FACILITY ASSOCIATION

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March 16, 2007

Ms. G. Cheryl Blundon
Director – Corporate Services & Board Secretary
Newfoundland and Labrador
Board of Commissioners of Public Utilities
120 Torbray Road
P.O. Box 21040
St. John's, Newfoundland and Labrador
Canada A1A 5B2

Re: **Facility Association Rate Revision Application**
<u>Private Passenger and Selected Miscellaneous Vehicles</u>

Dear Ms. Blundon,

We enclose a Category 2 filing with respect to Private Passenger Vehicles, Interurban Trucks, Taxis, Ambulances, Public Buses and School Buses in the Province of Newfoundland & Labrador.

With respect to Private Passenger Vehicles, this filing proposes changes to territorial base rates in response to an analysis of Facility Association experience reported to 30 June 2006, the current such rates having become effective 1 August 2005. In addition, rating rule changes are proposed, some of which are expected to have a rate level effect which has been estimated where the available data permits. No other changes to current risk classification category definitions or differentials are proposed. The following table summarizes the indicated and proposed changes in provincial average rate level by coverage and overall:

Province of Newfoundland & Labrador Private Passenger Vehicles Provincial Changes in Average Rate Level							
Basis	Liability	Acc. Ben.	Unin. Auto	Collision	Comp.	Spec. Per.	Combined
Indicated	+8.8%	+31.3%	+9.3%	+20.6%	-10.3%	-22.0%	+10.0%
Proposed	+8.8%	+12.0%	+9.3%	+12.0%	-10.3%	-15.0%	+8.4%

A voluntary capping of + 12% and -15% on Private Passenger vehicles has been applied to give consideration to the effect of the proposed indications on the policy holders.

With respect to the selected classes of Miscellaneous Vehicles, this filing proposes rate changes for independently rated coverages in response to an analysis of Facility Association experience reported to 31 December 2005. In addition, rating rule changes are proposed, the rate level impact of which is not estimable with the data sources currently available. No other changes to current risk classification category definitions or differentials are proposed. The following table summarizes the indicated and proposed changes in provincial average rate level by coverage (and overall where applicable):

Province of Newfoundland & Labrador Selected Miscellaneous Vehicles Provincial Changes in Average Rate Level							
Basis	Liability	Acc. Ben.	Unin. Auto	Collision	Comp.	Spec. Per.	Combined
Interurban Trucks (since Dec/03)							
Indicated	+3.9%	+3.2%	+5.8%	+0.3%	+2.8%	+2.3%	+2.8%
Proposed	+3.9%	+3.2%	+5.8%	+0.3%	+2.8%	+2.3%	+2.8%
Taxis, Jitneys and Liveries (since May/93)							
Indicated	+77.5%	+311.0%	+234.9%				
Proposed	+50.0%	+100.0%	+100.0%				
Ambulances (since May/93)							
Indicated	+5.8%		+5.8%				
Proposed	+5.8%		+5.8%				
Public Buses (since May/93)							
Indicated	+4.6%	+1.5%	+8.1%				
Proposed	+4.6%	+1.5%	+8.1%				
School Buses (since May/93)							
Indicated	+28.3%	+0.9%	+13.7%				
Proposed	+15.0%	+0.9%	+13.7%				

For Taxis, Jitneys and Liveries, the indications have been capped at 50% for Liability and 100% for Accident Benefits and Uninsured Automobile coverage, as a response to the magnitude and persistency of the indications over the past 5 accident years and to help modify the impact on the policy holders. School buses have been capped at 15%, due to the low volume and low credibility of the indications and again to help modify the impact to policy holders.

<u>Cost of Capital Provision</u>

This application contains a cost of capital provision in all indicated and proposed rates.

Due to the nature of Facility Association, i.e. because it is not an insurer, certain costs resulting from their compulsory membership in Facility Association are incurred on the members' own accounts, rather than on those of Facility Association. Prominent among these are health levies, premium taxes, and the cost of capital. Because member companies must book their share of premiums written through Facility Association on their own books, they must pay premium taxes, health levies, and other charges based on premium volumes themselves. Similarly, member companies are required by solvency regulators to support their share of Facility Association premiums with their own capital. Historically, Facility Association's rates have been developed with the goal of generating enough of a surplus to distribute to members to cover their costs arising from their membership in Facility Association, with the exception that no provision in previous rate filings was made for the cost of capital. The position not to include a cost of capital was taken voluntarily by Facility Association at the direction of our Board of Directors. In 2003, the Board of Directors passed a motion that the cost of capital to member companies should be addressed in Facility Association's rates. This change in approach is based on the philosophy that higher-risk drivers should face the same cost elements in their rates as drivers in the voluntary market, and that Facility Association's rates should not be subsidized by member companies or their policyholders.

Facility Association included the cost of capital in its rate filing for Prince Edward Island for all classes of vehicles to take effect during 2004. Following an investigation, the Island Regulatory and Appeals Commission approved the rates as filed.

From time to time, the issue has arisen of how a cost of capital provision is consistent with Facility Association's non-profit status. Facility Association and its non-profit status were the subject of a comprehensive public hearing before the Newfoundland & Labrador Board of Commissioners of Public Utilities (PUB) in 2000 – 2001. In its order A.I.36 (2000-2001), the PUB offered the following comment:

> "From the evidence of witnesses and argument of Counsel, the Board concludes that Facility is a non-profit association that operates as nothing more than the administrator of a risk sharing automobile insurance pool. The servicing carrier companies of Facility underwrite the business risks and, on behalf of the member companies Facility carries out an administration function including, *inter alia*, investment of funds, administration of the bank accounts, issuing of reports on the status of funds and accounts, distribution of members profits and issuing assessment notices for losses incurred. Facility's expenses are paid by the member companies and that is all Facility is paid. As their revenues can never exceed their expenditures, Facility can never earn a profit."

In its press release announcing the above Order, the PUB stated:

> "The Board found that any profit generated by the operation of Facility Association belongs to the members of the Association."

In relation to the appropriate level of a Cost of Capital provision, at a hearing before the Nova Scotia Insurance Review Board in November of 2004, that Board's actuarial advisor (Mr. Ted Zubulake of Mercer Oliver Wyman) acknowledged that Facility Association operations are inherently more uncertain that those of the voluntary market and that appropriate levels of return on equity should vary directly with the levels of uncertainty facing the enterprise:

From the transcripts (page 604):

> Mr. Zubulake: "…to the extent a target -- a cost of capital provision is allowed the Facility Association and to then -- and to the extent that a target or a cost of capital or

> a profit contingency provision is -- a standard one is identified and selected for the regular market that perhaps I would certainly suggest or believe that consideration should be given to perhaps a slightly higher return for the Facility Association. How much higher, what the absolute number is, I don't know."

We believe that the volatility in both the size of Facility Association and in its net operating results pose a significant business risk to member companies due to their compulsory participation in Facility Association.

In relation to the appropriateness of a cost of capital provision in Facility Association's rates, Dr. Richard McGaw of the Department of Economics at the University of New Brunswick offered the following in his submission to the New Brunswick Insurance Board (NBIB) in June, 2005:

> **"Facility Association Cost of Capital**
>
> The arguments used to justify a return to capital for a regulated enterprise apply equally to the Facility Association. If capital is provided to the operation of the FA then it has a cost like any other capital provided. To the extent that the cost of capital is borne either by the insurance companies through lower profits or regular policyholders cross-subsidizing FA rates through higher premiums, there is an undesirable element of subsidization. Markets perform best when participants bear the full cost of their choices. As a matter of principle, there should be recognition of the cost of capital and it should be at least as high as the rate for normal business. Given the larger risk, there are valid arguments to exceed the general ROE. I note that a number of companies have written to the effect that they have not included the FA capital in their capital determination for regular policies."

The rate indications in this application include a cost of capital provision based on the following assumptions:

- Industry After Tax Return on Equity 12%
- Industry Premium to Surplus Ratio 2:1
- Income Tax Rate 36.1%
- Before Tax Return on Investment 3.8%

The Industry after tax return on equity and premium to surplus ratio assumptions were adopted as Industry benchmark assumptions based on an informal survey of Industry practice.

Market Share

The Facility Association Private Passenger market share in Newfoundland and Labrador, measured on a written exposure count basis peaked in September 2003 at 8.0%. We are pleased to report that our private passenger market share is at 2.6% as of February 2007, the lowest level since we began tracking this number in 1990. Work has been done by a number of stakeholders to achieve this result, including the PUB, ensuring that only those risks that need to be insured through the Facility Association are.

Aligned with Facility Association being the "market of last resort" for higher risk drivers and vehicles is the concept that in a general way, Facility Association rates should be above that of our member companies to avoid Facility Association prices being "inadvertently attractive" to the consumer. A recent review of 4 Private Passenger Comp-u-quote profiles in 3 Territories showed that Facility Association was competitive in 58% of the profiles.

Please find an illustration showing our competitive market position attached. Allowing the increase as filed will help to ensure we are less competitively priced relative to our member companies.

Brian Pelly, FCIA, FCAS, our Consulting Actuary, may be contacted directly to answer any questions on the technical aspect of the filing, while Jill Hepburn, Facility Association's Vice President of Underwriting and Claims may be contacted directly to answer any questions on any other aspect of the filing.

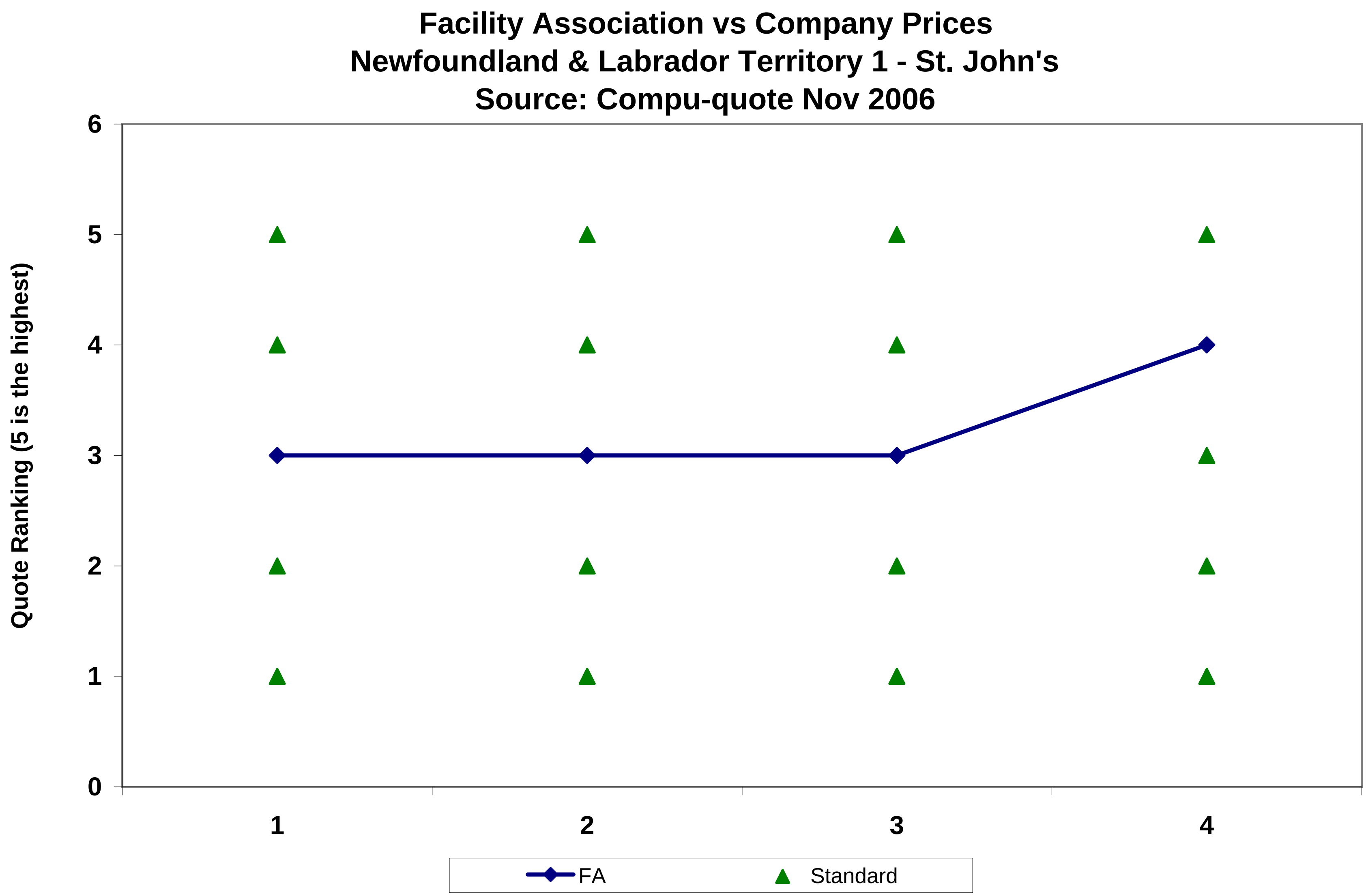
The proposed implementation date is September 1 2007.

We look forward to your approval in the near future.

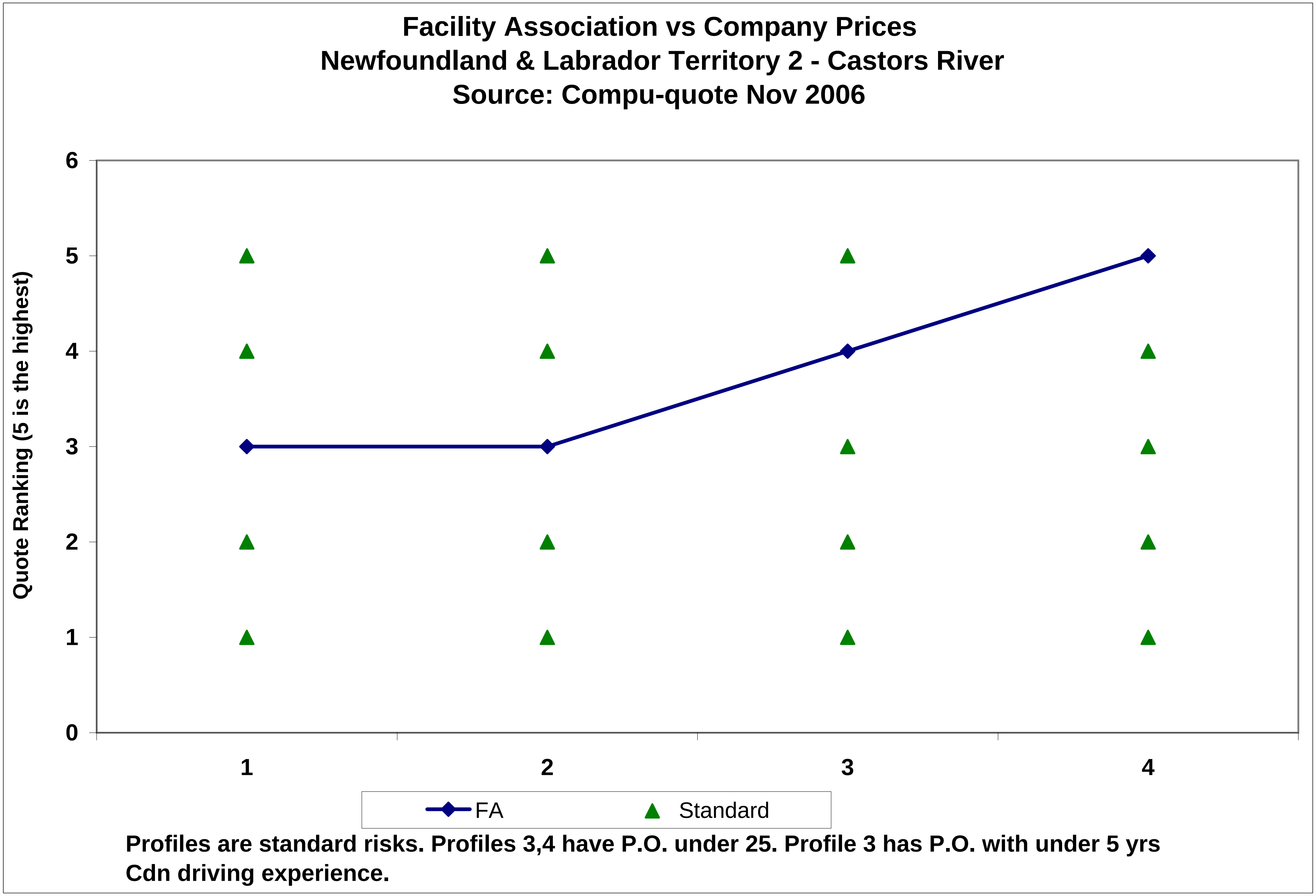
Yours truly,

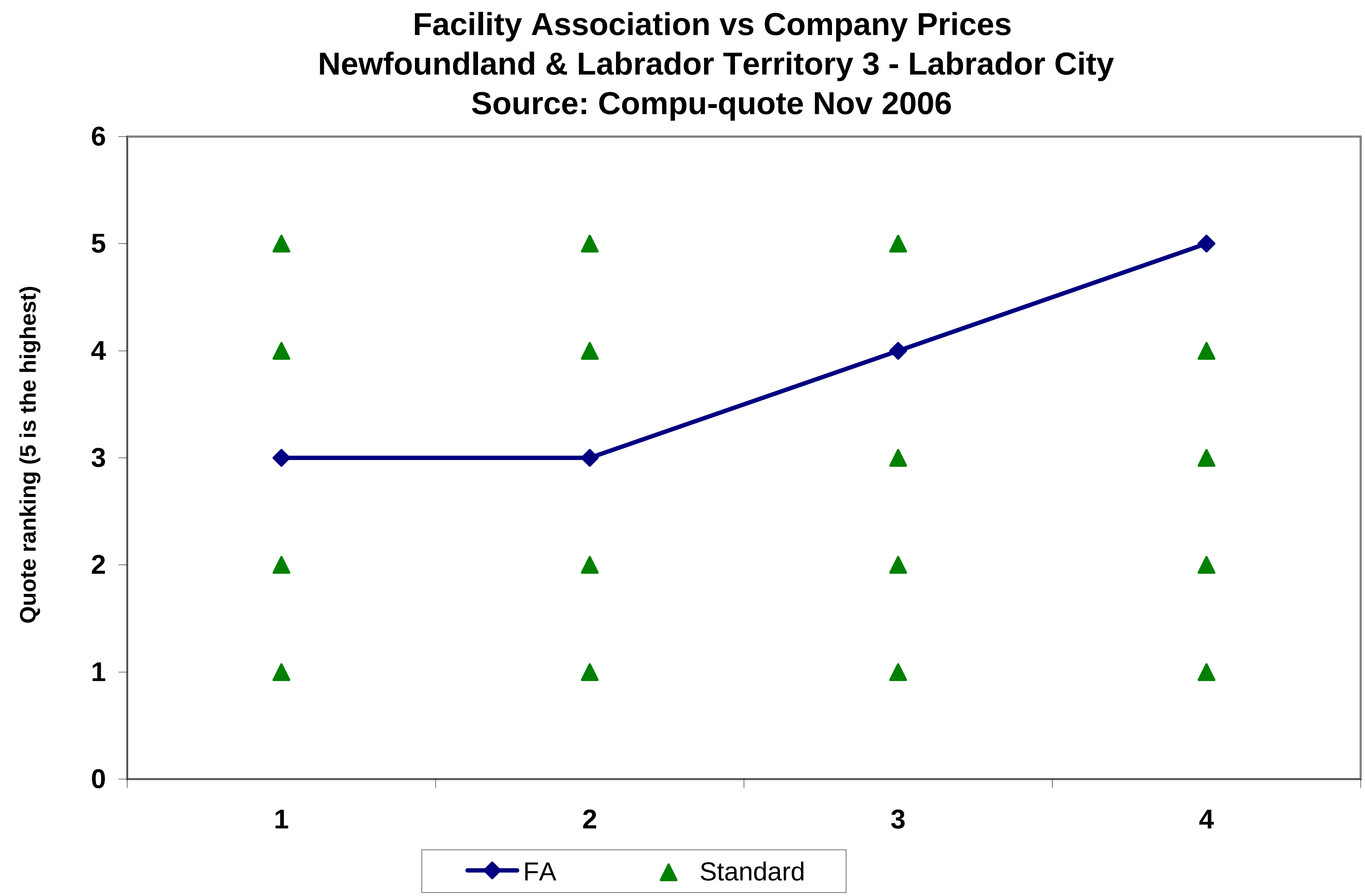
David J. Simpson, M.B.A., FCIP
President and CEO

Attach.



Profiles are standard risks. Profiles 3,4 have P.O. under 25. Profile 3 has P.O. with under 5 yrs Cdn driving experience.


Facility Association vs Company Prices
Newfoundland & Labrador Territory 2 - Castors River
Source: Compu-quote Nov 2006
Quote Ranking (5 is the highest)
0
1
2
3
4
5
6
1
2
3
4
FA
Standard
Profiles are standard risks. Profiles 3,4 have P.O. under 25. Profile 3 has P.O. with under 5 yrs Cdn driving experience.



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Profile Descriptions

Standard Risk - Newfoundland & Labrador

Profile Number 1

Operator #1
Adult, age 70, qualifies for retirees discount
No chargeable accidents or convictions in last 10 years
New business application to Company

Licensed 50 years, class G licence
Pleasure use only, annual mileage under 10,000 km.
1997 Chevrolet Lumina 4 door (VICC Code 5589)

Coverages
Liability and SEF44 - $1,000,000
Basic Accident Benefits and Uninsured Automobile
Collision and Comprehensive - $500 and $250 deductible

Profile Number 2

Operator #1
Male, age 40 (husband), licensed 24 years, class G licence
No chargeable accidents or convictions in last 6 years
Drive to work, 10 km. one way, annual mileage <16,000 km.
1998 Jeep Grand Cherokee Limited 4 WD (VICC Code 7182)
New business application to company

Operator #2
Female, age 39 (married), licensed 20 years, class G licence
No chargeable accidents or convictions in last 6 years
Drive to work, 20 km. one way, annual mileage 20,000 km.
1998 Dodge Neon 4 door (VICC Code 2261)
New business application to company

Coverages
Liability and SEF44 - $1,000,000
Basic Accident Benefits, Uninsured Automobile
Collision and Comprehensive - $500 and $250 deductible

Profile Number 3

Operator #1
Male (single), age 19
Licensed 3 years, 1 year with G licence, Owner and Principal Operator, No claims or convictions
Commute - 5 km one way, annual mileage under 12,000 km.
1997 Pontiac Grand Am GT 2 door (VICC Code 6488)
New business application to Company

Coverages
Liability and SEF44 - $500,000
Basic Accident Benefits and Uninsured Automobile
Collision and Comprehensive - $500 and $250 deductible

Profile Number 4

Operator #1
Male (Single), age 24
Licensed 6 years, G licence
No chargeable accidents in last 5 years
2 minor convictions in last 3 years

Commute - 5 km one way, annual mileage under 12,000 km.
1994 Ford F150 Pickup 2WD (VICC Code 3629)
New business application to Company

Coverages
Liability and SEF44 - $200,000
Accident Benefits and Uninsured Automobile
Collision and Comprehensive - $500 and $250 deductible