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Automobile Insurance Rate Board
200 Terrace Building
9515 – 107 Street
Edmonton, AB T5K 2C3

Dear Sir,

We have given some thought to the matter of an appropriate target level of return on equity to be used in establishing automobile insurance rates in Alberta and have the following comments, which we hope will be of some value to the Board.

The automobile insurance business is similar to the oil industry; both are cyclical and have fairly low distribution risks. Oil has a high exploration risk, while insurance has a high risk of an unexpected claims result. Both industries use expertise and data in attempting to improve their outcomes, but there is no one providing any guarantees of ultimate success. (A 'dry hole' in the oil industry is the approximate equivalent of an unfavourable court decision in auto insurance.) Therefore, the AIRB should look first to the oil industry to find a suitable rate of return on equity for the auto insurance industry.

A privately-supplied, multi-company auto insurance system does not lend itself well to the 'regulated utility' model. For many years, the Ontario government has mandated a 'return on equity factor' of approximately 12% in its approved auto rate filings for insurers. However, the actual returns on equity that many of these companies subsequently experience vary quite widely from the 12% target. Hence, in Ontario an elaborate and costly rate approval system has been created, which does not achieve one of its primary goals. The Alberta government should be responsible to thoroughly check out the results in Ontario before proceeding down a similar path.

In its letter, the AIRB says, "The Board is cognizant of the importance of ensuring that insurers operating in Alberta are able to cover their cost of capital and provide a competitive return for their shareholders." However, this was not Echelon's experience. The introduction of the grid rating system made it impossible for Echelon to earn any profit going forward, in the only segment of the market for which it had suitable underwriting and claims expertise. Echelon effectively had its Alberta automobile business confiscated by provincial government fiat, without any compensation. This is very reminiscent of the National Energy Program.

The cross subsidy of the premiums of higher risk drivers by the premiums of lower risk drivers, caused by the grid rating system and the supporting grid risk sharing pool, has been estimated at $105 per non-grid vehicle (as at April/06) and can be expected to be higher now and to climb further if the system is not changed. Such over-charging of premiums is extremely unfair to non-grid drivers. An insurer's return on equity should be earned more or less equally over all of its rating sub-groups.

Inadequate premiums for higher risk drivers increases the number of accidents, injuries and deaths. Aggregate claims and premiums go up, along with the added misery. Is this good public policy? Although we don't intend to try to prove the foregoing case in this submission, we believe that it is intuitively correct and is supported by some earlier work undertaken by the Fraser Institute and others. The Alberta government should be responsible to thoroughly check out this hypothesis before deciding on continuing the current grid system or any similar structure.

The non-standard insurers have much expertise in pricing and handling the claims of higher risk drivers and are prepared to make their capacity available to the market, if provided with an opportunity to earn an appropriate return on equity. In the current circumstance, this expertise is lost to the market, which can be expected to increase aggregate claims costs and further diminish the proper matching of risk and premium at the individual policyholder level.

Should the Board wish to have additional information or clarification on any of these points, please do not hesitate to contact the writer.

Yours truly,

Douglas E. McIntyre

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