A.I. 23(2006)

IN THE MATTER OF THE *Automobile, Insurance Act*, RSNL 1990, c. A-22, as amended (the "*Act*")

AND

IN THE MATTER OF an application by Traders General Insurance Company (the "Applicant") for a rehearing in relation to its application to implement revised rates for its Private Passenger class of business (the "Application").

APPLICATION

On March 30, 2006 the Board issued Order No. A.I. 8(2006) in connection with a Category 2 automobile insurance rate filing submitted by the Applicant on September 14, 2005. The Order was issued following extensive review and analysis of all evidence and information supplied in connection with the revised rating program including a thorough review of all evidence related to actuarial and cost of capital issues. The Board did not accept a number of the proposals contained in the rate filing and directed the Applicant to submit a revised rate proposal based on the rate indications flowing from the findings of the Board. In particular, the Board rejected the rate filing proposals in relation to the cost of capital issue, which included a return on equity (ROE) for the Applicant of 12.5%. An ROE of 10% was accepted by the Board as reasonable for the Applicant in determining rate levels.

On May 2, 2006 the Applicant filed an Application for approval of a schedule of rates based on the parameters established by the Board in Order No. A.I. 8(2006). The Applicant also sought a change in the methodology by which All Perils premiums are calculated. In addition the Applicant applied for a reconsideration of the Board's determination in relation to the ROE.

On May 9, 2006 the Board issued Order No. A.I. 18(2006) approving the revised rate proposals and deferring to a subsequent Order a decision on the All Perils premiums and the reconsideration of the ROE.

DECISION

This Decision and Order relates to the Applicant's request for a reconsideration of the ROE of 10% approved by the Board in Order No. A.I. 8(2006) and also deals with the proposal to change the methodology for calculation of All Perils premiums.

In relation to the reconsideration of the ROE the Board engaged N/E/R/A, its cost of capital consultants, to review the information filed in support of the request for an ROE of 12.5%. Two information requests were issued. Responses to the information requests were received from the Applicant on September 13, 2006. N/E/R/A completed a review and issued a report on September 21, 2006. This report was forwarded to the Applicant with an opportunity to provide additional evidence and commentary. The Applicant filed additional commentary on October 7, 2006.

In relation to the All Perils issue the Board will make its decision based on the information filed.

ROE Reconsideration

The Applicant is a wholly owned subsidiary of Aviva Canada Inc., itself a wholly owned subsidiary of Aviva plc, a large multinational corporation. Aviva Canada comprises the second largest property and casualty insurance group in Canada and includes Aviva Insurance Co. of Canada, Traders General Insurance Company, Scottish and York Insurance Co. Limited, and Pilot Insurance Co.

The Application states the key corporate financial targets of Aviva Canada as being:

1. To achieve a long term 15% post-tax ROE; and
2. To achieve a long term 98% Combined Operating Ratio (incurred losses plus expenses divided by earned premiums) or equivalently a 2% target underwriting margin.

The Application suggests that the Board erred in its March 30, 2006 decision [Order No. A.I. 8(2006)] by failing to give sufficient consideration to certain ROE assumptions and calculations. The Applicant states that the ROE approved for ratemaking purposes of 10% is insufficient to attract capital and that a more appropriate ROE is 12.5%.

The Board notes the Applicant does not propose to alter its currently approved rates as set out in Order No. A.I. 18(2006) as a result of any change in ROE that may arise from this Order. Given the lapse of time since the last rate change the Applicant would be required to submit a rate filing in order to effect any change to currently approved rates.

The Board has considered all information before it, including the Application and supporting documentation, the responses to Requests for Information, N/E/R/A's September 21, 2006 report and the additional comments provided by the Applicant.

i) <u>ROE Range</u>

The Applicant's requested ROE of 12.5% is derived from a range determined by the Applicant. The Applicant calculates its proposed ROE range based on the two most commonly used methodologies, the Discounted Cash Flow Methodology (DCF) and the Capital Asset Pricing Model Methodology (CAPM). The Board has in the past had reference to both of these methodologies. Based on the record in this matter the Board concludes that both these methodologies are informative in determining an appropriate ROE range.

In support of the requested ROE Application the Applicant filed a letter from Kathleen McShane of Foster Associates Incorporated. Ms. McShane stated at page 1 of the letter: *"The evidence that has been prepared for this submission supports a return on equity in the range of 11.0% to 14.0% for an average risk automobile insurer, with a mid-point of 12.5%."*

The evidence prepared for the submission includes a calculation of an unadjusted ROE for Aviva plc of 11.80%, using the CAPM methodology. In its review of this methodology N/E/R/A concluded that the manner in which the calculation was undertaken was in error. N/E/R/A recalculated the ROE for Aviva plc using the CAPM methodology to be 10.14% rather than 11.80% as calculated by the Applicant and supported by Kathleen McShane. The Applicant, after having reviewed the N/E/R/A report, stated in its October 13, 2006 response: *"We agree that N/E/R/A is technically correct in pointing out that theory requires that all data used to calculate a CAPM ROE is at the same point in time. Accordingly we thank N/E/R/A for updating their calculations on Proxy Group II and presenting it in Appendix B of their report."*

The Applicant did not provide an updated CAPM calculation or updated opinion from Ms. McShane. Given that the Applicant's ROE calculation using the CAPM methodology was admittedly in error the specific proposals of the Applicant as they relates to the CAPM methodology should be adjusted. The Board accepts an ROE of 10.14% as reasonable using the CAPM methodology.

N/E/R/A states that the ROE range developed by the Applicant from the sustainable growth based DCF model is reasonable. N/E/R/A makes no adverse comment with respect to the Applicant's DCF ROE of 13.3% for Aviva plc. Using the DCF methodology the Applicant calculates the ROE for insurers in Canada, the United States and Europe. The median ROE for Canadian insurers is 13.7%. The median for the United States insurers ranges from 11.5% to 13.9%, using two types of growth assumptions and two sets of data sources. N/E/R/A suggests that because the Canadian and European calculations, both referencing the sustainable growth method, the most relevant ROE for United States insurers is 11.5% as it is based on the sustainable growth method. The median for European insurers is 11.0% with an ROE of 13.3% for Aviva plc. The Board finds the particular calculation for Aviva plc compelling given that it is in relation to the Applicant's parent company and is also in line with the calculations for Canadian insurers and the range for United States insurers. The Board accepts an ROE of 13.3% using the DCF methodology as reasonable.

As discussed above the Board found that the reasonable ROE using the CAPM methodology is 10.14% and using the DCF methodology is 13.3% creating a range of 10.14% to 13.3%. The Board finds that this range is the reasonable and appropriate range, given that it is based on the most relevant data and methodologies. Based on the record the Board finds that the appropriate range of ROE's for the Applicant is 10.14% to 13.3% rather than the range proposed by the Applicant.

In the absence of evidence suggesting circumstances requiring a premium or discount the allowed ROE is generally the midpoint of the range established. This approach is in keeping with the Board's rate-making principles and history, contributing to consistency and predictability. Therefore the midpoint of 11.74% is accepted as the appropriate ROE in the absence of circumstances suggesting a premium.

b) Market Size

The Applicant represents itself as a micro-cap company requiring additional return under the CAPM method by adding a premium based on market size. The Applicant cites a table from *Stocks, Bonds, Bills, and Inflation® Valuation Edition 2006 Yearbook*, Ibbotson Associates, Chapter 7 indicating that the largest capitalization of a company in the micro-cap designation is stated to be $586,393,000 US. The Applicant further states in its Application at page 5, paragraph 15: *"…it is reasonable to conclude that Traders General Insurance Company would qualify as a micro-cap company if it was publicly traded."* The size premium attached to a micro-cap company under CAPM according to the Applicant's submission is 3.95%.

The Applicant was asked to provide specific information in support of the claim for a size premium. In response to these information requests the Applicant acknowledged that it did not issue any debt to third parties and does not issue share capital in the general financial markets and, as a result, does not possess or require an independent bond rating from that assigned Aviva Canada Inc. In this context there is not an individual Standard and Poor's rating for the Applicant separate from Aviva Canada Inc. In its December 21, 2005 report Standard and Poor's assigns Aviva Canada Inc. a financial strength rating of A+, indicating strong financial security and capacity to meet policyholder obligations under a variety of economic and underwriting conditions. N/E/R/A noted in its report that: *"As a member of the Aviva companies, Traders General does not appear to qualify for a positive size adjustment to its ROE. Unless Traders General can provide documentary evidence to support its independent financial structure, any size adjustment would be a negative one resulting in a lower ROE"*.

In the context of the corporate structure of the Applicant and its related companies it would be necessary for the Applicant to demonstrate that such a premium is appropriate in the circumstances. A corporate structure consisting of a number of smaller companies cannot alone justify a premium for each of the smaller member companies. Such companies could demonstrate that a premium is appropriate in the circumstances with evidence such as details of independent borrowing or ratings for the group which suggest increased risk for the members of the group. The Board concludes that it is unreasonable to assume an ROE premium in relation to market size in the absence of evidence supporting such a contention.

ROE on the basis of operating in a substandard market or of being a micro-cap company may have merit in certain circumstances, the Applicant has not provided sufficient evidence to show that it is applicable in this case. On the basis of the information before While the argument advanced for a higher it the Board does not accept the Applicant's arguments that a premium on ROE is warranted. In the absence of any compelling argument that special circumstances justify a premium or discount, the Board finds it reasonable to accept an ROE derived from the midpoint of the range established using both the DCF and CAPM methodologies for Aviva Canada Inc. The Board therefore determines that 11.74% is an acceptable ROE for the Applicant.

<u>All Perils Premium Calculation</u>

The Applicant proposes to change the method of calculating its All Perils premium. Currently the All Perils premium is 100% of the Collision premium plus 90% of the Comprehensive premium at the same deductible level. The proposal is to charge 100% of the Collision premium plus 100% of the Comprehensive premium at the same deductible level.

All Perils is simply another name by which the combined coverage of Comprehensive and Collision is referenced. A consumer purchasing Collision and Comprehensive coverage separately would receive the exact same coverage benefits as a consumer purchasing All Perils. The only difference is that when purchased individually a consumer can purchase different deductibles, whereas a consumer purchasing All Perils has the same deductible for losses under both types of coverages.

The Applicant's proposed premium change effectively eliminates a discount of 10% on the Comprehensive premium which was applied when the coverages were purchased together as All Perils. The proposed premiums for the combined coverage would be the same as premiums for the total of the coverages purchased separately. The currently approved methodology for the All Perils coverage was last approved in the context of a full rate filing from the Applicant which was made on October 27, 2005. The current Application for a change to this methodology did not include actuarial evidence in support of the change. In the absence of up to date actuarial evidence supporting the elimination of the discount the Board finds it unreasonable to approve the change.

In the circumstances the Board will not approve the proposed changes to the All Perils premiums.

ORDER

IT IS THEREFORE ORDERED THAT:

1. The proposed ROE of 12.5% is not accepted.

2. An ROE of 11.74% is accepted as reasonable in the circumstances.

3. The rates approved for the Applicant in Order No. A.I. 18(2006) shall remain unchanged.

4. The proposed All Perils premium is not approved.

5. The Applicant shall pay all the costs and expenses of the Board arising from the Application.

DATED at St. John's, Newfoundland and Labrador, this 19th day of December 2006.

Robert Noseworthy
Chair & Chief Executive Officer

Darlene Whalen, P. Eng.
Vice-Chair

G. Cheryl Blundon
Board Secretary