

NORTH CAROLINA DEPARTMENT OF INSURANCE
RALEIGH, NORTH CAROLINA

COPY

IN THE MATTER OF THE FILING)
DATED JANUARY 3, 2024, BY THE)
NORTH CAROLINA RATE BUREAU)
FOR REVISED HOMEOWNERS)
INSURANCE RATES)
BEFORE THE)
COMMISSIONER OF)
INSURANCE)
DOCKET NO. 2157)

BEFORE: AMY FUNDERBURK, HEARING OFFICER

TRANSCRIPT
OF
HEARING

VOLUME XVI - P. M. SESSION

Raleigh, North Carolina
Tuesday, December 3, 2024
1:00 p.m.

A P P E A R A N C E S

On behalf of the North Carolina Rate Bureau:

MICKEY SPIVEY, ESQ.
BRIAN BEVERLY, ESQ.
Young, Moore & Henderson, P.A.
3101 Glenwood Avenue, Suite 200
Raleigh, North Carolina 27612

On behalf of the North Carolina Department of Insurance:

TERENCE FRIEDMAN, ESQ.
SHANNON WHARRY, ESQ.
North Carolina Department of Insurance
3200 Beechleaf Court
Raleigh, North Carolina 27604

Hearing in the matter of the filing dated January 3, 2024, by the North Carolina Rate Bureau for revised homeowners' insurance rates, at North Carolina Department of Insurance, 3200 Beechleaf Court, Raleigh, North Carolina, on the 3rd day of December, 2024, at 1:00 p.m., before Wendy Sawyer, Court Reporter and Notary Public.

I N D E X O F E X A M I N A T I O N S

THE WITNESS: LAURA CAVANAUGH EXAMINATION

Continued Cross, by Mr. Spivey..... 2332

I N D E X O F E X H I B I T S

(No exhibits offered.)

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P R O C E E D I N G S

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HEARING OFFICER FUNDERBURK: Good afternoon. All right. It is 1:00 p.m. on December 3rd. We are back on the record and resuming hearing in this matter. Before we begin, are there any preliminary matters that need to be addressed?

MR. SPIVEY: Not that I'm aware of, Your Honor.

MR. FRIEDMAN: No, Your Honor.

HEARING OFFICER FUNDERBURK: One thing I do want to keep in mind is scheduling for Thursday and Friday. I understand that your expected rebuttal witnesses will have some conflicts based on teaching schedules. Will they need to leave North Carolina, or will they be able -- how is that going to -- how is that going to work?

I'm just trying to determine if we're going to be able -- because I would very much like to. Are we going to be able to proceed Thursday Friday around their schedules, or are we going to run into a complete roadblock?

MR. SPIVEY: So, Your Honor, we have we have three folks here that we're hoping -- that we

1 complete Ms. Cavanaugh so we can put on, and then
2 Dr. Zanjani's teaching, and he's not going to be
3 able to get here this week at all.

4 HEARING OFFICER FUNDERBURK: Okay.

5 MR. SPIVEY: So, and Ms. Mao a meeting,
6 business meeting she has to participate in on,
7 like, Thursday at 2:00?

8 MS. MAO: Yes, Thursday at 2:00.

9 MR. SPIVEY: Thursday at 2:00 for
10 hopefully not more than one hour, and those are the
11 things we're trying to work around right now. But
12 so we would -- we would expect that we -- if we can
13 get started on our rebuttal on Thursday morning
14 that we would do Thursday and probably all of
15 Friday, but then we need to come back at least one
16 day next week for Dr. Zanjani.

17 That's what we're envisioning at this
18 point, and that's all assuming that we complete Ms.
19 Cavanaugh by the end of tomorrow. Is it still the
20 case that she's not available Thursday and Friday
21 this week?

22 MR. FRIEDMAN: Yes.

23 MR. SPIVEY: Okay.

24 HEARING OFFICER FUNDERBURK: All right.
25 After we finish with testimony today, I'm just

1 going to want to check in on that again and get
2 some more preliminaries down, both so that we can
3 schedule and try to figure out what next week is
4 going to look like and also because, we have a
5 court reporter here every day, and we need to
6 schedule them as far out in advance as we can, to
7 respect their schedules and make sure they can
8 actually provide us with someone to be here. Okay.
9 Okay.

10 MR. FRIEDMAN: Your Honor, so but as I
11 understand it, if the -- we're unable to finish
12 with Ms. Cavanaugh by tomorrow afternoon, then
13 there still will be none -- no testimony at all on
14 Thursday and Friday?

15 HEARING OFFICER FUNDERBURK: No, I
16 don't think that's the case. You have some --

17 MR. FRIEDMAN: Okay. So --

18 HEARING OFFICER FUNDERBURK: Mr. Spivey
19 has some rebuttal.

20 MR. SPIVEY: But we have them -- I'm
21 sorry, I don't mean to interrupt.

22 HEARING OFFICER FUNDERBURK: No. Go
23 ahead.

24 MR. SPIVEY: Obviously, we have them
25 here, but what we're talking about is --

1 HEARING OFFICER FUNDERBURK: Oh, I see
2 what you're saying.

3 MR. SPIVEY: -- going into our rebuttal
4 case, which we can't really start until you --

5 HEARING OFFICER FUNDERBURK: Until you
6 finish her. I understand.

7 MR. SPIVEY: -- finish your direct
8 case.

9 HEARING OFFICER FUNDERBURK: I was
10 thinking finish --

11 MR. SPIVEY: I think --

12 HEARING OFFICER FUNDERBURK: --
13 completely at the end of the day.

14 MR. FRIEDMAN: Yeah, because I think
15 the one of the two scenarios that Ms. Pearce
16 communicated to us, the one was if Ms. Cavanaugh is
17 not off the stand by Wednesday, then you offered
18 Thursday and Friday off, as I understand it, and
19 then one day next week, and then a number of days
20 in the third week.

21 HEARING OFFICER FUNDERBURK: Well,
22 let's see how far we can get today. I would very
23 much like to have your rebuttal begin on Thursday,
24 and I think some other folks would, too, to have
25 that Thursday and Friday so that we can keep

1 proceeding with this matter and bring it to an end.

2 All right. Ms. Cavanaugh, again, I'll

3 remind you that you do continue to be under oath.

4 Mr. Spivey, please resume your questioning.

5 MR. SPIVEY: Thank you, Your Honor.

6 CONTINUED CROSS EXAMINATION

7 BY MR. SPIVEY:

8 Q. Good afternoon, Ms. Cavanaugh.

9 A. Good afternoon.

10 Q. Now, you began discussing underwriting
11 profit and your underwriting profit provision at page
12 39 of your written testimony; is that correct?

13 A. That's the section on underwriting profit
14 provision. I did discuss it in some of the preceding
15 sections as well.

16 Q. The preamble type stuff.

17 A. Yes.

18 Q. Right. Now, there at line 24 on page 39,
19 you asked the question, what is a cost of capital
20 approach to estimating a profit provision; do you not?

21 A. Yes.

22 Q. And in response to that question, you cite
23 a paper published by the International Association For
24 the Study of Insurance Economics. Correct?

25 A. That's correct.

1 Q. And you quote from that in that answer
2 starting there at line 26, and it -- and your quote is
3 as follows: insurer capital comes from investors, which
4 means there is a cost associated with it. The cost of
5 this capital is the expected rate of return insurers
6 have to pay for the capital they use. The cost of
7 capital is a well-established economic concept. The
8 concept encompasses several important elements.

9 First, the cost of capital is a forward looking
10 concept. It is the return investors demand in order to
11 be induced to invest the funds. Second, the cost of
12 capital is determined in capital markets and includes
13 the notion of opportunity costs.

14 Investors face an ever growing array of
15 opportunities from which to choose, and the cost of
16 capital or expected return must compensate for other
17 foregone opportunities.

18 Finally, the cost of capital is dependent on
19 risk. Higher risk investments require higher returns
20 to attract capital. First of all --

21 MR. FRIEDMAN: I'm sorry. I really
22 much regret. Both of my witnesses -- okay. Sorry,
23 the audio has been fixed. Excuse my interruption.

24 MR. SPIVEY: I'm sorry, I missed what
25 you were saying.

1 MR. FRIEDMAN: My witnesses were not
2 getting audio online, but now they are. Sorry
3 about the interruption.

4 BY MR. SPIVEY:

5 Q. Ms. Cavanaugh, first of all, did I read
6 that correctly?

7 A. Yes.

8 Q. And that's something, literally, you've
9 quoted from that source in your testimony. Correct?

10 A. Yes.

11 Q. And you agree with each of those three
12 elements as they are described in that quotation; do
13 you not?

14 A. I generally, you know, I referenced this
15 quote. I generally agree with what it's saying here.

16 Q. Well, for example, you agree that the cost
17 of capital is a forward looking concept; do you not?

18 A. Yes. As it's being used in this -- in
19 this discussion. Yes.

20 Q. And you agree also that the cost of
21 capital is determined in capital markets. Correct?

22 A. Yes.

23 Q. Would you agree that this discussion of
24 cost of capital is entirely consistent with the
25 discussion of that concept in ASOP 30?

1 A. The Actuarial Standard Of Practice No. 30
2 says different words, but it is also discussing the
3 concept of cost of capital. And so both quotes are
4 discussing the concept of cost of capital.

5 Q. You have reviewed -- either heard or
6 read -- Dr. Zanjani's testimony in this case to this
7 point; have you not?

8 A. Yes.

9 Q. Would you agree that Dr. Zanjani's
10 discussion of the concept of cost of capital is
11 consistent with the quote you included in your
12 testimony at page 39?

13 A. So Dr. Zanjani's testimony including his
14 oral testimony, is pretty lengthy, but he does
15 reference cost of capital and that is that concept --
16 that overall concept in my understanding of what he's
17 saying is consistent with what is discussed in both of
18 the in the ASOP No. 30 and in this quote.

19 Q. Now, on page 40 of your testimony, shortly
20 after you've quoted the material we just discussed, you
21 discussed your understanding that a cost of capital
22 approach is not permissible under applicable North
23 Carolina law; is that correct?

24 A. That's my understanding, and that it --
25 it's correct that I say that on page 40.

1 Q. How did you determine or develop your
2 understanding of what is permissible under North
3 Carolina law?

4 A. So I reviewed the 2014 order, and I also
5 discussed the -- that order and other relevant
6 information with counsel for DOI.

7 Q. Now, you testified earlier that you're not
8 a lawyer and have not had any training or education to
9 become a lawyer. Correct?

10 A. That's correct.

11 Q. And you don't hold yourself out as an
12 expert in North Carolina law; do you?

13 A. I do not.

14 Q. Did you discuss this -- this element of
15 North Carolina law with anyone other than Department
16 counsel?

17 A. Yes. I discussed it with my colleagues.

18 Q. And by colleagues, are you referring to
19 other consultants or employees at RRC?

20 A. Yes.

21 Q. Any colleagues outside of RRC? I'm just
22 trying to understand what "colleagues" is referring to.

23 A. Yeah. Not that I recall.

24 Q. Thank you. Immediately following that on
25 page 40, and this is lines 11 through 16, you state

1 that you understand that North Carolina law permits
2 a -- the use of a comparable earnings analysis, and
3 that a comparable earnings analysis does not violate
4 the prohibition in North Carolina on considering
5 investment income on capital surplus; do you not?

6 A. I do discuss that concept on page 40.

7 Q. Do I understand correctly that you
8 developed your recommended underwriting profit
9 provision using a comparable earnings analysis?

10 A. So my -- my testimony discusses the -- the
11 analysis that I use, and I think that that's in line
12 with what was termed comparable earnings analysis in
13 the 2014 order.

14 Q. I mean, do you characterize what you did
15 here in developing your recommendation on underwriting
16 profit as a comparable earnings analysis?

17 A. Before I read the 2014 order, I don't know
18 if I would have termed it that way, but I think that's
19 a reasonable title for what I did.

20 Q. Had you not read the 2014 order, how would
21 you characterize the type of analysis you performed
22 here in developing what you recommend as underwriting
23 profit?

24 A. I would honestly probably reference my
25 entire section, you know, because it's -- it's -- it's

1 a whole discussion of the -- the cost of capital
2 approach and that my understanding is that that isn't
3 in preparing -- preparing in accordance with the cost
4 of capital approach is not permissible under the law
5 and then I would discuss what I did. It -- it's really
6 because this is, you know, a unique situation here in
7 North Carolina.

8 Q. Well, I guess what I'm curious about is
9 you stated a moment ago that after reading the 2014
10 order, you would characterize what you did as a
11 comparable earnings analysis. And I'm just curious
12 what you -- how you would have characterized what you
13 did had you not read what is set out on that matter in
14 the 2014 order.

15 A. I probably wouldn't have used those words,
16 comparable earnings analysis. I would have just
17 proceeded as, you know, as it's laid out in my pre-
18 filed testimony.

19 Q. Would it be fair to suggest or ask, but
20 for the North Carolina law as it relates to
21 underwriting profit and the consideration of investment
22 income on capital surplus, would you have done a
23 completely different analysis to develop underwriting
24 profit provision?

25 A. I want to understand your hypothetical.

1 So you are -- are you asking me if the law was not in
2 place regarding the use of cost of capital or the words
3 that are in the law, what would my analysis have been
4 different? Is that your question?

5 Q. Yes.

6 A. Yes.

7 Q. Can you describe generally what -- what
8 that would have been? And I'm not asking you to give
9 me specific numbers or anything like that, but just
10 describe what kind of analysis you would more typically
11 do in determining underwriting profit provisions in
12 a -- in a rate case.

13 A. I would more typically do an analysis as
14 is discussed in Actuarial Standard Of Practice No. 30.

15 Q. Now, the underwriting profit provision
16 that you developed in the analysis you perform in this
17 case is 7.7 percent of premium. Correct?

18 A. The underwriting profit provision that I
19 use in my indication is 7.7 percent.

20 Q. And that's what you developed through the
21 methodology you used here. Correct?

22 A. Yes.

23 Q. Is it your contention that your analysis
24 developing that 7.7 percent underwriting profit
25 provision does not consider investment income on

1 capital in surplus?

2 A. I would say that my analysis is prepared
3 in accordance with my understanding of the way the law
4 has been interpreted, and that understanding comes from
5 the review of the 2014 order and discussion with
6 counsel.

7 Q. All right. Given your understanding of
8 that, is it your contention that the result, the 7.7
9 percent of premium that you recommend for underwriting
10 profit, does not consider investment income on capital
11 in surplus?

12 A. The methodology -- the methodology does
13 not use -- use that, and it is looking at North
14 Carolina profits, which, if my understanding is correct
15 regarding the law, the underwriting profits should
16 reflect a provision that would not include investment
17 income on capital in surplus.

18 Q. Would considering investment income from
19 capital in surplus have led you to a different
20 underwriting profit provision than the 7.7 percent
21 provision that you developed here?

22 A. I would reference the testimony I just
23 gave that if the law was different, if the -- if the
24 law was not in place that you couldn't use investment
25 income on capital in surplus, then I would use a

1 methodology, you know, in line with what -- what I
2 quote regarding Actuarial Standard Of Practice No. 30.

3 Q. Do you believe that had you been able
4 under the law here to perform an analysis consistent
5 with that described in ASOP 30 that the result would
6 have been materially different from the 7.7 percent
7 provision that you recommend.

8 MR. FRIEDMAN: I'm going to object
9 because this is essentially asking her to engage in
10 a whole new calculation. And she's already stated
11 that's not what her opinion is in her filing. And
12 these are being phrased at or even saying
13 materially different would technically compel her
14 to sit down and run one.

15 MR. SPIVEY: I'm not asking her to
16 perform a calculation. I've asked what her -- what
17 her belief is based on what she understands about
18 the law here and what she would do if the law were
19 different here.

20 MR. FRIEDMAN: I just respond, how can
21 she know if she doesn't have the time to actually
22 run that calculation whether there would be a
23 material difference, whatever that means to Mr.
24 Spivey?

25 MR. SPIVEY: Again, I'm not asking her

1 to run a calculation. I'm asking her a general
2 question that I would think that she is fully
3 capable of answering.

4 HEARING OFFICER FUNDERBURK: Yeah.
5 Overruled. Please restate your question for the
6 benefit of the witness.

7 BY MR. SPIVEY:

8 Q. Ms. Cavanaugh, I'm going to try to restate
9 that. I probably will mess it up, but I'll try. If
10 you had been able to perform a profit analysis
11 consistent with the provisions of ASOP 30 here and
12 assuming that the law here allowed that as per your
13 understanding of what the law here is, had you been
14 able to do that, do you believe that the result, the
15 resulting underwriting profit provision, would be
16 materially different from the 7.7 percent provision you
17 are recommending in this case?

18 A. Okay. First, I want to just clarify that,
19 I do discuss Actuarial Standard Practice No. 30 in my
20 pre-filed testimony, and it is my view that I am in --
21 that -- that -- that my work is in adherence to that
22 because of the consideration of the law in place, and I
23 discussed that in my pre-filed testimony.

24 So the words that you just said, I just wanted
25 to clarify that, you're posing a hypothetical that the

1 law was not in place that would -- that the law that
2 prohibits cost of capital analysis is not in place.
3 Correct?

4 Q. That's a very loaded statement, Ms.
5 Cavanaugh. I'm asking you to just assume that North
6 Carolina law regarding the investment income on capital
7 in surplus and the prohibition that we consider that
8 when we're developing underwriting profit provisions,
9 assume that that is not in place here, that the law
10 here would be -- well, just assume that that law is not
11 prohibiting you from performing a profit analysis in
12 whatever way you would choose to perform a profit
13 analysis.

14 A. Okay. So then, under that hypothetical, I
15 believe the -- the analysis would be different as I
16 stated earlier. Whether or not it's a material
17 difference, I would have to perform that analysis in
18 order to determine that.

19 Q. All right. Just to make sure I'm
20 understanding, you're saying that your -- the analysis
21 would be a different analysis, and whether the result
22 would be materially different, you just don't know
23 because you haven't done it. Is that a fair summary of
24 what you just stated?

25 A. Yes. So -- so sometimes, you know, two

1 different people can come up with the same number using
2 different approaches. So, or a very -- a very similar
3 number using different approaches, and that's what I
4 would need to do an analysis in order to determine
5 whether there is a material difference. I would also
6 need to consider materiality.

7 Q. Have you ever performed a comparable
8 earnings analysis as part of your profit analysis in
9 any state other than North Carolina?

10 A. I don't recall performing the type of
11 analysis I performed here in another state. I just
12 want to, clarify, though, that I have, you know,
13 considered the overall profits for -- in a particular
14 state for a particular line of business when reviewing
15 rate filings in other states to just, you know,
16 consider the -- the selection that the insurance
17 company is making against that overall average. So
18 just to clarify that, that would be fairly similar to
19 the analysis I did here.

20 Q. Now, did you consider doing any other
21 analyses or using different measures of profitability
22 or different time periods to implement the -- the
23 comparable earnings analysis that you utilized in this
24 case?

25 A. Can you ask that question again?

1 Q. Did you consider doing any other analyses
2 or using different measures of profitability or
3 different time periods to implement the comparable
4 earnings analysis that you performed in this case?

5 A. Yes.

6 Q. Can you describe what other alternatives
7 you considered?

8 A. I considered countrywide homeowners'
9 underwriting profits. I considered different time
10 periods. I believe I looked at a couple of different,
11 you know, averages for the different time periods. I
12 landed on a ten-year average.

13 You know, as outlined in my pre-filed testimony,
14 I considered cost of capital approach, and that's
15 discussed in my pre-filed testimony, and I've also
16 discussed that. And as I'm sitting here today, that's
17 all I recall.

18 Q. What different time periods -- did you
19 literally run analyses using different time periods?

20 A. I don't understand the question. So do
21 you -- do you mean did I determine the overall rate
22 indication using different time periods?

23 Q. All right. Let me clarify. You responded
24 a moment ago that you considered different time
25 periods. The time period you utilized in the case is a

1 ten-year period. Correct?

2 A. Correct.

3 Q. Did you run a calculation to determine an
4 underwriting profit provision using a different time
5 period from ten years?

6 A. Yes.

7 Q. What time period?

8 A. I believe I looked at a five-year time
9 period. And I don't know if I ran that through to
10 determine what their rate indication would be, but I
11 but I considered, you know, the prior ten years, and I
12 considered the -- you know, I really looked at it at
13 all the numbers in the last ten years and I -- I
14 believe it was a -- maybe a, you know, a five-year
15 period is what I'm remembering, and there might have
16 been a couple other averages that I looked at.

17 Q. Was the five-year average higher or lower
18 than the ten-year average?

19 A. I believe it was lower. I'd also just
20 add, I'm looking at my pre-filed testimony on page 42.
21 I state that, as can be seen from this chart,
22 underwriting profits vary greatly from year to year but
23 average at 7.7 percent. I select a ten-year time
24 horizon to allow for a longer term view of overall
25 profitability.

1 So that provides a little bit more explanation
2 as to why I landed at ten years versus five years or
3 some shorter time period.

4 Q. Did you look at measures of underwriting
5 profit from sources other than the NAIC report on
6 profitability?

7 A. Yes.

8 Q. What other sources?

9 A. I did look at S&P Global data that
10 aggregates annual statement data.

11 Q. I'm sorry. What was the last thing?

12 A. Aggregates annual statement data.

13 Q. Now, is that what were you suggesting or
14 saying that that's what you looked at from S&P Global?

15 A. Yes.

16 Q. So the 7.7 percent figure, which was the
17 ten-year average from the NAIC report on profitability,
18 you state at line 12, starting there at line 12, that
19 those are shown on a direct basis so it is not offset
20 for the cost of reinsurance; do you not?

21 A. That's what I say. That's what I state
22 there.

23 Q. When you say that it is not offset for the
24 cost of reinsurance, what exactly do you mean?

25 A. I mean that this was -- this is shown on a

1 direct basis. So the underwriting profit would be the
2 overall -- it was calculated as, like, the overall
3 difference between the total premiums subtracted --
4 subtracting the loss and expenses, but not the expense
5 of reinsurance.

6 And so essentially, when you're looking at an
7 underwriting profit provision on a direct basis, those
8 profits would have to be shared by the insurance
9 company and the reinsurers if anything is ceded.

10 Q. But when it's not -- when the profit
11 provision is not offset for the cost of reinsurance, it
12 is before the consideration of the premiums that
13 insurers cede to reinsurers and before the losses that
14 they recover from reinsurers; is it not?

15 A. It is all done on a gross basis or direct
16 basis, I should say. So it's all the direct premiums
17 written and the direct losses prior to any reinsurance
18 sessions.

19 Q. So that means that the direct premiums
20 that insurers collect would be -- would need to be
21 sufficient to pay the losses that they retain on the
22 business that they've written as well as their
23 underwriting expenses but also to pay for the
24 reinsurance they purchase in order to protect against
25 catastrophic loss. Correct?

1 A. Could you say that again?

2 Q. By stating that it -- this provision is on
3 a direct basis and that it is not offset for the cost
4 of reinsurance, that means that the direct premiums
5 that the insurers collect need to be sufficient to pay
6 for the losses that they retain, their underwriting
7 expenses, and also to pay for the reinsurance that they
8 purchase in order to protect against catastrophic loss?

9 A. So the question is, in my mind, kind of
10 mixing up the historical premiums versus a prospective
11 premium. So prospectively, premiums need to cover the
12 expected costs, including losses, expenses, and
13 reinsurance.

14 What this is showing is a historical view of
15 premiums. Sometimes premiums can be insufficient to
16 cover those, just depending on, you know, if there's,
17 if expected losses are higher than -- or I'm sorry,
18 actual losses are higher than expected losses, for
19 example.

20 Q. On a direct basis, Ms. Cavanaugh,
21 insurers -- strike that.

22 When insurers write homeowners' insurance
23 business here in North Carolina, they collect premiums.
24 And when we consider what those premiums need to
25 provide for when we're in this setting trying to set

1 the appropriate rates, those premiums need to be
2 sufficient to pay the losses. What we -- what we
3 project prospectively, they can anticipate. Also to
4 pay their expected underwriting expenses, again, what
5 we are projecting prospectively they have to pay, and
6 they also have to be sufficient to pay for the
7 reinsurance that they purchase, again, what we're
8 projecting prospectively that they're going to buy and
9 have to pay for. Correct?

10 A. I believe that's what I just testified to.
11 I'm not sure if there was another -- a different
12 question there.

13 Q. So you -- so the answer is yes. That's --
14 we're saying the same thing.

15 A. I'm just confused at the question because
16 I think that that's what I said earlier. I would
17 reference my prior testimony a couple minutes ago.

18 Q. And we're all well aware that, in fact,
19 the insurers writing homeowners' insurance in North
20 Carolina do buy reinsurance, catastrophe reinsurance,
21 and they do cede some losses to reinsurers. That's
22 correct, isn't it?

23 A. That's my understanding.

24 Q. Do you believe that if insurers are
25 allowed a 7.7 percent underwriting profit provision in

1 the rates that we set as a result of this proceeding,
2 that the rates that are set and the premium they're
3 able to collect as a result will enable them to pay all
4 of their costs and still earn a fair and reasonable
5 return?

6 A. So I do want to caveat that it is -- my
7 analysis was done, you know, in accordance with the
8 law. But I did consider the underwriting -- the
9 historical underwriting profits and also considered the
10 overall deviations that were put in place by insurance
11 companies that was provided in the filing. And
12 overall, you know, it's about net zero.

13 So there -- there doesn't seem to be, based on
14 that historical need for additional profits, than what
15 has been experienced because, otherwise, I would expect
16 to see, you know, greater, positive deviations through
17 the method of the CTR.

18 So I did consider that, but like I said, it's --
19 it is -- the analysis is done in accordance with the
20 law, which is different than what I would normally do
21 as I testified earlier. Like, what I would normally do
22 to determine whether, you know, the overall
23 underwriting profit provision is reasonable.

24 Q. If I understood what you just said, then
25 you just stated that the analysis you did here, you

1 believe to have been in compliance with the law in
2 North Carolina, and that that is different from what
3 you would typically do when you determine whether the
4 profit that's allowed in the rates will be a fair and
5 will lead to a fair and reasonable return? Is that a
6 fair characterization of what you just testified to?

7 A. I would state that -- I guess I wouldn't
8 put it in those words.

9 Q. Well, let me ask you -- ask you this way.
10 If the result of this proceeding is that a 7.7 percent
11 underwriting profit provision that you recommend to the
12 hearing officer here is utilized and incorporated into
13 the rates that are set here, and if everything else
14 happens as you recommend in the rates that you propose,
15 do you believe that those rates will allow insurers to
16 pay all of their expected costs and earn a fair and
17 reasonable return?

18 A. So, I'll just reference Actuarial Standard
19 Of Practice No. 30, which is quoted at the bottom of
20 page 40. Property casualty insurance rates should
21 provide for all expected costs, including an
22 appropriate cost of capital associated with the
23 specific risk transfer.

24 I testified earlier that I did not do the -- do
25 a cost of capital analysis, so I don't know if there's

1 any material difference between cost of capital
2 analysis and the 7.7 percent. And I would need to know
3 that in order to answer that question, but I -- but I
4 can say, subject to that, if that difference, which is
5 my understanding according to law, then -- then it is
6 my understanding that the rates in place, if it -- if
7 all of the assumptions were -- were put in place per my
8 report, it would provide for all expected costs,
9 subject to the fact that my analysis was limited based
10 on the data that was provided in the filing and in
11 discovery, and we've requested additional information
12 that we didn't receive.

13 Q. Ms. Cavanaugh, what data are you referring
14 to there at the end of your response, did you request
15 in discovery and were not provided that -- or should I
16 assume somehow related to issue of profit?

17 A. When I -- when I was referencing there, I
18 was referencing the data that is discussed in my pre-
19 filed testimony and discussed in my oral testimony
20 earlier, not necessarily related to underwriting
21 profit.

22 And I -- and I brought that up because you were
23 asking a question about the overall rates, not just the
24 rates in relation to the underwriting profit.

25 Q. Ms. Cavanaugh, as I'm understanding what

1 you stated to this point, I'm understanding that you're
2 not able to testify to whether if rates are set based
3 on your recommended underwriting profit provision, that
4 the result of those rates will be that companies will
5 be able to write the business and earn a fair and
6 reasonable profit. You're unable to make that
7 statement because of whatever limitations you perceive
8 have been imposed in this case.

9 MR. FRIEDMAN: Objection, Your Honor.

10 She made that statement and said subject to the, of
11 course, the data that we didn't receive.

12 HEARING OFFICER FUNDERBURK: Mr.

13 Spivey, I think I've given some leeway. I think
14 you are rehashing some things with the -- with the
15 witness. And I understand the need to do that for
16 clarity and follow-up, but we do seem to be asking
17 her repeated questions. If you could rephrase your
18 question and present that to her one more time,
19 please do so.

20 BY MR. SPIVEY:

21 Q. Ms. Cavanaugh, am I correct in
22 understanding that you are unable to express an opinion
23 or statement as to whether insurers would earn a fair
24 and reasonable return if the rates are set using your
25 recommended underwriting profit provision in this case?

1 MR. FRIEDMAN: Same objection, Your
2 Honor. That's literally, so far as I can tell, the
3 same question he just asked. It's barely
4 rephrased. And again, she has already testified
5 that she believes that number, given the law,
6 arrives at a fair and reasonable profit, and I
7 think the, as I understood her testimony to be, but
8 that would have been possible, you know, they may
9 be not fair and reasonable profit if she'd actually
10 received more data in the request.

11 He's asking the same question over and
12 over again. And what's more is he's
13 mischaracterizing what she already testified to.

14 MR. SPIVEY: I certainly apologize if
15 I'm mischaracterizing it, but I would say that I
16 did not hear this witness' answer to be stated in
17 the terms that Department counsel just set it out.
18 I didn't hear her say that. And I'm just trying to
19 understand if that's what -- if that's what she's
20 saying.

21 HEARING OFFICER FUNDERBURK: I'm going
22 to do one more go at it. And anytime you're
23 answering a question, also, "I don't know" is a
24 perfectly appropriate response. If that is a
25 correct answer. Proceed, and then we're going to

1 move on.

2 MR. SPIVEY: And, Your Honor, all I
3 know is ask it again the way I've tried to ask it.

4 HEARING OFFICER FUNDERBURK: Proceed,
5 and then we're going to we're going to move on.

6 BY MR. SPIVEY:

7 Q. Ms. Cavanaugh, do you believe that if
8 insurers are allowed a 7.7 percent underwriting profit
9 provision in the rates that we set in this proceeding
10 that that will enable them to pay all their costs and
11 earn a fair and reasonable return?

12 A. So I am not sure what how you're defining
13 a fair and reasonable return. I reference actuarial
14 standards when considering prospective rates, and so I
15 would reference the Actuarial Standard 30, which I did
16 in my analysis.

17 I also -- and so I could state that again, but I
18 would just state the, you know, just reference back to
19 what I quoted earlier regarding what the purpose of the
20 underwriting profit provision is and what it's intended
21 to include.

22 I would also reference that in my discussion of
23 the 7.7 percent that I state on page 42 that the
24 underwriting profits are shown on a direct basis, so
25 it's not offset for the cost of reinsurance. And if it

1 was, this would lower the overall underwriting profit
2 provision.

3 I also state that the countrywide homeowners'
4 underwriting profits are more stable and average 2 a
5 half percent over ten years. And so the 7.7 percent
6 metric for North Carolina may be overstated if it is
7 due to volatility or due to excess profits earned in
8 that state compared with other states. So that -- that
9 is my answer to your question.

10 Q. When you looked at the data from NAIC
11 profitability study that you show there in Figure 3 and
12 that you discussed in your testimony that you were just
13 reading from, the profit that was earned on the -- on
14 the -- I'm sorry. That profit that you're showing
15 there was earned on the entire direct premium of those
16 insurers; was it not?

17 A. Yes.

18 Q. Now, on page 44 of your pre-filed
19 testimony, there at line 1, you state that the -- the
20 NCRB selects an underwriting profit provision of 9
21 percent, which compares to my selected provision of 7.7
22 percent. Is that correct?

23 A. Yes.

24 Q. Then you go on to explain that the NCRB
25 applied the profit to -- the profit expenses -- the

1 profit provision to expenses, all direct losses,
2 including those ceded to reinsurance, and the net cost
3 of reinsurance. Correct?

4 A. Yes.

5 Q. And then you go on to indicate some
6 disagreement with that manner of treatment in the
7 filing; do you not?

8 A. Yes.

9 Q. And when you perform the calculations that
10 you perform to develop a rate level, you do not apply
11 your selected profit factor of 7.7 percent to either
12 the net cost of reinsurance or the losses that are
13 ceded to reinsurers; do you?

14 A. That's correct.

15 Q. Do you know what percentage of the total
16 premium in your analysis is accounted for by the two
17 components, net cost of reinsurance and ceded losses?

18 A. I don't know that number. I mean, I would
19 have to calculate it.

20 Q. In our review of your testimony, that
21 appears to be approximately 28 percent of the total
22 underlying cost. Does that sound like it's in the
23 right ballpark?

24 A. It could be.

25 Q. By excluding a profit factor on those two

1 components of the rate, isn't it the case that if
2 everything works out exactly as you projected in your
3 analysis, meaning that if all of your loss projections
4 and all of your expense projections are exactly
5 correct, the 7.7 percent underwriting profit that you
6 target will not, in fact, be earned on the direct
7 premium of insurers in North Carolina?

8 A. So the way that I determined the analysis
9 is essentially looking at the net portion and applying
10 a 7.7 percent profit to that and then doing a separate
11 calculation for the net cost of reinsurance. So the
12 analysis does not provide -- apply an additional profit
13 over and above the reinsurance expenses.

14 So in the extreme sense of, you know, let's say
15 everything was ceded, it would be that net cost of
16 reinsurance that would be the, you know, profit
17 provision because the profits would be borne by the
18 reinsurers.

19 Q. Ms. Cavanaugh, does that answer mean that
20 the 7.7 percent underwriting profit provision that you
21 select and target in your analysis will or will not be
22 earned by carriers on their direct premium?

23 A. So on the net premium, it would be 7.7,
24 and on the gross, it would be a higher number.

25 Q. So you just stated that on the net, it

1 would be 7.7 and on the gross, it would be a higher
2 number? Is that what you just stated?

3 A. That's what I said.

4 Q. What is the gross that you're referring
5 to?

6 A. On the gross premium.

7 Q. Is that the direct premium that I was
8 asking you about?

9 A. Yes.

10 Q. So it's -- it's your testimony that if
11 rates are set using the 7.7 percent underwriting profit
12 provision that you recommend -- I'm sorry. Let me
13 strike that. Let me just start again.

14 It's your testimony that if everything works out
15 as you projected in your analysis, the 7.7 percent
16 profit provision would be the amount earned on the net
17 premium and that a higher amount would be earned on
18 direct premium?

19 A. Yes. Because the net cost of reinsurance
20 is higher than the 7.7 percent.

21 Q. Now, in your recommended overall rate
22 change, the indicated rate increase for the owner's
23 form is 2.5 percent. Correct? And I could ask you
24 could turn to your LJC-3.

25 A. Yes. Owners' is 2.5 percent.

1 Q. Is it your contention that a 2.5 percent
2 rate increase for the owners' form will produce an
3 expected profit of 7.7 percent of direct premium?

4 A. No.

5 Q. What would the actual profit as a percent
6 of direct premium if rates are set as you recommend and
7 everything occurs exactly as you project it will occur?

8 A. Well, first, I would caveat, as I have
9 before, that my analysis was an alternative indication
10 subject to limitations. And if I had other data, the
11 analysis might be different.

12 But the -- and this -- the -- your question on
13 what the percentage as a direct basis, I have not
14 included that in my analysis, but it would be higher
15 because the way that the analysis works is it -- it
16 looks at the net losses and apply -- the net portion
17 applies a 7.7 percent to that.

18 And then for the ceded portion, it looks at the
19 net cost of reinsurance. And that portion of profits
20 to reinsurers is a higher percentage than the 7.7
21 percent.

22 So when you average it out, it's going to
23 average out to a higher percentage.

24 MR. BEVERLY: Your Honor, may we have a
25 moment?

1 HEARING OFFICER FUNDERBURK: Yes.

2 MR. SPIVEY: Thank you, Your Honor.

3 BY MR. SPIVEY:

4 Q. Ms. Cavanaugh, I'm having a difficult time
5 following the explanation you've given in the last
6 answer or two here. And I'm thinking perhaps maybe if
7 we work through an example from your testimony, you can
8 maybe show me how that would work. Is that okay?

9 A. Okay.

10 Q. All right. Looking at your LJC-3 appended
11 to your written pre-filed testimony, can you tell me
12 how you would calculate the expected underwriting
13 profit based on the values shown in that page of
14 your -- of your exhibits?

15 A. As I've testified, the 7.7 percent is
16 applied to everything except the reinsurance, the ceded
17 losses, and the net cost of reinsurance. And I can
18 move on to the net cost of reinsurance unless you have
19 a question on that. Do you want me to point out the
20 row number?

21 Q. No. Well, please point out the row
22 numbers for the items that you say you would not apply
23 your recommended profit provision to.

24 A. So the first is row 21, the net cost of
25 reinsurance per policy.

1 Q. And the value shown for that row is
2 \$176.47.

3 A. Are we looking at LJC-3?

4 Q. Yes.

5 A. Okay. So I believe the row 21 is \$945.77.

6 Q. Well, actually, Ms. Cavanaugh, I'm having
7 to hold a piece of paper across there to see that.

8 A. I'm sorry. I was wrong. I'll do that as
9 well. \$176.47. My apologies.

10 Q. Okay. No problem. All right. So what
11 other item on this page would you not apply your
12 recommended profit provision to?

13 A. Row 17, 16 -- \$62.16. That is the portion
14 of losses ceded to reinsurance.

15 Q. Now, I assume in the calculations you made
16 in your testimony here, you actually performed them in
17 that manner. You did not apply profit to those items.
18 Correct?

19 A. That's correct.

20 Q. So how would we or how would you calculate
21 the expected underwriting profit that you're telling us
22 would result from the value shown on LJC-3?

23 A. Do you mean on a direct basis?

24 Q. That's how this exhibit is presented. Is
25 it not?

1 A. This exhibit shows ceded losses, shows net
2 cost of reinsurance. I just -- I was just asking
3 whether you were asking me about a, basically, what
4 metric you are asking me to describe how to determine.

5 Q. All right. So then please explain how it
6 would be derived to determine the expected underwriting
7 profit on a direct basis.

8 A. Okay. I need a minute. So I believe it
9 would be row 19, 769.29, divided by row 25, 945.77.

10 Q. So just --

11 A. And that would -- I'm sorry. One minus
12 that number would get to the direct underwriting
13 profit.

14 Q. So just -- just to repeat to make sure I'm
15 following you, to determine what the expected
16 underwriting profit provision on a direct basis would
17 be based on the values you're showing on LJC-3, we
18 would formula would be 1 minus row 19 divided by row
19 25.

20 A. Yes. And I'm doing this on the fly, so if
21 when I -- when I go back to my notes, if there's any
22 clarifications, you know, I'll -- I'll determine those
23 in redirect. The other thing I would mention is that
24 that is the formula assuming that deviations and the
25 compensation for assessment risk and dividends and

1 contingencies are zero.

2 Q. All of those assumptions are, in fact,
3 what you have presented in your presentation on LJC-3.
4 Correct?

5 A. Yeah. Those are -- those are the
6 assumptions, but I'm just clarifying because if the
7 deviation was different, then I think the formula would
8 be different.

9 Q. So do you have a calculator available to
10 you? I'm curious what the result of the calculation
11 you just described is.

12 A. No. I don't. I could get my phone and
13 use the calculator on that.

14 MR. SPIVEY: Your Honor, may we -- I'd
15 like for the witness to perform that calculation if
16 possible.

17 HEARING OFFICER FUNDERBURK: I'll allow
18 her to do that calculation, but I'm also going to
19 clarify, do you feel comfortable doing that
20 calculation? You also referenced that you might
21 need to review notes to make sure that you are
22 doing the correct calculation.

23 THE WITNESS: Yeah. Subject to -- I
24 can make the calculation on my calculator, but I
25 still -- I still always like to double check my

1 work. So subject to that, I can make the -- the
2 number -- the numeric calculation, though.

3 HEARING OFFICER FUNDERBURK: Yeah. We
4 can do the numeric calculation subject to Ms.
5 Cavanaugh may present additional information at a
6 later point after she's had an opportunity to
7 verify whatever she needs to verify.

8 Basically, I don't -- I don't want to
9 put the witness on the spot with -- when it sounds
10 like she may need additional verification to
11 accurate -- make sure she's accurately answering
12 your questions.

13 MR. SPIVEY: And I'm fine with that.
14 I'm not trying to put you on the spot, Ms.
15 Cavanaugh. I'm just -- you've described, the way
16 that calculation would be performed, and I'm just
17 curious what the result of that calculation is.
18 Would you prefer to wait and may perhaps do that at
19 a break or something like that?

20 THE WITNESS: Either way is fine.

21 HEARING OFFICER FUNDERBURK: You've
22 been on the stand a little over an hour now. Would
23 you like to go ahead and take a break?

24 THE WITNESS: Sure.

25 HEARING OFFICER FUNDERBURK: All right.

1 Is there anything we need to address before we take
2 a ten-minute break?

3 MR. FRIEDMAN: So if I could just
4 clarify, is the Court expecting Ms. Cavanaugh
5 during that break to run the calculation plus
6 confirm based on any other note she has that she's
7 good with that calculation? She had otherwise
8 spoken of, I mean, taking this evening to --

9 HEARING OFFICER FUNDERBURK: To the
10 extent she's -- to the extent she's able to.
11 Again, I don't want her put on the spot to do a
12 quick calculation that she does not feel
13 comfortable with or to give testimony that she's
14 ultimately not comfortable with if she feels like
15 she needs more time.

16 But I think to the extent we can
17 determine if it's possible to get the information
18 Mr. Spivey is looking for in the break, let's do
19 that. But, again, that's subject to your comfort
20 level. And if you need to come back and say, I
21 need to look at something else, I need to review
22 something else, that is fine and acceptable. I
23 don't want you to feel like you're put on the spot.

24 THE WITNESS: Okay. Thank you.

25 HEARING OFFICER FUNDERBURK: I also

1 want Mr. Spivey to get the information that he's
2 requesting.

3 All right. It is 2:12. We are in
4 recess until 2:30. Thank you.

5 (Recess was taken from 2:12 p.m. to 2:20 p.m.)

6 HEARING OFFICER FUNDERBURK: We're back
7 on the record and back in session at 2:30. Ms.
8 Cavanaugh, you do remain under oath. Were you able
9 to conduct some of those calculations during the
10 break?

11 THE WITNESS: Yes. But in order to
12 make a final conclusion, I would need to, you know,
13 refer to additional notes.

14 HEARING OFFICER FUNDERBURK: Okay. Mr.
15 Spivey, I'm going to let you proceed, and subject
16 to she may need to do some additional review or
17 calculations after your line of questioning.

18 MR. FRIEDMAN: Your Honor, I guess, I
19 want to make clear that I'm clear about what Ms.
20 Cavanaugh feels comfortable doing today, if at all,
21 about that calculation? Because it's unclear to
22 me, whether she feels even secure in running that
23 initial purely calculator calculation.

24 HEARING OFFICER FUNDERBURK: And I --
25 and I -- my -- my impression so far, Ms. Cavanaugh,

1 is she would be comfortable telling us that. Is
2 that a correct assumption?

3 THE WITNESS: I could -- I think I
4 would feel more comfortable. I could tell that
5 number, but that's not going to necessarily be the
6 number that I will arrive at after checking notes
7 and --

8 HEARING OFFICER FUNDERBURK: I'm sorry.
9 I misspoke. I think you would be comfortable
10 telling us, I'm not comfortable yet. I need to
11 look at something else. That's --

12 THE WITNESS: Yes.

13 HEARING OFFICER FUNDERBURK: That -- is
14 that a correct statement on my part?

15 THE WITNESS: That is correct.

16 HEARING OFFICER FUNDERBURK: Okay. So
17 I recognize the concern. And, again, Mr. Spivey,
18 if it was -- if it was one of the Bureau's
19 witnesses, I'd have the same concern. I don't want
20 to put somebody on the -- on the spot when they can
21 take some additional time and do the calculations
22 necessary to get you what you're looking for.

23 Is there anything else we need to
24 address before we resume questioning?

25 Okay. Mr. Spivey, please proceed.

1 MR. SPIVEY: So let me, Your Honor,
2 make sure I'm understanding. My understanding when
3 we broke that was that during the break, Ms.
4 Cavanaugh was going to see whether she could make
5 the calculation using the formula she had just
6 given me in a -- in a response.

7 HEARING OFFICER FUNDERBURK: Correct.

8 MR. SPIVEY: And what I'm understanding
9 now is that she prefers to do some more review
10 before she provides that response. Is that
11 correct?

12 HEARING OFFICER FUNDERBURK: I think
13 that might depend on what you're -- what all you
14 end up asking her. Is that accurate?

15 THE WITNESS: That's accurate.

16 HEARING OFFICER FUNDERBURK: Okay. I
17 think it's -- I think what calculations may need to
18 be done overnight or tomorrow are going to depend,
19 in part, on what exactly you ask on further cross.

20 MR. SPIVEY: Well, then, Your Honor, if
21 I may, I'll just ask these questions. And if I --
22 if I'm getting where I -- where Department counsel
23 or the witness is not comfortable and it's
24 objectionable or whatever, just please speak up.

25 MR. FRIEDMAN: I thought, Your Honor, I

1 think she -- all -- I mean, she did make clear
2 already that she's not comfortable making -- doing
3 any numbers today. And then it's sort of like --

4 HEARING OFFICER FUNDERBURK: She didn't
5 say she wasn't comfortable doing any numbers. I'm
6 going to let her answer the questions.

7 If, Ms. Cavanaugh, you get to a point
8 where you're not comfortable asking a question,
9 either you don't know, you can't make that
10 determination, you need additional time to do those
11 calculations, let us know. Your testimony so far
12 makes me believe that you are comfortable doing
13 that and saying, I need to do calculations. I
14 can't do that right now.

15 THE WITNESS: Yes. That's correct.

16 HEARING OFFICER FUNDERBURK: Okay. So,
17 Mr. Spivey, I want you to proceed with your line of
18 questioning, and Ms. Cavanaugh will let us know if
19 she needs some additional time or needs to come
20 back with additional information or review
21 additional data.

22 MR. SPIVEY: Thank you.

23 MR. BEVERLY: May we have one more
24 moment?

25 HEARING OFFICER FUNDERBURK: Sure.

1 MR. SPIVEY: All right. Thank you,
2 Your Honor.

3 BY MR. SPIVEY:

4 Q. Ms. Cavanaugh, before we broke, you had
5 responded that the manner in which you would
6 calculate the expected underwriting profit on a
7 direct basis based on the information shown on LJC-
8 3 would be to calculate the result of 1 minus row
9 19 divided by row 25. Correct?

10 A. That's what I -- that's what I stated.

11 Q. Did you perform that calculation? I'm
12 following up. Did you perform that calculation over
13 the break?

14 A. I did.

15 Q. And what was the result?

16 A. Well, I -- what I want to clarify is that
17 I do need additional time to confirm that the equation
18 that I gave, what is accurate, and also this is just
19 owners' forms. I would need to do it for tenants and
20 condos as well.

21 Q. All right. Subject -- given the
22 conditions you just stated, did you determine the
23 result of that calculation over the break, and what was
24 the number?

25 MR. FRIEDMAN: Objection, Your Honor.

1 I mean, she said that she's not even comfortable at
2 this point with the formula that he's quoting, even
3 though she initially thought she was. I mean, this
4 is going to be a tortuous, I mean, period where
5 he's keeping -- trying to force her to answer and
6 run calculations that she's made clear she's not
7 ready to do today.

8 MR. SPIVEY: Your Honor, I'm not asking
9 her to do a test. I'm not asking her anything
10 other than simply what the result of that
11 calculation was, and she can then explain whatever
12 she needs to explain about what that number is or
13 may be. She -- I'm just wondering what the number
14 is.

15 MR. FRIEDMAN: She has just answered,
16 Your Honor, that she would need to check that
17 number against other forms numbers and other
18 factors. So she's not comfortable saying what that
19 number -- whether that number means anything at
20 this point.

21 HEARING OFFICER FUNDERBURK: At this
22 point, Ms. Cavanaugh, prior to the break, you
23 talked about using a particular formula, and I
24 think we can all pick up a calculator and do math.
25 But you talked about using a particular formula.

1 It sounds like your concern at this point is that
2 may not be ultimately the formula that you would
3 use?

4 THE WITNESS: That's correct. Yeah.
5 And so if I -- so I'm concerned that if I state a
6 number, you know, I don't want -- I don't want to
7 mislead that that is indeed the number, as
8 appropriately calculated.

9 HEARING OFFICER FUNDERBURK: Okay. So
10 is it correct, then, that the concern is not what
11 the math comes out to? The concern is what the
12 actual formula is to lead to the correct
13 calculations and assessment?

14 THE WITNESS: That's correct.

15 HEARING OFFICER FUNDERBURK: Okay. And
16 what would you need to be able to make sure you
17 were getting to the correct calculation?

18 THE WITNESS: I would need to look at
19 my -- the formulas in my work papers closer and
20 discuss with my peer reviewer.

21 HEARING OFFICER FUNDERBURK: And when
22 could that be done?

23 THE WITNESS: I'm hoping either tonight
24 or tomorrow morning.

25 HEARING OFFICER FUNDERBURK: Okay.

1 BY MR. SPIVEY:

2 Q. Okay. Ms. Cavanaugh, my general
3 understanding of underwriting profit is that it is
4 calculated as the proposed premium minus the expected
5 losses and loss expenses and the expected expenses. In
6 a very high level general statement, is that a fair
7 statement?

8 A. Which -- are you referring to direct
9 underwriting profit as determined by the NAIC data or
10 something different?

11 Q. Well, let's say on a direct basis. So
12 underwrite -- is underwriting profit on a direct basis
13 determined as the proposed premium minus the expected
14 losses and loss expenses and minus the expenses?

15 A. So if I understand, I'm having difficulty
16 understanding your question. I believe you're asking
17 about prospective underwriting profit, expected
18 underwriting profit on a direct basis. And if that's
19 the case, I would say that that would be calculated as
20 the direct premiums less the expected direct losses,
21 less underwriting expenses, and that those expenses
22 would not include the net cost of reinsurance.

23 Q. Ms. Cavanaugh, looking at LJC-3, am I
24 correct in understanding that the total losses that the
25 insurer would have to pay are reflected in your lines

1 12 and 14 and would be the sum of the \$410.86 and the
2 \$106.28.

3 A. Yes. I believe that's correct for owners'
4 forms.

5 Q. Correct. I'm just referring to LJC-3 at
6 the moment. The fixed expenses that the insurer
7 will -- would pay under this scenario would be \$84.68
8 shown in line 15; would they not?

9 A. Yes. Subject to all of the caveats and
10 assumptions that I'm making in my report.

11 Q. Now, the variable expenses that the
12 insurer would incur, in your analysis here, are simply
13 14.8 percent of the total premium. Is that correct?

14 A. I'd have to take a look at that exhibit.

15 Q. So where would we find that to get the --
16 that would be -- the variable expenses would include
17 commission and brokerage, taxes, licenses, and fees,
18 and profit. Is that correct?

19 A. I'm looking for the -- for the exhibit
20 that this is shown in. So I'm looking at one place,
21 where I see the commission and brokerage and the taxes,
22 licenses, and fees referenced, and that's on LJC-23.
23 It's also in the original filing. Commission and
24 brokerage is 12 percent. Taxes, licenses, and fees is
25 2.8 percent.

1 So that adding that up is 14.8 percent, which
2 I -- that might have been the number. Okay. Yes.

3 Q. And you get those, you say, from LJC 23 --

4 A. 23.

5 Q. -- correct?

6 A. And that's just referring to the filing.
7 I'm just -- since I have my report in front of me, I
8 was using that. I didn't make any changes to those.

9 Q. And that would be to determine the dollars
10 of variable expenses, we would simply multiply the 14.8
11 percent times the ultimate rate that you propose here
12 in line 25 of \$945.77. Correct?

13 A. I believe so. I'll just add that, you
14 know, I am going to, you know, go back and do this
15 calculation.

16 Q. And if I've done it correctly myself, 14.8
17 percent of \$945.77 is \$139.97, I believe. So if you
18 want to make a note of that when you've checked the
19 calculations, that's what I'm getting.

20 A. I don't have anything to even take notes
21 with.

22 Q. Okay. But my general understanding is you
23 want to check these calculations.

24 A. I do.

25 Q. Now, the other expense that's reflected on

1 your Exhibit LJC-3 for the owners' forms is the net
2 cost of reinsurance. Correct?

3 A. The net cost of reinsurance is on this
4 page.

5 Q. And it is an expense that the insurers who
6 write homeowners' insurance incur. Correct?

7 A. I would reference my pre-filed testimony
8 regarding the net cost of reinsurance and some of the
9 limitations of the analysis that -- that I had,
10 including that I didn't have the actual reinsurance
11 expenses provided in the filing or in the discovery
12 requests.

13 Q. Ms. Cavanaugh, you've included a provision
14 for net cost of reinsurance on LJC-3; have you not?

15 A. Yes.

16 Q. And it's included here as an expense item.
17 Correct?

18 A. It's included as the net cost of
19 reinsurance per policy, and it is discussed in my pre-
20 filed testimony.

21 Q. So how many dollars of net cost of
22 reinsurance are provided for in your analysis on
23 page -- on sheet LJC-3?

24 A. \$176.47.

25 Q. That amount of -- or that number of

1 dollars is your NCOR, or net cost of reinsurance
2 provision, which has been loaded up for variable
3 expenses. Is it not? And I should clarify, variable
4 expenses as I'm understanding your testimony other than
5 profit.

6 A. It has been -- a factor has been applied
7 to include commission and brokerage, taxes, licenses,
8 and fees.

9 Q. And therefore, the actual out-of-pocket
10 costs for net cost of reinsurance would be the amount
11 left after we've -- we take out the loading for those
12 variable expenses. Correct?

13 A. Can you say that again?

14 Q. So we just discussed the fact that the
15 \$176.47 provision for net cost of reinsurance that you
16 show on line 21 includes a loading for certain variable
17 expenses.

18 A. That's true.

19 Q. And so the actual out-of-pocket costs for
20 companies that pay that to, you know, the cost they
21 have that they're going to incur here would be that
22 amount after you remove the loading for those variable
23 expenses.

24 A. So the net cost of reinsurance starts with
25 the costs estimated, you know, as I discussed in my

1 pre-filed testimony, and then there is a separate
2 loading for commission and brokerage and taxes,
3 licenses, and fees. So you could look at those
4 separately. You could split those out, and I think
5 that's what you're asking me, and I would agree with
6 that.

7 Q. Correct. So if I were to remove the
8 loading for what they have to pay for commission and
9 brokerage and what they have to pay for taxes,
10 licenses, and fees, the remainder would be the actual
11 out-of-pocket costs for your provision for net cost of
12 reinsurance. Correct?

13 A. That's correct.

14 Q. So if I were trying to get from my own
15 information, the actual amount of profit an insurer
16 would expect to earn if it charged the rates that
17 you're setting out here for the owners' forms, I would
18 start with the total premium of \$945.77, and I will
19 subtract out the total losses of \$517.14. I would
20 subtract out the fixed expenses of \$84.68. I would
21 take out the variable expenses of \$139.97, and I would
22 take out the out-of-pocket portion of the net cost of
23 reinsurance provision that you show is \$176.47.
24 Correct?

25 A. Not if you're trying to calculate on a

1 direct basis.

2 Q. And if I'm trying to determine what
3 dollars of premium are left out of the numbers you're
4 showing here, is it correct that that's the calculation
5 I would do?

6 A. I don't understand the question.

7 Q. The calculation I just described would
8 inform me of the dollars left over for a carrier after
9 writing the business and incurring the losses and
10 expenses that you display on LJC-3. Is that correct?

11 A. So I have not independently verified any
12 of the numbers that you just stated, the ones that
13 aren't shown on LJC-3. And as I stated earlier, the
14 direct profit is calculated, not including the net cost
15 of reinsurance.

16 Q. Ms. Cavanaugh, in my last question, I
17 don't believe I asked what the direct profit was or
18 what maybe on a net basis or whatever basis you may be
19 referring to in your answer. I was simply asking if
20 the homeowners' insurers in this state write the
21 owners' forms coverage using the provisions you're
22 recommending in your rate calculations and that are
23 reflected on LJC-3, I'm trying to determine what
24 numbers of dollars will be left over after they pay
25 those losses and pay the expenses that are reflected on

1 LJC-3. And my question was the way I just
2 characterized it, would that tell me how many dollars
3 are left over?

4 A. So the amounts left for the insurer would
5 be -- I don't -- I'm not comfortable kind of answering
6 your question with regard to the actual numbers that
7 you stated, but it would include the losses and the
8 expected losses, the expected expenses, the, you know,
9 variable expenses, fixed expenses.

10 And if you're looking at net of reinsurance,
11 then you would also subtract out the net cost of
12 reinsurance per policy.

13 Q. From your testimony earlier this
14 afternoon, if I did that and I get a number of dollars
15 left over and I divide that by the premium you show
16 there of \$945.77, my understanding from your testimony
17 earlier that that would be 7.7 percent. Is my
18 recollection correct?

19 A. No. I discussed that in my analysis, I
20 bifurcated the underwriting profit to be on it -- on
21 the net portion and the ceded portion. The net portion
22 applied to the -- it applied in the formula was using a
23 7.7 percent figure. And I can get the exact numbers,
24 you know, after I, you know, just do those
25 calculations.

1 Q. In your calculation on LJC-3, my
2 understanding from your testimony to this point is that
3 you have not allowed the 7.7 percent underwriting
4 profit provision that you recommend on the portion of
5 the premium here that's reflective of the net cost of
6 reinsurance and the ceded losses. Correct?

7 MR. FRIEDMAN: Your Honor, at the -- I
8 mean, this has truly become repetitive that she has
9 answered repeatedly in various forms that he's
10 posed the same question.

11 HEARING OFFICER FUNDERBURK: Any
12 response, Mr. Spivey?

13 MR. SPIVEY: I'm trying to orient us
14 for the next question, Your Honor.

15 HEARING OFFICER FUNDERBURK: Okay.
16 Please proceed. Restate your question for the
17 witness.

18 BY MR. SPIVEY:

19 Q. Given the manner in which you've
20 calculated your recommended rate level change, that
21 change is 2.5 percent as shown on line 27; is it not?

22 A. Can you ask the question again?

23 Q. Given the manner in which you've made your
24 rate calculations and, specifically, the manner in
25 which you've applied your profit provisions, the result

1 that you come up with is an indicated rate level change
2 for the owners' forms of 2.5 percent. Correct?

3 A. That's correct.

4 Q. And just again to clarify, that's after
5 you -- that's including the fact that you do not apply
6 your recommended profit provision to your provisions
7 for the net cost of reinsurance and the ceded losses.
8 Correct?

9 A. That's correct.

10 Q. If you were to allow the profit provision
11 to be applied to the net cost of reinsurance and to the
12 ceded losses, is it correct that the indicated rate
13 level change in line 27 would be higher?

14 MR. FRIEDMAN: Your Honor, this is,
15 again, an attempt to have her calculate or agree to
16 calculate exactly what she said she's not
17 comfortable calculating right now. He has asked
18 previously the same question in the form of saying,
19 first, it was materially different. Now he's using
20 a slightly different iteration, but it's ultimately
21 all the same question about the same calculations.

22 MR. SPIVEY: Your Honor, we're in a
23 totally different area now from what Department
24 counsel is referring to, and I haven't asked her to
25 do a calculation. I think the question is fairly

1 simple. I think she can answer it fairly easily.

2 HEARING OFFICER FUNDERBURK: And I
3 trust that Ms. Cavanaugh will let us know if she
4 cannot answer the question. And when we move to
5 redirect, if you need to clarify anything, we can
6 clarify at that time. And certainly, if Ms.
7 Cavanaugh doesn't feel comfortable answering a
8 question for whatever reason, she will let us know.

9 Please proceed, Mr. Spivey.

10 BY MR. SPIVEY:

11 Q. You need me to restate the question?

12 A. Please.

13 Q. If in performing the calculation shown on
14 LJC-3, you were to apply your recommended underwriting
15 profit provision of 7.7 percent to the provisions you
16 show for the net cost of reinsurance and to the ceded
17 losses, is it correct that your rate level indication
18 on line 27 would be higher than the 2.5 percent that is
19 showing there now?

20 A. If I made no change to the 7.7 percent and
21 I made that calculation, which I don't believe is
22 appropriate, then, yes, it would be higher

23 Q. Ms. Cavanaugh, would you turn back to page
24 40 and 41?

25 A. Page 40 or 41?

1 Q. Well, I'm just generally getting us
2 oriented to pages 40 and 41. Okay. This is, again,
3 within your testimony about underwriting profit
4 provision. Correct?

5 A. Yes.

6 Q. Now, we've had a considerable amount of
7 testimony in this hearing about ASOP 30; have we not?

8 A. We've had some testimony on that. Yes.

9 Q. And you literally quote portions of ASOP
10 30 there in your testimony at pages 40 and 41; do you
11 not?

12 A. Yes.

13 Q. And ASOP 30 provides pretty plainly that
14 property casualty insurance rates should provide for
15 all expected costs, including the cost of capital; does
16 it not?

17 A. Yes. The exact words -- I'm just reading
18 the exact words just so we have it. I never like to
19 paraphrase in ASOP. So the exact words are property
20 casualty insurance rates should provide for all
21 expected costs, including an appropriate cost of
22 capital associated with the specific risk transfer.

23 Q. And you've testified here in this
24 proceeding that you've been advised that North Carolina
25 law does not allow us to consider the cost of capital

1 in setting the rates here. Is that a fair statement?

2 A. I'm just looking at the exact wording of
3 my testimony. So in lines 9 and 10 of page 20 -- or
4 I'm sorry -- page 40, I say it is my understanding
5 that a cost of capital approach is not permitted per
6 the current statute and precedent related to that
7 statute.

8 Q. And on page 41, your testimony at lines 11
9 through 13 are that, given that the existing North
10 Carolina law statute -- no, I'm sorry -- given that the
11 existing North Carolina statutes and precedent do not
12 allow for calculating underwriting profits using a cost
13 of capital approach, one conclusion could be that no
14 underwriting profit provision is permitted. First of
15 all, did I read that correctly?

16 A. You did.

17 Q. And that's a statement you've made in your
18 testimony. Correct?

19 A. Yes.

20 Q. What do you mean by that statement?

21 A. So as I explained in my pre-filed
22 testimony, the Actuarial Standard Of Practice No. 30
23 discusses consideration of a cost of capital in
24 determining an appropriate underwriting provision. And
25 that my understanding is that that is not allowed under

1 the statutes.

2 So if it's not allowed to do a cost of capital,
3 one interpretation would be that there is no
4 underwriting profit provision. And I would just read
5 in the next sentence that I say in my testimony, which
6 is, however, as discussed earlier in my testimony, it's
7 my understanding that a comparable earnings analysis is
8 permitted to be used to estimate an underwriting profit
9 provision.

10 Q. Well, thank you for that. But I was
11 asking what you meant by the statement in your
12 testimony there at line 13 that one conclusion could be
13 that no underwriting profit provision is permitted.
14 And I'm curious what you meant by that.

15 A. I believe I've answered the question.

16 Q. Is it your understanding of North Carolina
17 law that -- are you suggesting that the North Carolina
18 law means that underwriting profit provision should not
19 be allowed in setting rates here?

20 A. So I think the sentence needs to be read
21 in connect in conjunction with all the rest of my
22 testimony, including the next sentence which says that
23 it's my understanding that a comparable earnings
24 analysis is permitted.

25 So there is another approach. So I was

1 discussing -- you know, I would go to the Actuarial
2 Standard Of Practice when considering underwriting
3 profit. And in that, it discusses a cost of capital.

4 So without any other information, I might say,
5 well, if a cost of capital approach isn't permitted,
6 then there would be no underwriting profit provision.
7 However, I looked at the 2014 order, and I saw that
8 there was another approach that was permissible. And
9 so that's -- that's the -- that's what I'm trying to
10 say in this paragraph here.

11 Q. Ms. Cavanaugh, did you review the North
12 Carolina statutes that apply to the -- this rate making
13 proceeding in terms of the manner in which we're
14 supposed to set rates?

15 A. I did. I reviewed some of the statutes.
16 It looks like that's being pulled up on the screen.

17 Q. We're showing you on this -- are we
18 showing on the screen now? Yeah. G.S. 58-36-10. Now,
19 did you review this statute in preparing to testify in
20 this case?

21 A. This looks like the statute I reviewed.

22 Q. And this looks specifically at subsection
23 2 of G.S. 58-36-10. Is it -- well, do you agree that
24 the statute provides that due consideration shall be
25 given to and then goes on to list a variety of

1 different items or factors to which due consideration
2 is to be given in setting rates?

3 A. Yes.

4 Q. Is it correct that one of those items is a
5 reasonable margin for underwriting profit?

6 A. Yes.

7 Q. So do you believe that North Carolina law
8 on the topic of determining underwriting profit
9 provisions in rate making could be interpreted in any
10 manner or that any possible conclusion of interpreting
11 North Carolina law would mean that no underwriting
12 profit provision is permitted?

13 MR. FRIEDMAN: Objection. Asked and
14 answered, two times over.

15 HEARING OFFICER FUNDERBURK: Any
16 comment, Mr. Spivey?

17 MR. SPIVEY: Your Honor, I don't
18 believe I've asked that question today or ever for
19 this witness.

20 HEARING OFFICER FUNDERBURK: I believe
21 you've asked her multiple times about the -- about
22 this. I'm going to sustain the objection and ask
23 you to move on.

24 BY MR. SPIVEY:

25 Q. In your testimony, Ms. Cavanaugh, you

1 state that Section 4.1, and I'm referring, I believe,
2 to page 41 in the paragraph starting at line 17, the
3 Section 4.1 of ASOP 30 requires the actuary to disclose
4 any material difference between a rate that is
5 developed in accordance with the law or regulation and
6 the actuarially determined rate. Correct?

7 A. So I'm just looking at -- the exact quote
8 is to disclose any material difference between the rate
9 so developed and the actuarially determined rate. And
10 I -- and I only quoted that portion. We could pull up
11 ASOP 30, Section 4.1, if you want to look at the other
12 words around that.

13 Q. Well, as it relates to the subject of
14 profit, the rate that is determined in accordance with
15 law and regulation in your testimony here is the -- is
16 the rate that you calculate using historical
17 underwriting profit as the basis for your underwriting
18 profit selection. Is that correct?

19 A. Yes.

20 Q. And the actuarially determined rate would
21 be the rate that would be developed taking into account
22 the cost of capital, would it not?

23 A. Well, it would be in accordance with the
24 remainder of the standard, Actuarial Standard Of
25 Practice 30, and it says more than the words -- or it

1 says different words than the words that you said. So
2 I would just refer to the Actuarial Standard Of
3 Practice.

4 Q. And you've testified that you cannot
5 provide information on the actuarially determined rate
6 in North Carolina because doing so would constitute a
7 violation of the law as you understand it. Correct?

8 A. So what I say exactly in my testimony is
9 in this situation, it is my understanding that
10 providing a comparison between the comparable earnings
11 analysis and analysis using a cost of capital approach
12 would also be impermissible.

13 Q. In line 24 through 28, is it correct that
14 you quote a portion of ASOP No. 1 and then state that,
15 "Thus, I did not, again, disclose any material
16 difference between the rate so developed and the
17 actuarially determined rate," since doing so would
18 constitute a violation of the law as I understand it.
19 And that's -- and I'm ending the quote from your
20 testimony. That's your testimony. Is that correct?

21 A. That's my testimony.

22 Q. Now, did anyone specifically tell you that
23 providing that information would be a violation of the
24 law? Or is that something that you determined on your
25 own?

1 MR. FRIEDMAN: Okay. A couple of
2 things. Objection one, if that relates to any
3 attorney-client discussions, and I can say there
4 were many discussions, particularly about the fact
5 that 2014 -- the Court of Appeals decision, and the
6 2001 auto (phonetic) decision both used
7 interchangeably "compare" and "test" against the
8 cost of capital analysis.

9 And so, I mean those statutes inform
10 what you can include in your -- in an acceptable
11 profit calculation. But in any case, he's asking
12 for the people who talked with her about that
13 substance, whether that is so, would be me.

14 MR. SPIVEY: Your Honor, I'm not asking
15 for any privileged discussions. I simply ask her
16 whether she came to that conclusion on her own or
17 whether someone advised her of that.

18 MR. FRIEDMAN: That's actually -- that
19 itself is asking for the substance. When he says
20 whether somebody advised her of that, that's asking
21 for the substance of a communication. And what I'm
22 representing is those communications would have
23 been between Ms. Cavanaugh, perhaps other
24 consultants or employees of the Department, but I
25 was present at all of them.

1 HEARING OFFICER FUNDERBURK: So, Mr.
2 Friedman, your position is the answer to that
3 question, even if it's a yes, is privileged.

4 MR. FRIEDMAN: It's revealing the
5 substance of the communication. Yep.

6 HEARING OFFICER FUNDERBURK: Does
7 your -- does your response itself confirm? So it's
8 your contention that she cannot say -- that -- that
9 it would violate your attorney-client privilege
10 with her to confirm that she was told by someone
11 that she could not -- that this is what the law is?

12 MR. FRIEDMAN: It would do so where
13 that someone -- I'm not saying this is what I said,
14 but where that someone just happens to be the
15 attorney.

16 HEARING OFFICER FUNDERBURK: Any
17 further comment, Mr. Spivey?

18 MR. SPIVEY: As I said, Your Honor, it
19 was not my intent to ask for any privileged
20 communications. I think Department counsel's
21 description here is a very expansive one of what
22 could conceivably be privileged.

23 As again, I'm simply curious as to
24 whether this witness reached this conclusion on her
25 own or whether she was so advised by someone other

1 than reaching it on her own.

2 MR. FRIEDMAN: Your Honor, whether --
3 regardless of what his intent is, think the plain
4 language of this question and the fact that I've
5 informed you that discussions of this would have
6 been -- and ultimate recommendations would have
7 been mine means that the question is improper.

8 HEARING OFFICER FUNDERBURK: I don't
9 think Mr. Spivey is asking if the question came
10 from -- if the direction came from you, just if it
11 came from someone outside of her own legal
12 research. Is that what your question is, Mr.
13 Spivey?

14 MR. SPIVEY: That's certainly -- that's
15 certainly a reasonable way to look at it. Yes.

16 HEARING OFFICER FUNDERBURK: Ms.
17 Cavanaugh, I don't want you to reveal any
18 conversations that you had with, any member of
19 counsel, whether that was Mr. Friedman or any other
20 counsel that you may have been working with because
21 those conversations could fall under attorney-
22 client privilege and not be subject to disclosure.

23 And I'm going to ask. Mr. Spivey.
24 reword your question very carefully so that you are
25 not potentially asking to reveal information that

1 could have come up in an attorney-client
2 communication.

3 BY MR. SPIVEY:

4 Q. All right. So just to try to orient us to
5 where I believe we are, Ms. Cavanaugh, you testified at
6 lines 24 through 28, where you quoted a portion of ASOP
7 No. 1, and then you state that you did not and then you
8 quote from ASOP 30, you say, disclose any material
9 difference between the rates so developed and the
10 actuarially determined rate, and that concludes the
11 quote from ASOP 30, and your testimony continues, since
12 doing so would constitute a violation of the law as I
13 understand it.

14 And my question to you was, did you come to the
15 conclusion yourself that providing that information
16 would be a violation of the law, or is that something
17 you were advised of, as it pertains to the law in North
18 Carolina?

19 A. So first, I would just reference the lines
20 21 through 23 and the footnote that -- that is what I'm
21 referring to when I say doing so would constitute a
22 violation of the law as I understand it, and I did
23 review that portion of the Court of Appeals that I'm
24 quoting there.

25 And so that -- that -- that's what I'm basing my

1 understanding off of.

2 THE WITNESS: And I just want to
3 understand your instructions to me regarding not
4 disclosing, you know, if can you just explain,
5 like, in the context of this question, how I can
6 respond then?

7 HEARING OFFICER FUNDERBURK: Did you
8 have a -- I don't want to know who you had the
9 conversation with, but did you do independent
10 research to determine what the law was like an
11 attorney would do? Like, if I was going to
12 determine what the law is, I would research the
13 statute. I'd pull the case law. Did you do that,
14 or were you told this is what your parameters are?
15 This is the law in North Carolina? Or a
16 combination of both?

17 THE WITNESS: Yeah. So I reviewed the
18 2014 order. I reviewed this section of the Court
19 of Appeals. I did discuss those documents with
20 others, and then I came to my conclusion.

21 BY MR. SPIVEY:

22 Q. All right. Thank you. So the statement
23 in ASOP 30, Section 4.1, is that if a law or regulation
24 conflicts with the provisions of this standard, and
25 this standard, as I understand it, is talking about the

1 ASOP 30 standard, the actuary should develop a rate in
2 accordance with the law or regulation and disclose any
3 material difference between the rates so developed and
4 the actuarially determined rate to the client or
5 employer?

6 MR. FRIEDMAN: Objection. Asked and
7 answered.

8 HEARING OFFICER FUNDERBURK: Can you
9 repeat your question for my benefit, Mr. Spivey?

10 MR. SPIVEY: Your Honor, I was
11 referring Ms. Cavanaugh to the statement in ASOP
12 30, Section 4.1, that she quotes at the top of her
13 testimony on page -- top of page 41 in her
14 testimony.

15 HEARING OFFICER FUNDERBURK: Um-hum.

16 MR. SPIVEY: I literally was just
17 reading what the ASOP provides.

18 MR. FRIEDMAN: I guess I have two
19 questions. It's on -- if he's, in fact, quoting
20 from something -- I don't have the ASOP in front of
21 me nor has he directed the witness to it. If he is
22 simply asking what she says on that part of the
23 ASOP she includes on 19 and 20, then she has
24 already read that into the record.

25 If he's talking about the actual ASOP,

1 then I think we also get the chance to look in,
2 would be the DOI Notebook 3 and see the ASOP.

3 HEARING OFFICER FUNDERBURK: Well,
4 what's your actual question, Mr. Spivey?

5 MR. SPIVEY: So, again, I was trying to
6 set the stage for a question.

7 HEARING OFFICER FUNDERBURK: Correct.

8 MR. SPIVEY: And I just literally
9 pointed her to a quoted portion of the ASOP in her
10 testimony.

11 HEARING OFFICER FUNDERBURK: Correct.

12 MR. SPIVEY: That's all I've done at
13 this point.

14 BY MR. SPIVEY:

15 Q. So the question is, in your analysis, Ms.
16 Cavanaugh, you have developed an underwriting profit
17 provision that you say complies with your understanding
18 of the law because, as you've testified, you say you
19 did not consider investment income from capital in
20 surplus in deriving your underwriting profit provision.
21 Correct?

22 A. I'd probably state it a little
23 differently, but I have prepared it in accordance or
24 prepared the underwriting profit provision in
25 accordance with my understanding of the law.

1 Q. And you've provided it or you have
2 complied with the first portion of the language we read
3 from ASOP 30 there on line 5 of your testimony
4 regarding developing a rate in accordance with the law
5 or regulation. Correct?

6 A. Yes.

7 Q. Do I understand correctly that you have
8 not disclosed to your client any material difference
9 between the underwriting profit provision you recommend
10 and the underwriting profit provision that would be
11 actuarially determined under ASOP 30?

12 MR. FRIEDMAN: Objection, Your Honor,
13 in terms of what she discloses to the client,
14 client being Department of Insurance, that would
15 have been the disclosure to me. And so what she's
16 disclosed to me isn't privileged.

17 And then I also just want to note, this
18 past half hour has been about an attempt to entrap
19 Ms. Cavanaugh into agreeing that she violated an
20 ASOP where the very case decision she cites in
21 footnote 127 says that she would have violated
22 North Carolina law had she engaged in her report in
23 this comparison.

24 You know, he can make that point easily
25 in his draft order. But this, at this point, this

1 little game is unnecessary, and as he emphasized
2 over and over again, she's not an attorney.

3 HEARING OFFICER FUNDERBURK: He's cross
4 examining the witness. I'm allowing him to cross
5 examine the witness. We have had some repeated
6 questions. I've given you some leeway. When you
7 cross examined the Bureau witnesses, we had some
8 repeated questions. I allowed some leeway.

9 So your position is determining her --
10 what she has disclosed in accordance with the ASOPs
11 violates attorney-client privilege because you are,
12 as counsel, the client and information she provided
13 as part of her analysis and contract was not to the
14 Department, it was to you directly?

15 MR. FRIEDMAN: I would say that --
16 okay. She's retained as our expert, so she is an
17 agent of the Department. If there is a fair
18 question, if she were simply to pick up the phone
19 call and call any other employee of the DOI and
20 say, this is what I'm disclosing to you, it would
21 not be privileged.

22 However, in this case, any alleged
23 disclosure would have been made to me, and that is
24 the very definition of attorney-client privilege.
25 And he is directly asking about the substance of

1 any alleged disclosure.

2 MR. SPIVEY: Your Honor, at this point,
3 I'm simply trying to ask the witness whether she
4 has made the disclosure that is described in the
5 ASOP that she quoted in her testimony on page 41.
6 I'm not asking her to tell me the substance of any
7 kind of any disclosure. I'm just curious as to
8 whether she made a disclosure.

9 HEARING OFFICER FUNDERBURK: I'll allow
10 the question with that limitation. Honestly, I
11 would need to review. If we go beyond that, I need
12 to review ASOP 30. And I would have some questions
13 about exactly who the intended disclosures are when
14 there's a difference in rate. And I would need to
15 do that from my own knowledge base if we go past
16 the question.

17 But if you'll restate your question for
18 the witness subject to those parameters, please.
19 And Ms. Cavanaugh, when he does that, please
20 respond.

21 BY MR. SPIVEY:

22 Q. Ms. Cavanaugh, my question to you is, do I
23 correctly understand your testimony to be that you have
24 not disclosed to your client any material difference
25 between the underwriting profit provision you recommend

1 and the underwriting profit provision that would be
2 actuarially determined under ASOP 30?

3 A. So I did not disclose any material
4 difference between the rates so developed and the
5 actuarially determined rate in my pre-filed testimony.
6 That's what I mean by that sentence.

7 Q. Have you disclosed any material difference
8 between the underwriting profit provision that you
9 recommend and the underwriting profit provision that
10 will be actuarially determined under ASOP 30 to your
11 client outside of what we understand to be your pre-
12 filed testimony?

13 MR. FRIEDMAN: Your Honor, I'm -- could
14 I just elaborate a little more? So constantly in
15 representing an agency, the situation is that two
16 employees may talk with one another, and that isn't
17 privileged. And a third party who's, like I said,
18 an -- or let's just say an agent, in this case a
19 retained expert of that party can talk with a
20 normal agency employee and that isn't privileged,
21 but in the context of litigation and when that's
22 conveyed through to the Department's attorney, in
23 this case, it's work product plus attorney-client
24 privilege information.

25 I'm just -- I'm sorry to be reiterating

1 this, but I fail to see the difference.

2 HEARING OFFICER FUNDERBURK: Okay. I
3 have a quick couple of questions for you, Ms.
4 Cavanaugh. I'm going to ask you to help me with
5 understanding your interpretation of ASOP 30. So
6 you do have a statement ASOP 30, Section 4.1,
7 requires the actuary to disclose any material
8 difference between the rates so developed, and the
9 actuarial determines rate. Is that correct?

10 THE WITNESS: That's right.

11 HEARING OFFICER FUNDERBURK: Who is --
12 who is that disclosure supposed to be to?

13 THE WITNESS: So the entirety of the
14 quote, I think we had it up just a second ago.

15 HEARING OFFICER FUNDERBURK: Can I get
16 someone to pull that back up for the witness,
17 please?

18 THE WITNESS: So at the end of that,
19 we're at Section 4.1. It says, to the client or
20 the employer. And so my interpretation of that is
21 that it's not -- not my employer, but rather my
22 client. And in this context, it would be, you
23 know, the disclosure would be in my pre-filed
24 testimony. That would be my interpretation of
25 this.

1 HEARING OFFICER FUNDERBURK: So your
2 interpretation would be that any required
3 disclosure would -- it would be appropriate to
4 provide it in the pre-filed testimony in writing?

5 THE WITNESS: Well, I mean, subject to
6 the next paragraph of my report, which says that,
7 you know, or the next sentence which says that in
8 this situation, it's my understanding that
9 providing a comparison between the comparable
10 earnings analysis and the analysis using a cost of
11 capital approach would be impermissible.

12 So when I was looking at the actuarial
13 standard and determining whether I should disclose
14 any material difference, I also considered this,
15 the law as it relates to even disclosing a
16 comparison, and that's what I determined, you know,
17 based on my understanding to be impermissible.

18 So then I did not disclose it in my
19 pre-filed testimony, but if that wasn't in place,
20 if I had a different understanding or if the law
21 was different, then I would have, according to the
22 Actuarial Standard Of Practice, disclosed that in
23 my pre-filed testimony.

24 HEARING OFFICER FUNDERBURK: Any
25 further comments for Mr. Spivey or Mr. Friedman?

1 BY MR. SPIVEY:

2 Q. I guess I'm just trying to make sure I'm
3 understanding you, Ms. Cavanaugh, that you are
4 interpreting the provision that we've been discussing
5 and that you quoted from ASOP 30, Section 4.1, to
6 provide the disclosure of any material difference to
7 the client or employer means that you would disclose it
8 in your written, pre-filed testimony. Is that the way
9 you are reading 4.1?

10 A. Yes. Subject to then I -- you know, like,
11 what I just said. But that is my interpretation is
12 that otherwise, I would have disclosed it in my pre-
13 filed testimony. And the reason why is because that my
14 client is the DOI, and so this this testimony is -- is
15 produced to assist the hearing officer.

16 MR. FRIEDMAN: Your Honor, just also
17 I like to add one thing. 26 -- Rule 26(b)(4) Civil
18 Rules of Procedure, specifically says that drafts
19 and other work product of an expert are, you know,
20 at least I guess I'm going to focus particularly on
21 drafts are, you know, at least, I guess, I'm going
22 to focus particularly on drafts, are not subject to
23 disclosure.

24 That's an interesting sort of deviation
25 from the federal rule, which says they are. I'm

1 not suggesting there wasn't anything in the draft,
2 but I think if there were discussion, it wouldn't
3 be under 26(b)(4) revealable. And what is
4 important is ultimately under 26(b)(4) the final
5 report by an expert.

6 HEARING OFFICER FUNDERBURK: I'm just
7 I'm reviewing the rule. Are you, Mr. Friedman,
8 considering this a 26(b)(4) report, (a)(2)?

9 MR. FRIEDMAN: 26(b)(A) -- I'm sorry,
10 Your Honor. 26(b)(A)(2)? Or (b) --

11 HEARING OFFICER FUNDERBURK: 4(a)(2).

12 MR. FRIEDMAN: (b)(4)(A)(2).

13 HEARING OFFICER FUNDERBURK: Witnesses
14 providing a written report. That's what we're
15 getting into discovery there. This is -- this is
16 submitted pre-filed testimony.

17 MR. FRIEDMAN: This is the exact --
18 pre-filed testimony is exactly the sort of expert
19 witness testimony, that's the very form in which --
20 in any case where there is a dispositive motion,
21 that's what the expert report is. I maintain
22 they're interchangeable.

23 MR. BEVERLY: Your Honor, may we
24 approach?

25 HEARING OFFICER FUNDERBURK: Yes.

1 Please do.

2 THE WITNESS: Would it be possible for
3 a break sometime soon? I don't know if it makes
4 sense now or --

5 HEARING OFFICER FUNDERBURK: Since
6 we're going to have a bench conference anyway,
7 we're going to be off the record. Do you have an
8 objection to giving Ms. Cavanaugh a quick break?
9 We'll be in recess for ten minutes. Thank you, Ms.
10 Cavanaugh. And during that time, we'll have a
11 bench conference. Please proceed.

12 (Bench Conference held 3:40 p.m. to 4:01 p.m.)

13 HEARING OFFICER FUNDERBURK: Counsel,
14 are we ready?

15 Ms. Cavanaugh, if you could retake the
16 stand, and I'll just remind you that you do
17 continue to be under oath.

18 Okay. Mr. Spivey, please proceed.

19 MR. SPIVEY: Thank you, Your Honor.

20 BY MR. SPIVEY:

21 Q. Ms. Cavanaugh, we've been talking about
22 ASOP 30, Section 4.1, as you've quoted it on page 41 of
23 your testimony. We've already discussed the fact that
24 in -- and without trying to read it again verbatim, my
25 understanding is the ASOP says that where a law or

1 regulation conflicts with the ASOP that the actuary
2 should, one, develop a rate, in this case, we're
3 talking about the underwriting. In this situation, I'm
4 asking you about the underwriting profit provision. So
5 the actuary first should develop profit provision in
6 accordance with the law or regulation, and secondly,
7 disclose any material difference between that profit
8 provision and the profit provision that will be
9 actuarially determined to the actuary's client or
10 employer.

11 And my question to you is, have you complied
12 with ASOP 30, Section 4.1?

13 A. So the -- you know, another provision is
14 ASOP No. 1, which discusses the requirements of the
15 law, when they conflict with the guidance of an ASOP.

16 So what I would say is, my interpretation of
17 ASOP 30, Section 4.1, that my understanding of the law
18 conflicts with what is stated in Section 4.1. So -- so
19 that's why I didn't disclose. So I did not disclose
20 because it conflicted with the law as I understand it.

21 Q. And just to be clear for the record, then
22 the answer to my question is you did not comply with
23 ASOP 30. Correct?

24 A. That's not correct. I have complied with
25 all actuarial standards. I disclosed when there --

1 there was a requirement of law that conflicted with the
2 guidance of the ASOP, and I have disclosed that there
3 is a conflict between the guidance in the ASOP and the
4 law as I understand it. And that's why I did not do
5 what it states in ASOP 30, Section 4.1. And I believe
6 that is in accordance with the entirety of the
7 Actuarial Standards Of Practice and the Code of
8 Conduct.

9 Q. So whether it's in compliance with the
10 ASOP 1 or ASOP -- all the ASOPs overall, then what your
11 testimony is, is that you did not disclose any material
12 difference between the profit provision you developed
13 and the profit provision that would be actuarially
14 determined in accordance with ASOP 30.

15 MR. FRIEDMAN: Your Honor, he's gone
16 far beyond the one acceptable question.

17 MR. SPIVEY: Can you repeat that?

18 MR. FRIEDMAN: You've gone -- my
19 objection is that the hearing officer gave you what
20 was the acceptable next question. Now, again,
21 you're asking about the content of, in this case,
22 communications between the expert and the client's
23 attorney.

24 MR. SPIVEY: And my response is we
25 haven't gotten an answer to the question that we

1 agreed at bench conference would be asked.

2 HEARING OFFICER FUNDERBURK: She has
3 provided her answer to the question. I'm going to
4 ask you to move on from this. If we need to make
5 additional arguments about it tomorrow, we can.
6 But as to continued questioning for today, let's
7 move on.

8 If you want to review documents and
9 make some additional arguments regarding this
10 particular issue tomorrow, we're happy to do that,
11 when we resume. But at this point, let's move on.

12 BY MR. SPIVEY:

13 Q. Ms. Cavanaugh, if you would turn to page
14 43 of your testimony. At line 4, you begin -- you have
15 a question there. Do you have any concerns with the
16 assumptions underlying the NCRB's cost of capital
17 approach? Correct?

18 A. I see that question.

19 Q. At line 13 -- I'm sorry. Give me just a
20 moment. All right. I'm sorry. At line 13, you
21 state -- again, I'm trying to shorten it somewhat to
22 speed things along, but you essentially state that the
23 Rate Bureau's range of returns appears too high, and it
24 appears too high is you're wording on line 14. Do you
25 see that?

1 A. I do.

2 Q. And then right below that, you set out two
3 numbered sentences or paragraphs related to your
4 statement that the range appears too high. Correct?

5 A. Yes. Specifically, I say that it's -- the
6 base -- it appears too high based on two metrics that
7 more closely align with insurance companies' returns.

8 Q. And the second reason there, the item
9 number 2 beginning at line 19, is based on a paper
10 published -- written and published by Aon, which was
11 coauthored by Ms. Mao, one of the witnesses in this
12 case. Correct?

13 A. Yes.

14 Q. That document that you referred to and
15 that you include a quote from there in your testimony
16 is the document that you referenced in footnote 136.
17 It's entitled Homeowners' Return On Equity Outlook, Aon
18 November 2023. Correct?

19 A. Correct.

20 Q. And that document is one that's in
21 evidence here that, yeah, I believe it's marked Exhibit
22 DOI 14, and we spoke about it yesterday. Correct?

23 A. I don't know what exhibit number it is,
24 but it is -- I believe it's in evidence, and we talked
25 about it yesterday.

1 Q. Do you have Exhibit DOI 14 there at the
2 witness stand?

3 A. Yes.

4 Q. Could you turn to that, please?
5 Give me just a moment, Your Honor.

6 So looking at your testimony on page 43, Ms.
7 Cavanaugh, you state there beginning at line 19 that
8 this paper that we've just identified, you say,
9 estimates a fully earned 2025 prospective return on
10 equity of 10.5 percent, which it states, and then you
11 quote from the -- from the paper, would be the first
12 double digit ROE ever reported by the study (if
13 achieved) and the highest ROE we have ever benchmarked
14 for a prospective period.

15 This can be considered a fully earned 2025 view
16 of what's possible and assumes all filed and approved
17 rate as of September 2023 fully earns in, inflation
18 remains stable, and catastrophe losses are normalized.
19 Now, did I read that correctly?

20 A. I believe you did.

21 Q. And that portion of the Aon publication
22 that's been marked Exhibit DOI 14 comes from page 5 of
23 the document marked Exhibit DOI 14. Does it not?

24 A. Yes.

25 Q. And that's in the second paragraph in the

1 column on the left side of that page. Is that correct?

2 A. Yes.

3 MR. BEVERLY: Can we have one moment,
4 Your Honor?

5 HEARING OFFICER FUNDERBURK: Yes.

6 MR. SPIVEY: I apologize, Your Honor.

7 BY MR. SPIVEY:

8 Q. So on that page 5, if you would look over
9 on the right hand column to the paragraph with the
10 heading attracting capital, do you see that?

11 A. Yes.

12 Q. Can you read that paragraph for the
13 hearing officer, please?

14 A. Even 13.2 percent ROE may be too low to
15 attract capital to the line of business. Where Aon's
16 capital advisory group works with clients attempting to
17 raise capital for de novo business plans and
18 homeowners' insurance, investor return requirements can
19 exceed 20 percent, requiring both an aggressive premium
20 growth ramp and strong profitability to hit mid-teen
21 ROEs. Private investors are hesitant to take on
22 volatile catastrophe exposed results for lower returns
23 in the catastrophe prone homeowners' line.

24 Q. Now, if you would, please, in that same
25 document, turn to page 10. And let's look at Exhibit 5

1 there on page 10. That Exhibit 5 is entitled within
2 this document now, it's labeled Exhibit 5, but it's
3 entitled November 2023 prospective ROE at current
4 rates; is it not?

5 A. Yes.

6 Q. And there's a map of the United States
7 shown there with the states displayed in a range of
8 colors. Correct?

9 A. Yes.

10 Q. And the different colors reflect different
11 prospective returns on equity in the different states
12 at different rate -- at current rate levels. Isn't
13 that what it's displaying?

14 A. That's my understanding.

15 Q. And it's correct, is it not, that the
16 lowest return on equity is shown in the very lightest
17 blue color. And according to the legend there, that is
18 indicated to be negative 1 percent or less; is it not?

19 A. Yes.

20 Q. And of the 50 states in the United States
21 shown on that map, there are 4 states shown in that
22 very light blue color. Are they not? Are they not?

23 A. That -- that's what it looks like. Yes.

24 Q. And North Carolina is one of those states.
25 Is it not?

1 A. Yes.

2 Q. So based on the information displayed on
3 this exhibit within Exhibit DOI 14, North Carolina is
4 one of the four lowest states in the United States in
5 terms of the prospective returns on equity at current
6 rate levels? Isn't that what this is showing?

7 A. This is showing just for national
8 multiline carriers, not for all of North Carolina
9 carriers.

10 Q. So for national multiline carriers, this
11 is displaying that North Carolina is one of the four
12 lowest states in the United States in terms of
13 prospective returns on equity at current rate levels.
14 Right?

15 A. That's what it's showing. Also, my
16 understanding is that this is assuming the catastrophe
17 losses -- the expected catastrophe losses, based on
18 catastrophe models. And there's another chart in here
19 that shows that actual losses for North Carolina are
20 much lower than what's being projected by these modeled
21 catastrophe losses. So it's subject to a lot of
22 assumptions, and that's one of them.

23 Q. Could you please turn to page 16 of this
24 report? And let's look at the Exhibit No. 20, showing
25 on the lower portion of page 16 there. The title of

1 that exhibit is national carriers rate need to achieve
2 10 percent ROE; is it not?

3 A. That's what it says.

4 Q. And on this map, again, this is a map of
5 the United States with the various states shown in
6 differing colors. The color code here runs from,
7 again, very light blue to a very dark blue. Does it
8 not?

9 A. It does.

10 Q. And here, the very light blue colors are
11 where the rate increase needed to achieve a 10 percent
12 ROE is relatively small. Correct?

13 A. Can you say that again?

14 Q. The manner in which the colors are
15 reflected on this exhibit is such that the very light
16 colors are where the rate increase needed to achieve a
17 10 percent ROE is relatively small.

18 A. The lowest on the scale is actually none.

19 Q. And the darker colors on this particular
20 exhibit indicate higher rate needs in order for
21 national carriers to achieve a 10 percent ROE. Isn't
22 that right?

23 A. That's my understanding.

24 Q. And North Carolina, again, is one of four
25 states in the United States that are in the darkest

1 blue color on this particular exhibit showing the
2 highest rate need. Correct?

3 A. I think so. I was trying to figure out if
4 New Jersey was also dark blue or the next, but I
5 believe it's four. That looks correct.

6 Q. All right. So have you determined that
7 that there are four states in the darkest color showing
8 on this exhibit?

9 A. I believe so.

10 Q. And North Carolina is one of those four
11 states?

12 A. Yes.

13 Q. And the rate need as displayed in the
14 legend there is 15 percent or above in order to achieve
15 a 10 percent ROE. Correct?

16 A. That's what it says.

17 Q. Your recommended rate change in this case,
18 in your written testimony, is less than 3 percent. Is
19 it not?

20 A. That's correct. I just want to, if you're
21 moving on, I just want to, you know, clarify that
22 this -- there's a lot of assumptions that are -- is
23 underlying this, including, I'm sure, a catastrophe
24 provision. And, you know, so in order to determine why
25 there might be differences, I would need to look at

1 those assumptions. But I imagine one of the key
2 differences would be the catastrophe provision.

3 HEARING OFFICER FUNDERBURK: And since
4 we're reviewing that exhibit, were the calculations
5 based on the manual rate or the actual rates that
6 are paid, including, consent to rate?

7 MR. SPIVEY: Your Honor, my
8 understanding was that these are based on whatever
9 the current rates are within the various states
10 that are being displayed there.

11 HEARING OFFICER FUNDERBURK: But for
12 North Carolina, is it the actual rates that people
13 are paying or is it the manual rate?

14 MR. SPIVEY: I don't know the answer to
15 that, Your Honor.

16 HEARING OFFICER FUNDERBURK: Okay.

17 MR. FRIEDMAN: Your Honor, if I could
18 just clarify one thing, and I may be entirely wrong
19 here, but when Ms. Cavanaugh stated that these were
20 national multi-lines carriers, my understanding is
21 that this is reflecting for North Carolina lines
22 that are outside of the North Carolina Rate
23 Bureau's jurisdiction, so don't have in that sense
24 manual rates.

25 HEARING OFFICER FUNDERBURK: Okay. And

1 I don't want to tie us up too much on -- too much
2 on it, but --

3 MR. FRIEDMAN: Don't have manual rates
4 in the sense of the Bureau having it.

5 HEARING OFFICER FUNDERBURK: Yeah. I
6 don't want to tie us up too much on it. But if I'm
7 going back and reviewing my notes and the testimony
8 and looking at it, that's one of the questions I'm
9 going to have. What actually underlies those --
10 what actually underlies the statistics that we're
11 looking at and where the number is actually being
12 pulled from. So my apologies for potentially
13 interrupting your flow. Please resume.

14 BY MR. SPIVEY:

15 Q. Ms. Cavanaugh, would you please turn to
16 page 13 in your testimony? I apologize. That doesn't
17 appear to be the right page. All right. My apologies.

18 Would you turn to page 39? And there on page
19 39, at the beginning of your testimony pertaining there
20 to underwriting profit starting at line 12, you quote a
21 passage from the Werner-Modlin paper regarding
22 underwriting profit. Do you not?

23 A. I do.

24 Q. And you quote that paper for this general
25 statement that the purpose of an underwriting profit

1 provision is to provide a reasonable expected return or
2 profit on the capital that an insurance company has to
3 hold to support the risk that it assumes when it writes
4 an insurance policy. Do you not?

5 A. I was just trying to find where that is.
6 Can you just point me to the line?

7 Q. And I was not quoting it.

8 A. I'm sorry. I was I was still trying to
9 look for it. Okay. So it wasn't a quote? Can you say
10 it again then?

11 Q. I'm not quoting it.

12 A. Okay.

13 Q. That's the general -- that'd be a
14 general -- the nature of what the statement here is
15 saying, though, is it not? And I'll just -- let's
16 quote it. This at the line 15 there, the quote from
17 the Werner-Modlin paper is, "The ultimate cost of an
18 insurance policy is not known at the time of the sale.
19 By writing insurance policies, the company is assuming
20 the risk that premium may not be sufficient to pay
21 claims and expenses. The company must support this
22 risk by maintaining capital, and this entitles it to a
23 reasonable expected return (profit) on that capital."

24 Do you agree with that statement?

25 A. I do.

1 Q. And that you quoted this passage from the
2 Werner-Modlin paper; did you not?

3 A. I did.

4 Q. The quote continues to identify the two
5 main sources of profit for insurance companies and
6 those being underwriting profit and investment income.
7 Correct?

8 A. Yes.

9 Q. The quote itself does not identify or
10 distinguish the differing types of investment income,
11 does it?

12 A. It doesn't. It does not.

13 Q. In general, we all often distinguish
14 between the investment income as being investment
15 income from policyholder supplied funds or reserves and
16 the investment income from capital in surplus funds.
17 Do we not?

18 A. Yeah. You can distinguish between -- the
19 last sentence here says investment income is the income
20 generated by investing funds held by the insurance
21 company and, yeah, you can -- you can look at those
22 into different buckets.

23 Q. And it is the investment income from
24 capital in surplus funds that North Carolina law says
25 that we're not to consider when determining an

1 underwriting profit provision. Correct?

2 A. Yes. And as I testified earlier, my
3 understanding regarding the interpretation of that is
4 that, therefore, a cost of capital analysis would be
5 impermissible.

6 Q. Ms. Cavanaugh, do you understand that the
7 fundamental reason for the North Carolina law that says
8 we are not to consider investment income from capital
9 in surplus is that that investment income is not
10 included in the list of items in G.S. 58-36-10,
11 subsection 2, that due consideration must be given to
12 when setting rates?

13 MR. FRIEDMAN: Objection, Your Honor.

14 I'm not -- that question it either is talking about
15 specific cases of which I'm not aware or else it's
16 talking about legislative intent. I mean, that's
17 unfair to ask of a non-attorney.

18 MR. SPIVEY: I'm simply asking this
19 witness what her understanding is.

20 HEARING OFFICER FUNDERBURK: I'll allow
21 the question. Please repeat it for the benefit of
22 the witness.

23 BY MR. SPIVEY:

24 Q. You've testified previously this afternoon
25 that you have reviewed that statute. Have you not?

1 A. Which statute?

2 Q. G.S. 58-36-10, subsection 2. We'll try to
3 pull it up.

4 A. Yeah. If it's the statute that we had
5 pulled up earlier, then yes. I've reviewed that.

6 Q. All right. Ms. Cavanaugh, do you have
7 that statute before you now on the screen?

8 A. Yes.

9 Q. Is it correct that investment income from
10 capital in surplus funds is not included in subsection
11 2 in the list of items to which due consideration is to
12 be given in setting rates?

13 A. There seems to be a window that keeps
14 popping.

15 MR. BEVERLY: Yes. This HDMI cord does
16 not like me.

17 THE WITNESS: Okay. Or if it's in -- I
18 don't know if it's at my desk. I could look at it
19 there. But okay. Maybe it's -- okay. I think --
20 I think I saw it before it popped up again. I do
21 not see that investment income earned by capital in
22 surplus referenced in this statute.

23 BY MR. SPIVEY:

24 Q. Right. It is not referenced in this
25 statute. Correct?

1 A. I don't see it there. No.

2 Q. It's correct, is it not, that investment
3 income earned or realized by insurers from their
4 unearned premium loss and loss expense reserve funds
5 generated from business within the state is included in
6 this list of items?

7 A. Yeah. Yeah. That's what it says to
8 investment income earned or realized by insurers from
9 there and then premium loss and loss expense reserve
10 funds generated from business within this state.

11 Q. And the investment income described there
12 is the investment income from reserves or what we might
13 call policyholder supplied funds. Is it not?

14 A. That's my understanding.

15 Q. And another way of describing that
16 particular investment income is sometimes referred to
17 as the investment income from insurance operations. Is
18 it not?

19 A. I've heard it be referred to that. Yes.

20 Q. Now, as we just discussed earlier this
21 afternoon, underwriting profit is also in this list.
22 Correct?

23 A. Yes.

24 Q. Have you given due consideration in your
25 analysis to investment income from insurance

1 operations?

2 A. I believe I have, and I do just want to
3 clarify something that I stated earlier that my
4 understanding of the law is not just based on the
5 statute itself, but also the 2014 order, the Court of
6 Appeals opinion, and I think that's what's -- those are
7 all the documents that I referred to. So it's -- it's
8 a combination of -- of those documents and discussions
9 that I had with others.

10 Q. And have you given due consideration in
11 your analysis to a reasonable margin for underwriting
12 profit?

13 A. I have a section in my pre-filed testimony
14 on underwriting profit provision, and it discusses my
15 understanding of the law and discusses the estimate
16 that I made based on my understanding of the law.

17 And one thing I wanted to state earlier, I'll
18 state it now, if my understanding of the law is
19 incorrect, then I would appreciate the opportunity to
20 amend my estimate.

21 Q. Will the underwriting profit provision
22 that you recommend and the rates that you recommend
23 provide a reasonable expected return or profit on the
24 capital that homeowner insurance companies must
25 maintain in order to support the risk that they assume

1 by writing homeowners' insurance policies in North
2 Carolina?

3 A. So my understanding is that that would be
4 interpreted -- that that would be, as a law is
5 interpreted, in accordance with the analysis that I
6 did. So the law would state that that reasonable
7 margin for underwriting profit would be not based on a
8 cost of capital approach, but rather on a different
9 analysis such as a comparable earnings analysis.

10 Q. And perhaps I just simply didn't
11 understand what you just said or misheard what you
12 said. But my question to you is, looking back now at
13 the quote that you included in your testimony on page
14 39 from the Werner-Modlin paper, will the underwriting
15 profit provision that you recommend and the rates that
16 you recommend provide a reasonable expected return or
17 profit on the capital that the companies must maintain
18 in order to support the risk they assume by writing
19 homeowners' policies in North Carolina?

20 A. I don't know because I did not complete
21 that calculation and finalize a calculation that would
22 show a cost of capital analysis in order to make that
23 determination.

24 Q. Ms. Cavanaugh, if you would please turn to
25 page 56 on your testimony.

1 A. Okay.

2 Q. You have a section there starting in the
3 roughly the middle of the page on wind exclusion and
4 mitigation credits. Do you not?

5 A. I do.

6 Q. And you state there at line 10 -- I'm
7 sorry -- on page 57, which is the next page there, on
8 line 10, you state that the overall approach to
9 estimating these credits is reasonable. Correct?

10 A. Yes.

11 Q. You go on, however, to state that the
12 calculation of the credits relies on the assumptions
13 used in the overall base rate indication. And that you
14 disagree with some of those assumptions and that,
15 therefore, you conclude that the calculated credits are
16 unreasonable; do you not?

17 A. Yes.

18 Q. Did you calculate wind exclusion credits
19 and wind mitigation credits to go with your recommended
20 rates?

21 A. I did not.

22 Q. If the hearing officer were to adopt your
23 recommended rates, what is she to do about determining
24 appropriate wind exclusion credits and wind mitigation
25 credits?

1 A. If the hearing officer were to accept my
2 rates, then I could make that calculation.

3 Q. And, Ms. Cavanaugh, there are a number of
4 actuarial items in the Rate Bureau's homeowners' filing
5 with which you agree or which you find to be reasonable
6 and appropriate; are there not?

7 A. I would say that there are a number of
8 assumptions included in the filing that I did not --
9 yeah, that I concluded were reasonable, and that's
10 documented in my pre-filed testimony.

11 Q. For example, using the weighted average of
12 five years of experience and the particular weights
13 that the Rate Bureau used in the filing, you used those
14 same weights; did you not? I can refer you to pages if
15 that helps.

16 A. It would. Yeah. I just want to make sure
17 I have the exact wording for my pre-filed testimony.

18 Q. And I apologize. I'm just trying to get
19 as much done as we can in the time we have.

20 A. Sure.

21 Q. Look at page 11.

22 A. Um-hum.

23 Q. Lines 26 and 27.

24 A. Yes. The indication uses the same
25 weights. I, you know, I do want to just state, and

1 this is why I needed -- I needed to look at the page.
2 You know, there are other words there. You know, it
3 says that there are different weights that I would
4 consider reasonable, including an equal weighting or
5 weighting based on premium.

6 And I've -- I also believe giving greater weight
7 to the more recent years in order to recognize that
8 more recent years may be reflective of future
9 conditions as reasonable, and that's what Mr. Ericksen
10 says in his testimony. So just want to add that
11 additional discussion that's in there.

12 HEARING OFFICER FUNDERBURK: And, Mr.
13 Spivey, are we at or reaching a pivot point?

14 MR. SPIVEY: We could certainly break
15 at this point if that works.

16 HEARING OFFICER FUNDERBURK: As to
17 scheduling tomorrow. Ms. Pearce?

18 MS. PEARCE: (Inaudible).

19 HEARING OFFICER FUNDERBURK: Madam
20 Court Reporter, if we resume at 9:00 tomorrow,
21 would you be available? You would? You would not?

22 THE COURT REPORTER: (Inaudible).

23 HEARING OFFICER FUNDERBURK: Okay. We
24 can free the courtroom up. We've been able to --
25 Ms. Pearce has been working on freeing up the

1 courtroom for tomorrow. So we'll -- the courtroom
2 is available. We're available to begin at 9:00
3 tomorrow, but we have to get a court reporter
4 secured.

5 And we'll keep -- we'll keep addressing
6 that. Is there anything else we need to address
7 before tomorrow? Scheduling is the big issue, of
8 course, making sure that we can actually be here.

9 MR. SPIVEY: I'm not aware of anything.

10 HEARING OFFICER FUNDERBURK: Okay. And
11 Mr. Spivey, you or Mr. Beverly, if we can start at
12 9:00, one of you can be here tomorrow. Is that
13 correct?

14 MR. SPIVEY: That's correct.

15 HEARING OFFICER FUNDERBURK: Mr.
16 Friedman, no conflicts. Ms. Cavanaugh would be
17 available, and Ms. Pearce has been able to make
18 some arrangements for having the courtroom
19 available. I mean, we can -- we can just text
20 everyone tonight. Is that workable? We can text
21 you tonight and let you know.

22 I hate for -- I apologize for not
23 knowing when we break for the day exactly when
24 we're going to come back, but we do have to have a
25 court reporter onsite to continue, and they're

1 working very diligently on getting that done.

2 So we'll let -- we'll let you know as
3 soon as -- as soon as we know when that will --
4 when that resumption time will be.

5 But I'm presuming if we can get Ms.
6 Cavanaugh started at 9:00, that will be a
7 substantial amount of time to finish cross and
8 redirect.

9 And, Ms. Cavanaugh, do you have any
10 avail -- I would hope it would not go into
11 Thursday. But if it did, would you have
12 availability Thursday morning if necessary?

13 THE WITNESS: I believe so. I need to
14 check flight plans, but --

15 HEARING OFFICER FUNDERBURK: Okay.

16 THE WITNESS: Yes.

17 MR. FRIEDMAN: Your Honor, I cannot
18 anticipate that my redirect or their conceivable
19 recross would go past 5:00 or 4:00 tomorrow.

20 HEARING OFFICER FUNDERBURK: If we're
21 able to resume at 9:00, I would very much hope that
22 Ms. Cavanaugh is off the stand by the end of the
23 day. And then we can make arrangements to continue
24 or we can set scheduling to continue with your
25 rebuttal.

1 All right. Ms. Pearce is working
2 diligently on getting a court reporter. Do you
3 have everyone's cell phone number? Yeah. Your
4 email will ping straight to your phone. Right? If
5 she emails you tonight, you'll get the email?

6 Okay. We'll plan to communicate that
7 way to know when -- what exact time we're going to
8 resume tomorrow. Again, contingent on getting a
9 court reporter.

10 Noteworthy's been very good to work
11 with, but it is kind of late in the day for them to
12 get someone here tomorrow, especially with the 24-
13 hour turnaround that we require on the transcripts.

14 All right. Thank you all very much,
15 and I hope to see you at 9:00 a.m. tomorrow. But
16 if not, I will see you sometime tomorrow. We're in
17 recess.

18 * * * * *

19 (Hearing adjourned at 4:46 p.m.)

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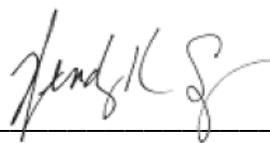
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CERTIFICATE OF REPORTER
STATE OF NORTH CAROLINA
COUNTY OF WAKE

I, Wendy Sawyer, court reporter, do hereby certify that the witnesses whose testimony appears in the foregoing hearing were duly sworn; that the testimony of said witnesses was taken by me to the best of my ability and thereafter reduced to typewriting under my direction; that I am neither counsel for, related to, nor employed by any of the parties to the action in which this hearing was taken, and further that I am not a relative or employee of any attorney or counsel employed by the parties thereto, nor financially or otherwise interested in the outcome of the action.

This, the 3rd day of December, 2024.



WENDY SAWYER, Court Reporter

Notary Public #202411500157

Commission Expires April 23, 2029

