167. One caveat is that not all insurance groups in a state are willing to write insurance to all consumers in the state. In some contexts, an individual consumer in a state may only be able to get quotes from a subset of carriers.

168. HHI stands for Herfindahl–Hirschman Index, the most prominent measure of market concentration. *See Horizontal Merger Guidelines*, U.S. DEP'T OF JUSTICE & FED. TRADE COMM'N § 5.2 (2010), <http://www.justice.gov/sites/default/files/atr/legacy/2010/08/19/hmg-2010.pdf> [<http://perma.cc/VN6D-3XVS>].

169. *See id.* § 5.3.

Table 1: Market Concentration in Property-Casualty Insurance Markets in 2014<sup>170</sup>

	Market Share of			Number of				Market Share of			Number of		
	Top 4 Insurance Groups			Competing Insurers				Top 4 Insurance Groups			Competing Insurers		
	Auto	HO	WC	Auto	HO	WC		Auto	HO	WC	Auto	HO	WC
Natl	47.77%	41.51%	23.44%	741	652	285	MT	56.64%	61.48%	47.84%	31	32	39
AL	59.81%	60.66%	35.05%	33	35	60	NE	52.31%	56.40%	35.35%	35	34	59
AK	76.75%	79.94%	64.80%	14	15	29	NV	49.19%	54.46%	34.95%	39	38	55
AZ	49.64%	52.81%	53.49%	50	49	57	NH	49.12%	39.84%	43.45%	38	43	48
AR	53.96%	57.96%	32.17%	37	34	57	NJ	53.51%	38.08%	51.54%	30	49	52
CA	44.28%	51.16%	35.68%	44	40	55	NM	55.43%	60.73%	58.03%	31	33	43
CO	48.48%	53.61%	73.85%	38	40	44	NY	65.04%	47.88%	65.00%	34	54	43
CT	48.20%	39.51%	46.09%	39	45	48	NC	49.41%	51.82%	29.44%	33	45	71
DE	62.65%	57.71%	33.93%	25	37	52	ND	47.98%	47.08%	72.95%	32	31	23
FL	62.65%	32.15%	36.27%	39	57	57	OH	51.80%	48.39%	59.85%	46	50	30
GA	56.71%	57.10%	28.02%	54	41	70	OK	51.76%	60.80%	36.52%	43	40	57
HI	63.10%	70.88%	63.12%	17	22	31	OR	53.79%	62.29%	85.33%	32	34	32
ID	45.50%	50.15%	73.87%	35	37	35	PA	55.41%	57.01%	25.99%	41	51	69
IL	56.23%	60.64%	27.92%	55	48	81	RI	53.63%	44.90%	77.77%	27	38	37
IN	50.46%	49.83%	26.55%	56	49	76	SC	58.49%	48.08%	29.12%	41	54	72
IA	55.86%	58.15%	28.61%	46	45	65	SD	49.14%	47.15%	37.23%	45	41	54
KS	51.64%	55.38%	35.21%	39	41	59	TN	55.62%	59.75%	30.65%	46	43	74
KY	56.60%	64.51%	64.51%	33	39	57	TX	49.40%	57.39%	59.57%	47	50	46
LA	66.98%	54.67%	46.26%	29	43	46	UT	48.71%	52.03%	67.70%	40	36	44
ME	45.83%	36.40%	78.30%	31	37	32	VT	45.91%	40.83%	51.09%	31	34	36
MD	63.48%	53.63%	48.90%	32	42	59	VA	56.33%	55.09%	30.72%	44	45	71
MA	57.23%	38.36%	45.98%	26	50	45	WA	44.89%	55.64%	66.35%	33	34	23
MI	53.72%	55.42%	37.81%	36	37	61	WV	62.26%	62.44%	72.60%	23	31	33
MN	57.43%	54.03%	31.07%	45	47	63	WI	54.51%	47.41%	31.70%	47	58	63
MS	57.75%	63.25%	36.10%	33	31	55	WY	60.99%	65.41%	70.14%	27	30	22
MO	51.69%	57.78%	45.53%	41	39	56							

The large number of competing firms in virtually all property-casualty insurance markets is not fortuitous; property-casualty insurance markets generally have quite low barriers to entry.<sup>171</sup> Perhaps the most important reason for this fact is that companies do not need substantial outside funding to enter the industry, as the product funds itself; policyholders pay premiums well before they ever receive any insurance benefits. As such, new entrants into the industry only require the minimal amounts of capital prescribed by state law (or required by prudent policyholders) in order to open shop and potentially grow quickly. Indeed, the natural competitiveness of property-casualty markets helps explain why insurers historically required legal intervention or else conspiratorial boycotts to prevent “ruinous competition.” As described in Part I, “ruinous competition” was such a problem in the 1800s precisely because individual insurers would undercut the rates set by rating bureaus. Similarly, after passage

170. Data is derived from 2014 *Competition Database Report*, NAT'L ASS'N OF INS. COMM'RS (2015) [http://www.naic.org/prod\\_serv/CLR-OPS-16.pdf](http://www.naic.org/prod_serv/CLR-OPS-16.pdf) [<http://perma.cc/L3XJ-96SU>].

171. See Joskow *supra* note 7, at 381.

of the McCarran Ferguson Act, several “direct writers” such as Allstate filed applications with insurance departments to undercut the premiums filed by rating bureaus by up to twenty percent.<sup>172</sup>

State guaranty funds also help to keep entry barriers low in insurance markets by diminishing the importance of insurers’ reputations for many policyholders. These funds protect most non-commercial policyholders against the risk that their insurers will be unable to pay claims, though the extent of this protection varies by insurance product and state.<sup>173</sup> Moreover, new entrants enjoy this protection without needing to pay any premiums for it, because the funds used to pay out policyholders of insolvent insurers are only collected after that insurer fails. All of this means that most individual policyholders in property-casualty markets do not need to worry about securing coverage from a new and relatively unestablished firm.

In fact, state insurance regulation operates as one of the primary barriers to entry in most markets. To be sure, in many contexts this is appropriate: insurers without adequate capital or expertise should be prevented from selling insurance. Not only are such carriers at risk of harming their own policyholders, but they can damage the industry more broadly by undermining the public’s faith in insurance markets. But public utility style rate regulation increases the extent to which state insurance regulation deters firm entry without producing any of these offsetting regulatory benefits.

Another relevant factor in the market structure inquiry—the fungibility of the underlying product—also suggests that modern-day data sharing is unlikely to have any anti-competitive effects. As the Second Circuit has explained, fungibility is relevant to evaluating the impacts of data sharing among competing firms “because it is less realistic for a cartel to establish and police a price conspiracy where it is difficult to compare the products being sold.”<sup>174</sup> Although insurance policies in most property-casualty insurance markets are relatively similar—albeit decreasingly so—there is no doubt that insurance products are not, in fact, fungible for purposes of the present inquiry. The character of insurance products varies tremendously based on the applicable policy limits and deductibles, the existence of any endorsements to the relevant coverage, and the character of the insured property or liability risk. Insurance products also vary in their quality based on factors such as the financial strength of the carrier and the carrier’s reputation for claims handling reliability and service. As a result, even assuming that the terms of coverage were completely standardized within

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172. MEIER, *supra* note 48, at 79-80. Rating bureaus attempted to resist these efforts by, for instance, limiting these insurers’ access to company-approved data, a strategy that ultimately failed.

173. See Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHI. L. REV. 1569, 1619-23 (2014).

174. See *Todd v. Exxon Corp.*, 275 F.3d 191, 209 (2d Cir. 2001); Donald S. Clark, *Price-Fixing Without Collusion: An Antitrust Analysis of Facilitating Practices After Ethyl Corp.*, 1983 WIS. L. REV. 887, 896; Brian R. Henry, *Benchmarking and Antitrust*, 62 ANTITRUST L. J. 483, 496 (1994).

individual property-casualty insurance markets, it would be immensely hard for members of a conspiracy to police either an explicit or a tacit price agreement.

In addition to market structure, courts examining the competitive effects of industry data sharing also scrutinize the nature of the information exchanged. Doing so allows courts to weigh the potential competitive benefits of data sharing against the prospect that it could facilitate implicit industry coordination with respect to pricing or product design. Modern day data sharing within the insurance industry fares well along this criterion as well.

Although courts are ordinarily suspicious of future-oriented price-related data,<sup>175</sup> several factors significantly reduce the risk that modern-day insurer data could result in tacit collusion. First, the same argument developed above with respect to the risk of explicit collusion comes into play here: the data disseminated does not include several key expenses as well as any profit component.<sup>176</sup> As a result, competing firms have no way of knowing, on the basis of end prices, what prospective cost estimates were actually used by their competitors. Second, the underlying data is aggregated across the industry and is not company specific. Data in this form is less conducive to price-fixing conspiracies because it is more difficult to police.<sup>177</sup> Third, the data that is shared is generally available to the public and regulators, thus increasing the likelihood that any tacit conspiracy would be spotted by these sources. Ultimately, insurers engaged in either an explicit or a tacit conspiracy would be unable to police the agreement.

Not only is the information exchanged within the modern insurance industry unlikely to facilitate even tacit collusion, but it in fact produces substantial competitive benefits. The primary value of data sharing in the modern industry is to continue to keep barriers to entry low.<sup>178</sup> The historical data available through statistical agents and regulators provides market entrants with the base of data needed to appropriately predict loss rates despite their own lack of experience in a particular market. Unlike in the mid-twentieth century, this benefit of data collection is available to all potential market entrants or competitors because the underlying market information is publicly available.<sup>179</sup>

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175. *Am. Column & Lumber Co. v. United States*, 257 U.S. 377, 398-99 (1921).

176. *See supra* section II.B.i and accompanying text.

177. *See Todd*, 275 F.3d at 212 (noting that “Courts prefer that information be aggregated in the form of industry averages, thus avoiding transactional specificity” because “Price exchanges that identify particular parties, transactions, and prices . . . may be used to police a secret or tacit conspiracy to stabilize prices”).

178. Data sharing can no longer be justified as a mechanism to prevent “ruinous competition.” The prospect of insurer insolvencies is now managed exclusively through an extensive financial regulatory regime that—among other things—requires insurers to maintain adequate capital levels, make relatively conservative investments, abide by an elaborate set of accounting rules, and contribute to a guarantee fund to compensate the policyholders of failed competitors. *See ABRAHAM & SCHWARCZ, supra* note 3, at 117.

179. *See Todd*, 275 F.3d at 213 (“Public dissemination is a primary way for data exchange to realize its procompetitive potential” and “A court is therefore more likely to approve a data exchange where the information is made public.”).

Meanwhile, the various data-analysis services provided by the advisory organizations allow small insurers with limited in house expertise to effectively and efficiently leverage this data, a task that can require substantial actuarial expertise and involve considerable economies of scale.

Insurers' modern data sharing practices also no longer impede competition with respect to product design. This is a direct result of the limited importance of aggregate industry loss data for the largest insurers. Historically, all property-casualty insurers used the model policy forms created by advisory organizations like the ISO because doing so was necessary to take advantage of aggregate industry loss data; insurers who provided non-standard terms of coverage could not easily rely on aggregate industry data that was itself based on the standard coverage terms.<sup>180</sup>

Now that many large and medium insurers no longer need to rely on aggregate industry loss data, they increasingly can, and do, use proprietary policy forms that differ significantly from the forms that advisory organizations produce.<sup>181</sup> For instance, in the context of homeowners insurance, some of the most prominent national insurers employ policy language that is systematically less generous than that provided in the policy that is collectively drafted by the leading insurance advisory organization.<sup>182</sup> At the same time, other large insurers utilize policy forms that are more generous than the presumptive industry standard in important ways.<sup>183</sup> Although these variations in policy terms have been most clearly documented in the homeowners insurance market, they also exist in other important property-casualty insurance markets, including auto and renters insurance.<sup>184</sup>

To be sure, as I have argued extensively elsewhere, this competition with respect to product design raises a host of new regulatory and legal challenges.<sup>185</sup> At the same time, however, it tends to further undercut the argument that insurers' data sharing practices justify conceiving of the industry as a type of public utility. To the extent that large insurers continue to offer policyholders products that conform to the models produced by industry advisory organizations, the explanations for this trend are attributable less to the industry's sharing of loss data, and more to the various other benefits of contract

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180. ABRAHAM & SCHWARCZ, *supra* note 3, at 35.

181. Schwarcz, *supra* note 53, at 1277-1317.

182. *Id.* at 1314

183. *Id.* at 1277-1317. Homeowners insurance policies can vary, among other things, with respect to (i) the scope of their anti-concurrent causation exclusions; (ii) the breadth of their trigger of coverage; (iii) their coverage of mold-related property damage; (iv) their coverage for liability relating to the illegal consumption of alcohol; (v) the breadth of insurers' subrogation rights; (vi) the scope of limits on specific classes of property; and (vii) the existence of theft coverage that cannot be clearly documented or that results from fraud.

184. For instance, auto insurance policies can vary on issues such as the scope of coverage that is available when a car is available for hire by the public through an application like Uber or Lyft or the amount of compensation for the policyholder.

185. See Schwarcz, *supra* note 11, at 413-14; Schwarcz, *supra* note 53, at 1345-48.

standardization, such as network effects and promoting cross-company comparability.

Ultimately, all of this suggests that the historical rationales for public utility style rate regulation in insurance simply do not apply to modern day insurance markets. Insurance markets are no longer “in the nature of a monopoly,” and the data sharing practices that currently predominate in the market are not likely to facilitate either explicit price fixing of the type that once predominated or more tacit coordination. To the contrary, these data sharing practices ultimately promote competition. In sum, if public utility style rate regulation is indeed justified, it must be for reasons that have nothing to do with the arguments and understandings that prevailed in the twentieth century when such regulation was developed and solidified.<sup>186</sup>

### III. The Economic Case Against Public Utility Style Rate Regulation In Insurance

Plenty of legal and regulatory regimes are no longer defensible based on their historic rationales, but may nonetheless promote social welfare on different grounds. Not so for public utility style insurance rate regulation. This Part explains that conclusion, by drawing on the extensive insurance economics literature on rate regulation. Those who are familiar with this literature may wish to skim this final Part. Section III.A explains why the various market failures that do indeed predominate in modern-day insurance markets—including information asymmetries regarding the scope of coverage, behavioral anomalies among insurance consumers, and state insurance purchase mandates—do not justify public utility style rate regulation. The key point is that none of these important failures in insurance markets undermine insurers’ incentives to sell coverage at rates that are neither “excessive” nor “unfairly discriminatory” because consumers are well aware of the price they pay for coverage and have ready access to competitors’ price quotes. Section III.B then explores the costs of public utility style rate regulation, which range from producing coverage shortages, to undermining policyholder precautions and care levels, to generating artificial fluctuations in rates.

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186. Recall that, in the natural monopoly context, competition among multiple firms in the development of infrastructure may ultimately be socially harmful. *See supra* section I.A. Such competition can result in multiple sets of unsightly cables or transmission lines or in higher prices for consumers. Neither of these costs associated with firm-specific development of key infrastructure carries over to the insurance context, thus further attenuating the link between property-casualty insurance markets and natural monopolies. First, individual insurers’ development of their own individualized “infrastructure” does not produce any negative externalities comparable to redundant transmission lines because insurers’ “infrastructure”—which consists of historical loss data—exists only on paper and in electronic data formats. Second, because all insurers in property-casualty markets have access to the shared industry data through advisory organizations and statistical agents, individual insurers will only resort to developing their own infrastructure if doing so produces net benefits for the carrier. Consequently, the concern that multiple sets of infrastructure will raise costs among consumers by limiting the consumer base over which those costs can be spread has no purchase in the insurance setting.

*A. Market Failures Do Not Create a Risk of “Excessive” or “Unfairly Discriminatory” Rates in Unregulated Property-Casualty Markets*

1. Market Forces Generally Limit Excessive or Unfairly Discriminatory Rates in Insurance Markets

A robust economics literature demonstrates that unregulated property-casualty insurance markets do not generally produce either “excessive” or “unfairly discriminatory” rates.<sup>187</sup> The best evidence of this point comes from studies of individual states—such as Illinois, South Carolina, and New Jersey—that eliminated or substantially reduced the intensity of insurance rate regulation in their auto insurance markets.<sup>188</sup> In each case, deregulation did not result in insurers earning outsized profits or consistently imposing substantial premium increases on their customers. To the contrary, over the long term, average prices for coverage in these states tracked both national averages and policyholder claims experiences, consistent with competitive markets.<sup>189</sup> Insurers’ profitability similarly tended to converge on national and regional averages in the wake of deregulation in these states.<sup>190</sup>

Not only did the states that limited public utility style rate regulation in auto insurance avoid “excessive” rates, but there is no evidence that policyholders in those states experienced “unfair discrimination” either. In fact, deregulation in each state tended to increase both the number of carriers doing business in the state and the number of drivers with insurance coverage.<sup>191</sup> Both results strongly suggest that, on average, policyholders were paying rates closer to their expected costs than had previously been the case. An increase in the number of carriers means more firms are competing to identify policyholders who can profitably be lured away from competitors with an offer of a reduced premium that is more reflective of their actual riskiness.<sup>192</sup> Meanwhile, the fact that coverage rates in

187. For more lengthy overviews of the insurance economics literature on rate regulation, see HARRINGTON, *supra* note 6, Cummins, *supra* note 5, at 2, and Tennyson, *supra* note 14.

188. The empirical evidence suggesting that deregulated insurance markets do not produce “excessive” or “unfairly discriminatory” prices goes well beyond these studies of states that embraced deregulation. As one example, studies have found that periods of large increases in insurance premiums are generally not associated with substantial increases in insurer profits. See J. David Cummins & Sharon Tennyson, *Controlling Automobile Insurance Costs*, 6 J. ECON. PERSP. 95, 104 (1992). Instead, they are often associated with more general cyclical patterns in insurance market pricing that stem from the uncertainty associated with predicting future claims costs. See Baker, *supra* note 116, at 422.

189. See, e.g., D’Arcy, *supra* note 5, at 272 tbl.6-4; Martin Grace, Robert W. Klein & Sharon Tennyson, *The Effects of Regulatory Reforms in the South Carolina Auto Insurance Market*, 32 J. INS. REG. 1, 26 fig.8 (2013); Grace, Klein & Phillips, *supra* note 5, at 164-66; Tennyson, *supra* note 14, at 17; Tennyson, *supra* note 5, at 518 tbl.5.

190. See D’Arcy, *supra* note 5, at 260; Grace, Klein & Tennyson, *supra* note 189, at 19 fig. 2; Tennyson, *supra* note 5, at 520-21.

191. See D’Arcy, *supra* note 5, at 260-62; Grace, Klein & Tennyson, *supra* note 189, at 17 tbl. 4, 23 fig. 5; Tennyson, *supra* note 14, at 16.

192. See Scott Harrington, *Rate Suppression*, 59 J. RISK & INS. 185 (1992); Mark Pauly, *Is Cream-skimming a Problem for the Competitive Medical Market?*, 3 J. HEALTH ECON. 84, 89-90 (1984).

these states increased after deregulation is consistent with the possibility that relatively low-risk policyholders reentered the market because they were able to purchase coverage that did not force them to cross-subsidize the rates of high-risk drivers.

These results are hardly surprising; they follow from basic and familiar principles of economics. Firms that charge excessive prices in competitive marketplaces will soon find that they cannot attract any customers, because competitors can profitably undercut their prices to attract new customers.<sup>193</sup> Similarly, insurers that do not charge policyholders risk-based prices will generally find profits decreasing as competitors “skim” good risks who were being over-charged for coverage.<sup>194</sup> Moral hazard, as well, may decrease the profitability of insurers that do not charge risk-based prices, as they experience larger losses than competing insurers who reward appropriate policyholder precautions.

To be sure, insurance markets are subject to numerous actual and potential market failures. As I have argued extensively elsewhere, these market failures justify regulatory oversight with respect to a broad range of issues, such as policy terms,<sup>195</sup> claims payment practices,<sup>196</sup> market transparency,<sup>197</sup> solvency,<sup>198</sup> and discrimination against historically disadvantaged groups.<sup>199</sup> But, these various market failures only pose limited obstacles to the basic economic logic that competition will tend to root out “excessive” or “unfairly discriminatory” rates.

Consider first the most important market failure (from a regulatory perspective) in many insurance markets: policyholders’ ignorance about the scope of the coverage they purchase.<sup>200</sup> This ignorance often extends to the specific terms of their policies,<sup>201</sup> their insurers’ approach to claims-handling,<sup>202</sup> and their insurers’ financial capacity to pay future claims.<sup>203</sup> Moreover, consumer ignorance is particularly pervasive in the very markets that are subject to public utility style rate regulation—such as auto insurance, homeowners’

193. See HARRINGTON, *supra* note 6, at 27-28.

194. See Pauly, *supra* note 192, at 89.

195. Daniel Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance Policies*, 48 WM. & MARY L. REV. 1389 (2007); Schwarcz, *supra* note 53.

196. Daniel Schwarcz, *Redesigning Consumer Dispute Resolution: A Case Study of the British and American Approaches to Insurance Claims Conflict*, 83 TUL. L. REV. 735 (2009) (discussing the importance of claims-handling regulation).

197. Schwarcz, *supra* note 11.

198. Daniel Schwarcz & Peter Siegelman, *The Law and Economics of Insurance*, in THE OXFORD HANDBOOK OF LAW AND ECONOMICS (Francesco Parisi ed., 2017).

199. See Avraham et al., *Understanding Insurance Antidiscrimination*, *supra* note 4.

200. See generally Schwarcz, *supra* note 11.

201. Schwarcz, *supra* note 53, at 1315. For one excellent recent study demonstrating consumers’ ignorance regarding whether they are entitled to their policy limits in the event of a total loss, see Peter Molk, *Playing with Fire? Testing Moral Hazard in Homeowners Insurance Valued Policies*, UTAH L. REV. (forthcoming 2018).

202. Schwarcz, *Redesigning Consumer Dispute Resolution*, *supra* note 198, at 741.

203. Schwarcz & Siegelman, *supra* note 198, at 484.



insurance, and renters' insurance.<sup>204</sup> For these reasons, commentators often suggest that these market failures justify state regulations designed to prevent "excessive" or "unfairly discriminatory" rates.<sup>205</sup>

This simplistic logic, however, is flawed because policyholders only require two key pieces of information for market forces to effectively combat the risks of "excessive" or "unfairly discriminatory" rates. First, policyholders must be informed about the rate that they pay for their coverage. Second, they must be informed about the rate that competing insurers would charge for roughly similar coverage. Standing alone, these two pieces of information limit the capacity of insurers to charge excessive prices, because any such attempt would generally cause policyholders to switch carriers. For similar reasons, policyholders' awareness of these two pieces of information will generally prevent "unfair discrimination" among carriers: any failure to charge actuarially fair rates would allow competitors to skim good risks.

In virtually all insurance markets, policyholders are indeed armed with these two key pieces of information.<sup>206</sup> This point, of course, is obvious with respect to the amount that one's insurer charges for coverage. But it is also relatively clear with respect to consumers' knowledge of the rates that competing insurers would charge for comparable coverage. Insurance consumers in virtually all markets have relatively easy access to price quotes from numerous competing insurers.<sup>207</sup> In addition to the traditional approach of seeing an insurance agent, consumers now have access to a plethora of rate comparison services, and insurers routinely advertise to consumers about the ease of acquiring a price quote.<sup>208</sup> These online or in-person price quote services, moreover, generally provide consumers with quotes for nominally similar coverage: consumers can set deductibles and limits, for instance, to match their current coverage levels.<sup>209</sup>

204. Schwarcz, *supra* note 11, at 415.

205. See, e.g., Hunter, *supra* note 5, at 27; Rosenfield, *supra* note 15, at 128.

206. Once again, title insurance is a notable potential exception. See *supra* note 166 and accompanying text. Many consumers do not actually pay close attention to the premiums they pay for title insurance because they purchase such insurance as one part of a much larger transaction: purchasing a home. In such settings, the salience of price is reduced substantially, thus undermining the effectiveness of price competition.

207. See, e.g., INS. RESEARCH COUNCIL, PUBLIC ATTITUDE MONITOR 2 (2009) (finding that the vast majority of consumers report being well informed about homeowners and auto insurance and how to buy it, about a quarter of consumers report comparison shopping in the past year, and the primary reason they did so was to find a better price). Numerous websites now offer premium rate comparison tools that allow consumers to compare the rates offered by competing insurers. See, e.g., PROGRESSIVE AUTO INSURANCE, <https://www.esurance.com/insurance/car/compare-quotes>.

208. See Tom Baker & Benedict Dellaert, *Regulating Robo-Advice Across the Financial Services Industry*, 103 IOWA L. REV. 713, 717-18 (2018). Daniel Schwarcz & Peter Siegelman, *Insurance Agents in the 21st Century: The Problem of Biased Advice*, in RESEARCH HANDBOOK IN THE LAW AND ECONOMICS OF INSURANCE 36, 58 (Daniel Schwarcz & Peter Siegelman eds., 2015).

209. See Laura Shin, *You Can Save Hundreds on Car Insurance. But Is It A Good Idea?*, FORBES (Jan. 9, 2015), <https://www.forbes.com/sites/laurashin/2015/01/09/you-can-save-hundreds-on-car-insurance-but-is-it-a-good-idea>.

To be sure, policyholders do not generally have meaningful access during this price comparison process to information about the comparative breadth of the terms different carriers sell, or to their approach to claims handling.<sup>210</sup> But these information asymmetries will not cause carriers to charge “excessive” or “unfairly discriminatory” prices, because any attempt to do so would still result in insurers tending to lose out on policyholder business entirely. Instead, information asymmetries about insurance policy terms and claims handling create the risk that carriers will hollow out their coverage or adopt excessively aggressive claims handling practices.<sup>211</sup> And this risk is itself driven, in part, by insurers’ incentives to win consumer business on the front end, when consumers are comparison shopping principally on the basis of rates. By narrowing coverage and adopting aggressive claims handling, insurers can cut costs, pass along some of these savings to consumers, and thereby attract premium-focused customers, even if those customers would be willing to pay for more robust or reliable coverage were they fully informed.<sup>212</sup>

A second market failure that is sometimes invoked to justify public utility style insurance regulation is that consumers are legally or practically required to purchase the underlying product.<sup>213</sup> The legal requirement to secure coverage is most familiar with respect to auto insurance, where states typically require any person who registers a motor vehicle to carry a specified minimum amount of auto liability insurance.<sup>214</sup> But states also legally require certain businesses to acquire workers’ compensation insurance to protect their employees<sup>215</sup> and, of course, the Affordable Care Act’s penalty for forgoing health insurance is often described as a legal mandate.<sup>216</sup> Even when insurance is not legally required, it is often practically required as a condition of modern life. Thus, anyone who purchases a home with a mortgage is generally required, as a condition of that mortgage, to maintain homeowners’ insurance on the property.<sup>217</sup> Because insurance is legally or practically required, the argument goes, states have a special obligation to ensure that consumers are not charged an “excessive” price for the underlying product.

The central problem with this logic is that a legal or practical mandate to purchase a product does not undermine the ordinary market mechanisms that tend to ensure competitive pricing of that product. To the contrary, so long as

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210. See Schwarcz, *supra* note 11, at 425; Schwarcz, *supra* note 53, at 1319-25.

211. See Schwarcz, *supra* note 11, at 415; Schwarcz, *supra* note 53, at 1315.

212. See INS. RESEARCH COUNCIL, *supra* note 207, at 12 (noting that price generally drives consumer comparison shopping).

213. See, e.g., Rosenfield, *supra* note 15, at 70.

214. See ABRAHAM & SCHWARCZ, *supra* note 3, at 656.

215. For a summary of state laws, see *Worker’s Compensation Law – State by State Comparison*, Nat’l Fed’n of Indep. Bus. (June 7, 2017), <http://www.nfib.com/content/legal-compliance/legal/workers-compensation-laws-state-by-state-comparison-57181> [<http://perma.cc/5VQC-2TNC>].

216. See Nat’l Fed’n of Indep. Bus. v. Sebelius, 567 U.S. 519, 561 (2012).

217. See Tennyson, *supra* note 14, at 9. Similarly, renters are often required as a condition of their lease to maintain renters’ insurance.

there are a sufficient number of competing suppliers of a product, competition among these suppliers will tend to produce competitive rates even if consumers are in some real or practical sense required to buy the product. The reason is simple: consumers who are practically or legally required to purchase a product are not required to purchase it from any particular firm. If anything, the external pressure to secure the product will tend to make purchasers more price sensitive rather than less, because they will care less about quality than purchasers who are not compelled by external forces to secure insurance.

The capacity of ordinary competition to discipline prices even in the face of a practical or legal mandate to purchase a product should not be surprising. In fact, numerous goods and services are practically (if not legally) required in a manner similar to insurance, with no thought that price regulation is consequently required due to competitive failures. For instance, every person obviously needs food to survive. But this practical necessity does not result in government intervention to prevent excessive food prices. Perhaps more analogously, credit is a practical necessity for many consumers. Notwithstanding this fact, the practice of regulating prices through usury restrictions has largely been eliminated in most credit markets out of recognition of the fact that such restrictions often limit access to credit.<sup>218</sup>

Yet a third market failure that is often invoked to justify a range of insurance regulations, but that cannot justify public utility style rate regulation, involves behavioral biases among policyholders. Extensive empirical evidence demonstrates that individuals do indeed systematically demonstrate persistently irrational or difficult to explain behaviors when it comes to insurance, ranging from misperceiving the risk of loss, to preferring low deductibles, to evaluating the value of insurance based on its payoffs in earlier years.<sup>219</sup> But so long as policyholders have information about the rates they pay and rates that competing insurers would charge for similar coverage, these biases should not generally result in excessive or unfairly discriminatory rates. After all, few individuals want to pay more money for a comparable product.<sup>220</sup>

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218. See, e.g., David A. Skeel, Jr., *Bankruptcy's Home Economics*, 12 AM. BANKR. INST. L. REV. 43, 51 (2004); Todd Zywicki, *The Economics of Credit Cards*, 3 CHAP. L. REV. 79, 96 (2000).

219. See generally HOWARD C. KUNREUTHER ET AL., *INSURANCE AND BEHAVIORAL ECONOMICS: IMPROVING DECISIONS IN THE MOST MISUNDERSTOOD INDUSTRY* 113-144 (2013).

220. A caveat to this analysis is that certain behavioral biases may effectively create "situational monopolies," where consumers feel forced to make a decision about insurance without having an easy avenue to acquire competitors' rates. However, only a limited number of insurance markets—such as consumer warranties—are subject to this problem. More importantly for present purposes, these markets are not generally subject to public utility style rate regulation, and alternative regulatory strategies to address the underlying problem are available. See Baker & Siegelman, *supra* note 166, at 6-9.

## 2. The Special Case of Price Optimization

There is one important exception to the logic that competition will tend to prevent “unfair discrimination,” and it goes by the short-hand of “price optimization.” Price optimization refers to the practice, employed by some insurers, of pricing coverage based in part on inferences about the price sensitivity of individual policyholders.<sup>221</sup> For instance, an insurer might increase rates on renewing policyholders not because of an increase in expected costs, but because it believes renewing customers are unlikely to actively shop for alternative coverage. Such price optimization rather clearly violates the prohibition against “unfair discrimination” in insurance.<sup>222</sup> Moreover, competition is unlikely to eliminate price optimization, because the practice specifically targets the consumers who are least likely to be responsive to the practice.

The merits of laws or regulations aimed at limiting price optimization involve a host of complicated public policy issues that are beyond the scope of this Essay. But even for those who believe that the state ought to restrict this practice, public utility style insurance rate regulation is both an over-inclusive and under-inclusive method for doing so. With respect to the first point, public utility style insurance regulation obviously goes much further than simply prohibiting price optimization. It potentially restricts any number of alternative insurer practices, ranging from providing group discounts, to experimenting with different algorithms, to inadvertently pricing similar customers differently, to using classification schemes that an insurer believes, but cannot substantiate, will be predictive in the future. To the extent that price optimization is itself problematic, it would be perfectly feasible for a state or the federal government to ban or restrict the practice without embracing public utility style insurance regulation.<sup>223</sup>

Second, price optimization is hardly unique to insurance. To the contrary, the phenomenon has become prevalent throughout the modern economy, with online firms ranging from Amazon to Uber allegedly experimenting with the practice.<sup>224</sup> Moreover, there is little reason to believe that the practice is more

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221. See *Price Optimization White Paper*, NAT'L ASS'N INS. COMM'RS 6-10 (2015), [http://www.naic.org/documents/committees\\_c\\_catf\\_related\\_price\\_optimization\\_white\\_paper.pdf](http://www.naic.org/documents/committees_c_catf_related_price_optimization_white_paper.pdf) [<http://perma.cc/E5FN-63JX>].

222. See *id.* at 15-16 (“[U]nder the requirement ‘rates shall not be . . . unfairly discriminatory,’ insurance rating practices that adjust the current or actuarially indicated rates or the premiums, whether included or not included in the insurer’s rating plan, should not be allowed when the practice cannot be shown to be cost-based or comply with the state’s rating law.”).

223. This, for instance, is one recommendation of the Bipartisan Policy Center report, *Improving US Insurance Regulation* (2017), which simultaneously calls on states to end the practice of rate regulation, while also recommending that they prohibit the practice of price optimization. *Improving U.S. Insurance Regulation*, BIPARTISAN POL’Y CTR. 26, 28 (Apr. 2017), <http://bipartisanpolicy.org/wp-content/uploads/2017/04/Improving-U.S.-Insurance-Regulation.pdf> [<http://perma.cc/WM4X-XQ2Y>].

224. See, e.g., Ryan Calo, *Digital Market Manipulation*, 82 GEO. WASH. L. REV. 995, 1027 (2014); Aniko Hannak et al., *Measuring Price Discrimination and Steering on E-commerce Web*

troubling in insurance than in other settings. Historically, one of the central reasons that unfair discrimination was deemed to be uniquely troubling in insurance is because it could undermine policyholders' incentives to take care by failing to reward them with lower rates for taking appropriate precautions.<sup>225</sup> But this is a limited concern with respect to price optimization precisely because the practice targets policyholders who are comparatively non-responsive to rates. Consumers who are unlikely to alter their purchasing decisions in response to differences in rates are also presumably unlikely to alter their levels of care on this basis: after all, precautions that can meaningfully impact risk levels are generally more time consuming and costly than comparison shopping for cheaper coverage.

*B. Attempts to Prohibit by Regulation "Excessive" or "Unfairly Discriminatory" Rates Often Produce Negative Consequences*

Despite the absence of any compelling economic rationale for public utility style rate regulation, many states devote extensive resources to the endeavor.<sup>226</sup> In many, if not most, of these instances such regulation has produced a host of negative side effects. First, in some cases, rate regulation ultimately limits competition by suppressing rates below competitive levels, thereby discouraging insurers from entering the state and encouraging preexisting carriers in the state to reduce their footprint or exit from the market entirely.<sup>227</sup> This pattern is perhaps best illustrated in Florida, where extensive public utility style rate regulation of homeowners insurers has resulted in a shortage of private insurers in many areas, requiring the state to create its own carrier to serve increasingly large segments of the population.<sup>228</sup> But large residual markets are common in many states that cling to public utility style rate regulation.<sup>229</sup>

Second, public utility style rate regulation in insurance markets also commonly results in rate compression, with low-risk policyholders being forced to cross-subsidize high-risk policyholders.<sup>230</sup> In part, this outcome is a direct byproduct of residual markets: in order to cover policyholders who are not able to secure coverage through private carriers, residual markets routinely charge

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Sites, PROC. 2014 CONF. ON INTERNET MEASUREMENT 305-316 (2014); Amit Chowdhry, *Uber: Users Are More Likely To Pay Surge Pricing If Their Phone Battery Is Low*, FORBES (May 5, 2016), <https://www.forbes.com/sites/amitchowdhry/2016/05/25/uber-low-battery/#6e0e894c74b3>; Jennifer Valentino-DeVries et al., *Websites Vary Prices, Deals Based on Users' Information*, WALL ST. J. (Dec. 24, 2012), <http://www.wsj.com/Essays/SB10001424127887323777204578189391813881534> [http://perma.cc/PTJ3-ZWVG].

225. See, e.g., *Merritt Committee Report*, *supra* note 57, at 48-49.

226. See *supra* note 5 and accompanying text, which provides surveys of states' rate regulatory regimes.

227. Joskow, *supra* note 7, at 415; Tennyson, *supra* note 5, at 510-512.

228. Grace & Klein, *supra* note 9, at 111-12.

229. See Grace et al., *supra* note 189, at 21.

230. See Derrig & Tennyson, *supra* note 9, at 174; Harrington, *supra* note 192, at 186; Regan et al., *supra* note 9, at 599.

premiums below cost and make up the difference by shifting costs to the remainder of the market.<sup>231</sup> But rate compression can also occur through the direct implementation of public utility style rate regulation, with states explicitly restricting permissible rating factors or relative rates across driver classes or territories.<sup>232</sup> Rate compression, in turn, often produces moral hazard. Indeed, empirical evidence suggests that claims costs are often higher in states and markets that employ public utility style rate regulation.<sup>233</sup> More generally, rate compression undermines the capacity of private insurance to operate as a form of quasi-regulation by matching premiums to care levels, thus prompting policyholders to take socially-optimal levels of care.<sup>234</sup>

Yet a third potential negative consequence of public utility style rate regulation is that it can cause premium rates to experience artificially large shifts based on political conditions. For instance, some studies suggest that premiums in intensely regulated markets are held below profitable conditions for sustained periods of time, but then allowed to artificially increase beyond cost-justified levels to allow carriers to “make up” for past losses.<sup>235</sup> In other instances, insurers may resist lowering rates in heavily regulated markets because of concerns that doing so will preclude them from raising rates in subsequent time periods.<sup>236</sup>

Fourth, and perhaps most obviously, public utility style rate regulation is expensive for both the state and insurers. Quantifying these costs is not easy. States, in the aggregate, have about 500 personnel who work directly on actuarial matters or rate and form filings in the property-casualty industry.<sup>237</sup> But this number likely understates the total number of personnel who support the process of rate review within state regulatory offices. And the direct compliance costs to insurers of public utility style rate regulation are certainly multiples of direct government expenditures.<sup>238</sup> Insurers subject to such regulation need to file a massive amount of documentation with state regulators.<sup>239</sup> Even greater

231. Derrig & Tennyson, *supra* note 9, at 175.

232. Tennyson, *supra* note 14, at 7, 12.

233. Patricia Danzon & Scott Harrington, *Workers' Compensation Rate Regulation: How Price Controls Increase Costs*, 44 J. L. & ECON. 1 (2001); Derrig & Tennyson, *supra* note 9, at 175.

234. See Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197 (2012).

235. See Scott E. Harrington, *Effects of Prior Approval Rate Regulation of Auto Insurance*, in DEREGULATING PROPERTY-LIABILITY INSURANCE 309-10 (J. David Cummins ed., 2002). Harrington, *Effects of Prior Approval Rate Regulation*, *supra* note 5.

236. See *id.*

237. 2016 Insurance Department Resources Report, NAT'L ASS'N OF INS. COMM'RS (2016), [http://www.naic.org/prod\\_serv/STA-BB-16-01.pdf](http://www.naic.org/prod_serv/STA-BB-16-01.pdf) [<http://perma.cc/V7QH-A4NF>].

238. See Borselli, *supra* note 14, at 111.

239. Under the NAIC's model rating law, for instance, insurers must file “every manual, minimum premium, class rate, rating schedule or rating plan and every other rating rule, and every modification of any of the foregoing which it proposes to use.” They also must submit “all supplementary rating and supporting information to be used in support of or in conjunction with a rate.” PROP. & CAS. MODEL RATING LAW, *supra* note 144, § 5(A)(1)-(2).

resources must often be channeled into responding to rate filings that are challenged or questioned.

To be sure, these potential downsides to public utility style rate regulation depend substantially on the details of how any particular state designs and implements its scheme of rate regulation. To take one important example, there is at least some evidence suggesting that California has managed to avoid most of these negative side-effects of public utility style insurance rate regulation in its auto insurance markets. In 1988, the state adopted one of the most extensive public utility style rate regulatory regimes in the country for its auto insurance market. Nonetheless, carriers in California remain profitable and competition remains relatively robust. Premiums, moreover, have generally grown at slightly less than the national average in the state, and claims rates have generally decreased despite stringent restrictions on permissible type of discrimination among policyholders.<sup>240</sup> Of course, California does indeed devote substantial regulatory resources to producing these results—including both a hefty regulatory staff and a system for compensating public intervenors in rate hearings<sup>241</sup>—and, as such, compliance costs for companies are likely quite large. But whether these costs are worth the benefits of rate regulation in California’s auto insurance market remains an open question.<sup>242</sup> So too does the question of whether results in California can be extrapolated to smaller states, which insurers can more easily choose to ignore or de-emphasize in their sales strategies.

### Conclusion

The economic and historical case against state laws prohibiting “excessive” or “unfairly discriminatory” rates is compelling. And eliminating this public utility style rate regulation is hardly unrealistic. The legislature in at least one state—Illinois—has already completely eliminated such regulation by statute, albeit perhaps unintentionally.<sup>243</sup> Various other states have also embraced statutory reforms that have the practical effect of diminishing the scope of public utility style rate regulation, either by establishing a presumption that insurers’ rates are neither “excessive” nor “unfairly discriminatory” or by exempting specific market segments from rate review.<sup>244</sup> Nor are statutory reforms the only way to ratchet back public utility style insurance rate regulation: individual state insurance commissioners exercise tremendous influence on the practical operation of traditional insurance rate regulation, as perhaps best illustrated by the fact that states no longer even consider whether carriers’ rates are

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240. Jaffee & Russell, *supra* note 5, at 210.

241. See Schwarcz, *supra* note 120.

242. Hunter, *supra* note 5, at 45-59; Jaffee & Russell, *supra* note 5, at 232-33; Sugarman, *supra* note 117, at 698-708.

243. See *supra* section I.B.2.4..

244. See *id.*

“inadequate,” notwithstanding that the prohibition on inadequate rates is still on the books in many states.

But eliminating public utility style insurance rate regulation does not necessitate jettisoning all forms of rate regulation in insurance. To the contrary, state laws restricting insurance discrimination against historically disadvantaged groups of policyholders have nothing to do with the public utility conception of insurance. Such laws arise out of a very different set of principles, which are focused on promoting fairness and equality both inside and outside of insurance markets. Unlike the public utility ideas that undergird state regulation of “excessive” or “unfairly discriminatory” rates, these principles of fairness and equality are just as relevant today as they were in decades past.

Nonetheless, state laws governing insurance discrimination against discrete minority groups are remarkably under-developed. States vary substantially in terms of when and how they restrict discrimination against particular subsets of the population.<sup>245</sup> And even when states do prohibit insurance discrimination against discrete groups, they almost universally interpret such prohibitions narrowly, so that they apply only when insurers directly and explicitly discriminate against members of these groups.<sup>246</sup> Meanwhile, state antidiscrimination laws have not even begun to catch up to the big data revolution.<sup>247</sup>

Ironically, the public utility style rate regulation may bear some responsibility for the stunted evolution of state laws governing insurance discrimination against discrete, historically-disadvantaged, groups. For instance, the prohibition against “unfair discrimination” in insurance implicitly suggests that insurance discrimination is legitimate so long as it can be actuarially validated.<sup>248</sup> By contrast, modern anti-discrimination laws generally apply irrespective of whether such discrimination can be supported with generalizable data. Public utility style rate regulation also focuses the attention of regulators looking for discrimination almost entirely on insurers’ rating processes. Yet discrimination is just as likely to influence insurers’ underwriting and marketing

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245. See generally Avraham et al., *Universal Framework*, *supra* note 4, at 5. Although states do indeed have a variety of laws restricting actuarially-justified discrimination against discrete minority groups, these laws are remarkably variable and limited. Most surprisingly, many states do not affirmatively ban insurers’ use of race, national origin, or religion in insurance rating or underwriting. Perhaps less surprising is the fact that states do not ban insurers’ use of sexual orientation or gender in a variety of coverage lines, ranging from automobile to life insurance. But the under-development of state anti-discrimination laws extends across a broad array of policyholder characteristics and coverage liens. Thus, only nine states ban the use of age in auto insurance; only six states ban the use of genetic testing in disability insurance; and only two states ban the use of location or zip code in property-casualty insurance. Meanwhile, no state affirmatively bans consideration of policyholder income in insurance rating or underwriting, notwithstanding a widespread understanding that such a practice would be troubling. *Id.* 17-19.

246. See *id.*

247. See Rick Swedloff, *Risk Classification’s Big Data Revolution*, 21 CONN. INS. L.J. 339, 344 (2014).

248. See Michael J. Miller, *Disparate Impact and Unfairly Discriminatory Insurance Rates*, CASUALTY ACTUARIAL SOC’Y E-FORUM, Winter 2009, at 276.



## Ending Public Utility Insurance Rate Regulation

functions. These enforcement patterns have at least in some cases produced regulatory arbitrage, with insurers moving potentially troubling risk classification schemes from their rating schemes into their underwriting and marketing processes, where they will receive less regulatory scrutiny.<sup>249</sup>

Whether or not public utility style rate regulation has stunted the evolution of insurance anti-discrimination law, its continued existence is difficult to justify. Such regulation emerged based on a series of perceived market conditions that simply do not accurately describe modern insurance markets. And the economic evidence suggests that its continued existence undermines the efficiency and vibrancy of property-casualty insurance markets across the country. Eliminating such regulation would both reflect these modern realities and potentially facilitate a rededication of regulatory resources to the types of anti-discrimination rules that actually make sense for property-casualty insurance markets.

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249. See Kevin M. McCarty, *The Use of Occupation and Education as Underwriting/Rating Factors for Private Passenger Automobile Insurance*, FLA. OFF. INS. REG. 9-12 (2007), <http://www.flair.com/siteDocuments/OCCRateRpt.pdf> [<http://perma.cc/GZX9-YY23>].

