

**A.I. 22(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 Elite 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. 7(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 15%. An  
24 ROE of 10% was accepted by the Board as reasonable for the Applicant in determining  
25 rate levels.

1 On May 1, 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. 7(2006). The  
3 Applicant also sought a change in the methodology by which All Perils premiums are  
4 calculated. In addition the Applicant applied for a reconsideration of the Board's  
5 determination in relation to the ROE.

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7 On May 9, 2006 the Board issued Order No. A.I. 17(2006) approving the revised rate  
8 proposals and deferring to a subsequent Order a decision on the All Perils premiums and  
9 the reconsideration of the ROE.

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11 **DECISION**

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13 This Decision and Order relates to the Applicant's request for a reconsideration of the  
14 ROE of 10% approved by the Board in Order No. A.I. 7(2006) and also deals with the  
15 proposal to change the methodology for calculation of All Perils premiums.

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

24  
25 In relation to the All Perils issue the Board will make its decision based on the  
26 information filed.

1 ROE Reconsideration

2

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

8

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

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

14

15 The Application suggests that the Board erred in its March 30, 2006 decision [Order No.  
16 A.I. 7(2006)] by failing to give sufficient consideration to certain ROE assumptions and  
17 calculations. The Applicant states that the ROE approved for ratemaking purposes of  
18 10% is insufficient to attract capital and that a more appropriate ROE is 15%.

19

20 The Board notes the Applicant does not propose to alter its currently approved rates as set  
21 out in Order No. A.I. 17(2006) as a result of any change in ROE that may arise from this  
22 Order. Given the lapse of time since the last rate change the Applicant would be required  
23 to submit a rate filing in order to effect any change to currently approved rates.

24

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

1 i) ROE Range

2

3 The Applicant's requested ROE of 15% is derived from the upper end of a range of ROE  
4 determined by the Applicant. The Applicant states that it selects an ROE at the upper end  
5 of the range to recognize the increased return that investors would demand in the context  
6 of the small size of the company and the substandard automobile market it serves.

7

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

13

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

19

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

1 The Applicant did not provide an updated CAPM calculation or updated opinion from  
2 Ms. McShane. Given that the Applicant's ROE calculation using the CAPM  
3 methodology was admittedly in error the specific proposals of the Applicant as they  
4 relates to the CAPM methodology should be adjusted. The Board accepts an ROE of  
5 10.14% as reasonable using the CAPM methodology.

6  
7 N/E/R/A states that the ROE range developed by the Applicant from the sustainable  
8 growth based DCF model is reasonable. N/E/R/A makes no adverse comment with  
9 respect to the Applicant's DCF ROE of 13.3% for Aviva plc. Using the DCF  
10 methodology the Applicant calculates the ROE for insurers in Canada, the United States  
11 and Europe. The median ROE for Canadian insurers is 13.7%. The median for the  
12 United States insurers ranges from 11.5% to 13.9%, using two types of growth  
13 assumptions and two sets of data sources. N/E/R/A suggests that because the Canadian  
14 and European calculations, both referencing the sustainable growth method, the most  
15 relevant ROE for United States insurers is 11.5% as it is based on the sustainable growth  
16 method. The median for European insurers is 11.0% with an ROE of 13.3% for Aviva  
17 plc. The Board finds the particular calculation for Aviva plc compelling given that it is in  
18 relation to the Applicant's parent company and is also in line with the calculations for  
19 Canadian insurers and the range for United States insurers. The Board accepts an ROE of  
20 13.3% using the DCF methodology as reasonable.

21  
22 As discussed above the Board found that the reasonable ROE using the CAPM  
23 methodology is 10.14% and using the DCF methodology is 13.3% creating a range of  
24 10.14% to 13.3%. The Board finds that this range is the reasonable and appropriate  
25 range, given that it is based on the most relevant data and methodologies. Based on the  
26 record the Board finds that the appropriate range of ROE's for the Applicant is 10.14% to  
27 13.3% rather than the range proposed by the Applicant.

28  
29 In the absence of evidence suggesting circumstances requiring a premium or discount the  
30 allowed ROE is generally the midpoint of the range established. This approach is in

1 keeping with the Board's rate-making principles and history, contributing to consistency  
2 and predictability. Therefore the midpoint of 11.74% is accepted as the appropriate ROE  
3 in the absence of circumstances suggesting a premium.

4  
5 ii) ROE Premium

6  
7 The Applicant has claimed an ROE higher than the midpoint on the basis that it is entitled  
8 to a premium for the risk it incurs operating in a substandard market and because of its  
9 small size.

10  
11 a) Substandard Market Risk

12  
13 The Applicant states that it operates in a substandard market which represents an  
14 inherently greater risk than does operating in the standard market. The Board recognizes  
15 that substandard risks may represent a greater probability of higher than average loss  
16 payments. However, generally speaking, these insureds pay proportionately higher  
17 automobile insurance premiums to reflect this increased risk. Therefore, to justify a  
18 premium on ROE, the Applicant must establish that operating in a substandard market  
19 results in an increased business risk.

20  
21 The Applicant has provided little in the way of supporting information to suggest that it  
22 experiences increased business risk as a result of operating in a substandard market. The  
23 Board would expect to receive detailed information in support of such an assertion,  
24 setting out particulars of how and where the book of business written by the Applicant  
25 varies from that of the other Aviva Canada Inc. subsidiaries and the market in general.  
26 This information would include an analysis of loss frequency and severity as well as  
27 recent trends that distinguish between the Aviva Canada Inc. subsidiaries in conjunction  
28 with other data particular to each company. A comparison of the Applicant's  
29 performance with that of other Aviva Canada Inc. subsidiaries, with other insurers, and  
30 the market in total would have assisted in supporting its proposition. The primary focus  
31 of any such information and analysis would need to clearly demonstrate that the

1 Applicant's operations in a substandard market are more volatile or risky than the other  
2 Aviva Canada Inc. subsidiaries, or that of the market as a whole. Given the cyclical  
3 nature of the automobile insurance business, data and analysis that spans at least one full  
4 market cycle would best demonstrate a pattern.

5  
6 In the absence of supporting information for a market premium adjustment the Board  
7 asked its expert to conduct an analysis of the available information to assist in the  
8 Board's review. N/E/R/A was not able to find support in the available data for the  
9 market premium. In its March 13, 2006 report on the originating application, and again  
10 in its September 21, 2006 report on the within Application, N/E/R/A/ states that the fact  
11 the Applicant writes substandard risks is not a justification for an increase in ROE for  
12 rate setting. These conclusions were provided to the Applicant. The Applicant did not  
13 provide additional information to refute N/E/R/A's conclusions. The Board notes that the  
14 report of Standard & Poor's which was provided by Aviva in response to Requests for  
15 Information, states that "*Elite is a leading carrier of specialty personal lines products,*  
16 *such as RV's, classic cars and boat insurance.*" No reference was made by Standard &  
17 Poor's of the substandard nature of the Elite market or the increased risk that might be  
18 experienced by a company operating in this market.

19  
20 The Board concludes that it is unreasonable to assume an ROE premium in relation to a  
21 substandard market in the absence of evidence supporting such a contention.

22  
23 b) Market Size

24  
25 The Applicant represents itself as a micro-cap company requiring additional return under  
26 the CAPM method by adding a premium based on market size. The Applicant cites a  
27 table from *Stocks, Bonds, Bills, and Inflation® Valuation Edition 2006 Yearbook*,  
28 Ibbotson Associates, Chapter 7 indicating that the largest capitalization of a company in  
29 the micro-cap designation is stated to be \$586,393,000 US. The Applicant further states  
30 in its Application at page 5, paragraph 15: "*...it is reasonable to conclude that Elite*  
31 *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, Elite does not appear to qualify for a*  
14 *positive size adjustment to its ROE. Unless Elite 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 While the argument advanced for a higher ROE on the basis of operating in a substandard  
29 market or of being a micro-cap company may have merit in certain circumstances, the  
30 Applicant has not provided sufficient evidence to show that it is applicable in this case.  
31 On the basis of the information before it the Board does not accept the Applicant's



1 arguments that a premium on ROE is warranted. In the absence of any compelling  
2 argument that special circumstances justify a premium or discount, the Board finds it  
3 reasonable to accept an ROE derived from the midpoint of the range established using  
4 both the DCF and CAPM methodologies for Aviva Canada Inc. The Board therefore  
5 determines that 11.74% is an acceptable ROE for the Applicant.

6  
7 All Perils Premium Calculation

8  
9 The Applicant proposes to change the method of calculating its All Perils premium.  
10 Currently the All Perils premium is 100% of the Collision premium plus 95% of the  
11 Comprehensive premium at the same deductible level. The proposal is to charge 100%  
12 of the Collision premium plus 100% of the Comprehensive premium at the same  
13 deductible level.

14  
15 All Perils is simply another name by which the combined coverage of Comprehensive  
16 and Collision is referenced. A consumer purchasing Collision and Comprehensive  
17 coverage separately would receive the exact same coverage benefits as a consumer  
18 purchasing All Perils. The only difference is that when purchased individually a  
19 consumer can purchase different deductibles, whereas a consumer purchasing All Perils  
20 has the same deductible for losses under both types of coverages.

21  
22 The Applicant's proposed premium change effectively eliminates a discount of 10% on  
23 the Comprehensive premium which was applied when the coverages were purchased  
24 together as All Perils. The proposed premiums for the combined coverage would be the  
25 same as premiums for the total of the coverages purchased separately. The currently  
26 approved methodology for the All Perils coverage was last approved in the context of a  
27 full rate filing from the Applicant which was made on October 27, 2005. The current  
28 Application for a change to this methodology did not include actuarial evidence in  
29 support of the change. In the absence of up to date actuarial evidence supporting the  
30 elimination of the discount the Board finds it unreasonable to approve the change.

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

3

4 **ORDER**

5

6 **IT IS THEREFORE ORDERED THAT:**

7

8 1. The proposed ROE of 15% is not accepted.

9

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

11

12 3. The rates approved for the Applicant in Order No. A.I. 17(2006) shall remain  
13 unchanged.

14

15 4. The proposed All Perils premium is not approved.

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

**DATED** at St. John's, Newfoundland and Labrador, this 19<sup>th</sup> day of December 2006.

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Robert Noseworthy  
Chair & Chief Executive Officer

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Darlene Whalen, P. Eng.  
Vice-Chair

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G. Cheryl Blundon  
Board Secretary