

A.I. 21(2006)

1 **IN THE MATTER OF THE** *Automobile,*
2 *Insurance Act*, RSNL 1990, c. A-22, as
3 amended (the “*Act*”)
4

5 **AND**
6

7 **IN THE MATTER OF** an application by
8 S & Y Insurance Company (the “Applicant”)
9 for a rehearing in relation to its application
10 to implement revised rates for its Private
11 Passenger class of business (the “Application”).
12

13 **APPLICATION**
14

15 On March 30, 2006 the Board issued Order No. A.I. 5(2006) in connection with a
16 Category 2 automobile insurance rate filing submitted by the Applicant on September 14,
17 2005. The Order was issued following extensive review and analysis of all evidence and
18 information supplied in connection with the revised rating program including a thorough
19 review of all evidence related to actuarial and cost of capital issues. The Board did not
20 accept a number of the proposals contained in the rate filing and directed the Applicant to
21 submit a revised rate proposal based on the rate indications flowing from the findings of
22 the Board. In particular, the Board rejected the rate filing proposals in relation to the cost
23 of capital issue, which included a return on equity (ROE) for the Applicant of 12.5%. An
24 ROE of 10% was accepted by the Board as reasonable for the Applicant in determining
25 rate levels.
26

1 On May 2, 2006 the Applicant filed an Application for approval of a schedule of rates
2 based on the parameters established by the Board in Order No. A.I. 5(2006). In addition
3 the Applicant applied for a reconsideration of the Board's determination in relation to the
4 ROE.

5
6 On May 9, 2006 the Board issued Order No. A.I. 19(2006) approving the revised rate
7 proposals and deferring to a subsequent Order a decision on the reconsideration of the
8 ROE.

9
10 **DECISION**

11
12 This Decision and Order relates to the Applicant's request for a reconsideration of the
13 ROE of 10% approved by the Board in Order No. A.I. 5(2006).

14
15 In relation to the reconsideration of the ROE the Board engaged N/E/R/A, its cost of
16 capital consultants, to review the information filed in support of the request for an ROE
17 of 12.5%. Two information requests were issued. Responses to the information requests
18 were received from the Applicant on September 13, 2006. N/E/R/A completed a review
19 and issued a report on September 21, 2006. This report was forwarded to the Applicant
20 with an opportunity to provide additional evidence and commentary. The Applicant filed
21 additional commentary on October 7, 2006.

22
23 **ROE Reconsideration**

24
25 The Applicant is a wholly owned subsidiary of Aviva Canada Inc., itself a wholly owned
26 subsidiary of Aviva plc, a large multinational corporation. Aviva Canada comprises the
27 second largest property and casualty insurance group in Canada and includes Aviva
28 Insurance Co. of Canada, Traders General Insurance Company, Scottish and York
29 Insurance Co. Limited, and Pilot Insurance Co.

30
31 The Application states the key corporate financial targets of Aviva Canada as being:

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

5

6 The Application suggests that the Board erred in its March 30, 2006 decision [Order No.
7 A.I. 5(2006)] by failing to give sufficient consideration to certain ROE assumptions and
8 calculations. The Applicant states that the ROE approved for ratemaking purposes of
9 10% is insufficient to attract capital and that a more appropriate ROE is 12.5%.

10

11 The Board notes the Applicant does not propose to alter its currently approved rates as set
12 out in Order No. A.I. 19(2006) as a result of any change in ROE that may arise from this
13 Order. Given the lapse of time since the last rate change the Applicant would be required
14 to submit a rate filing in order to effect any change to currently approved rates.

15

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

19

20 i) ROE Range

21

22 The Applicant's requested ROE of 12.5% is derived from a range determined by the
23 Applicant. The Applicant states that it selects an ROE at the upper end of the range to
24 recognize the increased return that investors would demand in the context of the small
25 size of the company.

26

27 The Applicant calculates its proposed ROE range based on the two most commonly used
28 methodologies, the Discounted Cash Flow Methodology (DCF) and the Capital Asset
29 Pricing Model Methodology (CAPM). The Board has in the past had reference to both of
30 these methodologies. Based on the record in this matter the Board concludes that both
31 these methodologies are informative in determining an appropriate ROE range.

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

6

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

17

18 The Applicant did not provide an updated CAPM calculation or updated opinion from
19 Ms. McShane. Given that the Applicant’s ROE calculation using the CAPM
20 methodology was admittedly in error the specific proposals of the Applicant as they
21 relates to the CAPM methodology should be adjusted. The Board accepts an ROE of
22 10.14% as reasonable using the CAPM methodology.

23

24 N/E/R/A states that the ROE range developed by the Applicant from the sustainable
25 growth based DCF model is reasonable. N/E/R/A makes no adverse comment with
26 respect to the Applicant’s DCF ROE of 13.3% for Aviva plc. Using the DCF
27 methodology the Applicant calculates the ROE for insurers in Canada, the United States
28 and Europe. The median ROE for Canadian insurers is 13.7%. The median for the
29 United States insurers ranges from 11.5% to 13.9%, using two types of growth
30 assumptions and two sets of data sources. N/E/R/A suggests that because the Canadian

1 and European calculations, both referencing the sustainable growth method, the most
2 relevant ROE for United States insurers is 11.5% as it is based on the sustainable growth
3 method. The median for European insurers is 11.0% with an ROE of 13.3% for Aviva
4 plc. The Board finds the particular calculation for Aviva plc compelling given that it is in
5 relation to the Applicant's parent company and is also in line with the calculations for
6 Canadian insurers and the range for United States insurers. The Board accepts an ROE of
7 13.3% using the DCF methodology as reasonable.

8
9 As discussed above the Board found that the reasonable ROE using the CAPM
10 methodology is 10.14% and using the DCF methodology is 13.3% creating a range of
11 10.14% to 13.3%. The Board finds that this range is the reasonable and appropriate
12 range, given that it is based on the most relevant data and methodologies. Based on the
13 record the Board finds that the appropriate range of ROE's for the Applicant is 10.14% to
14 13.3% rather than the range proposed by the Applicant.

15
16 In the absence of evidence suggesting circumstances requiring a premium or discount the
17 allowed ROE is generally the midpoint of the range established. This approach is in
18 keeping with the Board's rate-making principles and history, contributing to consistency
19 and predictability. Therefore the midpoint of 11.74% is accepted as the appropriate ROE
20 in the absence of circumstances suggesting a premium.

21
22 b) Market Size

23
24 The Applicant represents itself as a micro-cap company requiring additional return under
25 the CAPM method by adding a premium based on market size. The Applicant cites a
26 table from *Stocks, Bonds, Bills, and Inflation® Valuation Edition 2006 Yearbook*,
27 Ibbotson Associates, Chapter 7 indicating that the largest capitalization of a company in
28 the micro-cap designation is stated to be \$586,393,000 US. The Applicant further states
29 in its Application at page 5, paragraph 15: "...it is reasonable to conclude that S & Y
30 Insurance Company would qualify as a micro-cap company if it was publicly traded."

1 The size premium attached to a micro-cap company under CAPM according to the
2 Applicant's submission is 3.95%.

3

4 The Applicant was asked to provide specific information in support of the claim for a size
5 premium. In response to these information requests the Applicant acknowledged that it
6 did not issue any debt to third parties and does not issue share capital in the general
7 financial markets and, as a result, does not possess or require an independent bond rating
8 from that assigned Aviva Canada Inc. In this context there is not an individual Standard
9 and Poor's rating for the Applicant separate from Aviva Canada Inc. In its December 21,
10 2005 report Standard and Poor's assigns Aviva Canada Inc. a financial strength rating of
11 A+, indicating strong financial security and capacity to meet policyholder obligations
12 under a variety of economic and underwriting conditions. N/E/R/A noted in its report at
13 page 5 that: *"As a member of the Aviva companies, S & Y does not appear to qualify for a
14 positive size adjustment to its ROE. Unless S & Y can provide documentary evidence to
15 support its independent financial structure, any size adjustment would be a negative one
16 resulting in a lower ROE"*.

17

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

27

28 ROE on the basis of operating in a substandard market or of being a micro-cap company
29 may have merit in certain circumstances, the Applicant has not provided sufficient
30 evidence to show that it is applicable in this case. On the basis of the information before

1 While the argument advanced for a higher it the Board does not accept the Applicant's
2 arguments that a premium on ROE is warranted. In the absence of any compelling
3 argument that special circumstances justify a premium or discount, the Board finds it
4 reasonable to accept an ROE derived from the midpoint of the range established using
5 both the DCF and CAPM methodologies for Aviva Canada Inc. The Board therefore
6 determines that 11.74% is an acceptable ROE for the Applicant.

7

8 **ORDER**

9

10 **IT IS THEREFORE ORDERED THAT:**

11

- 12 1. The proposed ROE of 12.5% is not accepted.
- 13
- 14 2. An ROE of 11.74% is accepted as reasonable in the circumstances.
- 15
- 16 3. The rates approved for the Applicant in Order No. A.I. 19(2006) shall remain
17 unchanged.
- 18
- 19 4. The Applicant shall pay all the costs and expenses of the Board arising from the
20 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