

Calculating the notional premium

This information sheet explains how the notional premium is calculated.

About the notional premium

The notional premium is the amount determined that a self-insurer would have paid as a reasonable premium if it had held workers compensation coverage with a licensed insurer for the previous financial year.

The underpinning principle for calculating the notional premium is that notional premiums must be set in a way that ensures equity between the premiums paid by employers taking policies of insurance with licensed insurers and the premiums determined payable by self-insurers.

Premium rates should be reasonably equitable between the different policy holders and should reflect their expected experience.

Over the longer term, the premium must equal the cost plus a loading for factors such as administration costs and a return on the capital invested.

A self-insurer is advised of the amount of its notional premium before it is finalised.

How the notional premium is calculated

There are two methods used for calculating the notional premium. In most cases, the average derived from methods 1 and 2 will be used.

The size of the self-insurer or the level of the self-insurer's claims history may determine which method of calculation applies. In circumstances where a self-insurer is very small or where it has little or no claims history, either Method 1 or the actuarially assessed industry (based on ANZSIC) premium rate will apply.

Both methods may include historical data relating to claims which were incurred before self-insurance.

Method 1: simple method

This is the most simple assessment procedure that can be adopted for the calculation of the notional premium. Notional premium is calculated using a formula that estimates the risk premium rate as:

Risk rate =	$\frac{(C1+C2+C3) \times DF}{S1+S2+S3}$	
Where:	C1, C2 and C3=	paid claim expenses for the past three payment years
	S1, S2, and S3 =	gross salaries paid for the past three financial years
	DF =	1.5 years discount at the nominated interest rate to allow for timing

Once the risk rate is calculated, the gross rate can then be calculated as:

Gross rate =	$(1 + \text{On-cost Factor}) \times \text{Risk Rate}$	
Where:	On-cost factor =	the ratio of licensed insurer expenses to earned premium in the most recently completed financial year

Finally, the assessable premium is estimated as:

Assessable premium =	$(\text{Gross rate} \times S4) / 100$	
Where:	S4 =	estimated/budgeted gross salary for current year

Method 2: PPCI (payment per claim incurred) method

This method requires the development of a forecasting model that uses an analysis of past experience, with suitable adjustments to produce the assumptions that can be input into a notional premium model.

The formula for calculating notional premium is expressed as:

Notional Premium =	Projected Number of Claims x Risk x On-Cost Factor	
Where:	Projected Number of Claims =	uses estimated IBNR (incurred but not reported) claims based on three year moving average of claim numbers and gross salaries over the past three years, adjusted for wage inflation and factored by estimated gross salaries in current year. IBNR is based on the incidence rate that is tied to the total gross salaries/wages so that changing risk exposures can be directly taken into account
	Risk =	average claim size derived from amounts expressed as per claim payment, with adjustments to remove background inflation and averaged over the past three years
	On-Cost Factor =	the ratio of licensed insurer expenses to earned premium in the most recently completed financial year

There is input data used in Methods 1 and 2 calculations that may vary each year. These are:

- ▀ investment earnings. Based on three-year Commonwealth Treasury Bonds as at 30 June, as published in Table F2 of the Reserve Bank Bulletin
- ▀ inflation allowance. Set as 2% lower than the investment earnings assumption
- ▀ AWOTE Adjustment. Average weekly ordinary time earnings (AWOTE): fulltime adults, Australia, for the November quarter, as published in Table G5 of the Reserve Bank Bulletin: (RBA data sourced from: Average Weekly Earnings, Australia, Australian Bureau of Statistics, Catalogue No. 6302.0)
- ▀ IBNR Factors. From the most recent actuarial report based on whole scheme performance
- ▀ on-cost factor. The ratio of reported licensed insurer expenses to earned premium in the most recently completed financial year.

This information is for guidance only and is not to be taken as an expression of the law. It should be read in conjunction with the Workers Rehabilitation and Compensation Act 1988 and any other relevant legislation.



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