

**A.I. 24(2006)**

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

5 **AND**  
6

7 **IN THE MATTER OF** an application by  
8 Scottish and York Insurance Co. Limited  
9 (the “Applicant”) for a rehearing in relation  
10 to its application to implement revised rates  
11 for its Private Passenger class of business  
12 (the “Application”).  
13

14 **APPLICATION**  
15

16 On March 30, 2006 the Board issued Order No. A.I. 9(2006) in connection with a  
17 Category 2 automobile insurance rate filing submitted by the Applicant on September 14,  
18 2005. The Order was issued following extensive review and analysis of all evidence and  
19 information supplied in connection with the revised rating program including a thorough  
20 review of all evidence related to actuarial and cost of capital issues. The Board did not  
21 accept a number of the proposals contained in the rate filing and directed the Applicant to  
22 submit a revised rate proposal based on the rate indications flowing from the findings of  
23 the Board. In particular, the Board rejected the rate filing proposals in relation to the cost  
24 of capital issue, which included a return on equity (ROE) for the Applicant of 12.5%. An  
25 ROE of 10% was accepted by the Board as reasonable for the Applicant in determining  
26 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. 9(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. 16(2006) approving the revised rate  
8 proposals and deferring to a subsequent Order a decision on the All Perils premiums and  
9 reconsideration of the ROE.

10  
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. 9(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 12.5%. 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.

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28 **ROE Reconsideration**

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30 The Applicant is a wholly owned subsidiary of Aviva Canada Inc., itself a wholly owned  
31 subsidiary of Aviva plc, a large multinational corporation. Aviva Canada comprises the

1 second largest property and casualty insurance group in Canada and includes Aviva  
2 Insurance Co. of Canada, Traders General Insurance Company, Scottish and York  
3 Insurance Co. Limited, and Pilot Insurance Co.

4  
5 The Application states the key corporate financial targets of Aviva Canada as being:

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

10  
11 The Application suggests that the Board erred in its March 30, 2006 decision [Order No.  
12 A.I. 9(2006)] by failing to give sufficient consideration to certain ROE assumptions and  
13 calculations. The Applicant states that the ROE approved for ratemaking purposes of  
14 10% is insufficient to attract capital and that a more appropriate ROE is 12.5%.

15  
16 The Board notes the Applicant does not propose to alter its currently approved rates as set  
17 out in Order No. A.I. 16(2006) as a result of any change in ROE that may arise from this  
18 Order. Given the lapse of time since the last rate change the Applicant would be required  
19 to submit a rate filing in order to effect any change to currently approved rates.

20  
21 The Board has considered all information before it, including the Application and  
22 supporting documentation, the responses to Requests for Information, N/E/R/A's  
23 September 21, 2006 report and the additional comments provided by the Applicant.

24  
25 i) ROE Range

26  
27 The Applicant's requested ROE of 12.5% is derived from a range determined by the  
28 Applicant. The Applicant calculates its proposed ROE range based on the two most  
29 commonly used methodologies, the Discounted Cash Flow Methodology (DCF) and the  
30 Capital Asset Pricing Model Methodology (CAPM). The Board has in the past had  
31 reference to both of these methodologies. Based on the record in this matter the Board

1 concludes that both these methodologies are informative in determining an appropriate  
2 ROE range.

3

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

9

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

20

21 The Applicant did not provide an updated CAPM calculation or updated opinion from  
22 Ms. McShane. Given that the Applicant’s ROE calculation using the CAPM  
23 methodology was admittedly in error the specific proposals of the Applicant as they  
24 relates to the CAPM methodology should be adjusted. The Board accepts an ROE of  
25 10.14% as reasonable using the CAPM methodology.

26

27 N/E/R/A states that the ROE range developed by the Applicant from the sustainable  
28 growth based DCF model is reasonable. N/E/R/A makes no adverse comment with  
29 respect to the Applicant’s DCF ROE of 13.3% for Aviva plc. Using the DCF  
30 methodology the Applicant calculates the ROE for insurers in Canada, the United States  
31 and Europe. The median ROE for Canadian insurers is 13.7%. The median for the

1 United States insurers ranges from 11.5% to 13.9%, using two types of growth  
2 assumptions and two sets of data sources. N/E/R/A suggests that because the Canadian  
3 and European calculations, both referencing the sustainable growth method, the most  
4 relevant ROE for United States insurers is 11.5% as it is based on the sustainable growth  
5 method. The median for European insurers is 11.0% with an ROE of 13.3% for Aviva  
6 plc. The Board finds the particular calculation for Aviva plc compelling given that it is in  
7 relation to the Applicant's parent company and is also in line with the calculations for  
8 Canadian insurers and the range for United States insurers. The Board accepts an ROE of  
9 13.3% using the DCF methodology as reasonable.

10  
11 As discussed above the Board found that the reasonable ROE using the CAPM  
12 methodology is 10.14% and using the DCF methodology is 13.3% creating a range of  
13 10.14% to 13.3%. The Board finds that this range is the reasonable and appropriate  
14 range, given that it is based on the most relevant data and methodologies. Based on the  
15 record the Board finds that the appropriate range of ROE's for the Applicant is 10.14% to  
16 13.3% rather than the range proposed by the Applicant.

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

23  
24 a) Market Size

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

1 *and York Insurance Company would qualify as a micro-cap company if it was publicly*  
2 *traded.”* The size premium attached to a micro-cap company under CAPM according to  
3 the Applicant’s submission is 3.95%.

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

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

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

1 On the basis of the information before it the Board does not accept the Applicant's  
2 arguments that a premium on ROE is warranted.

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

9  
10 All Perils

11  
12 The Application seeks approval of a proposed change to the method of calculating the All  
13 Perils premium. The Application asks the Board to approve an All Perils rate which is  
14 100% of both Collision and Comprehensive. The Board notes that the current provision  
15 in the company's underwriting manual filed with the Board states All Perils calculation to  
16 be 100% Collision premium plus 100% of Comprehensive premium at the same  
17 deductible level. Therefore approval of the requested change is unnecessary.

18  
19 **ORDER**

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21 **IT IS THEREFORE ORDERED THAT:**

- 22  
23 1. The proposed ROE of 12.5% is not accepted.  
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25 2. An ROE of 11.74% is accepted as reasonable in the circumstances.  
26  
27 3. The rates approved for the Applicant in Order No. A.I. 16(2006) shall remain  
28 unchanged.  
29  
30 4. The Applicant shall pay all the costs and expenses of the Board arising from the  
31 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