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January 23, 2009

British Columbia Utilities Commission
Sixth Floor
900 Howe Street
Vancouver, BC V6Z 2N3

Attention: Ms. Erica M. Hamilton, Commission Secretary

**Re: Revised Terms of Reference for an Independent Third Party Review
Pursuant to Order G-73-08 respecting ICBC's Regional Claim Centres Allocation**

Dear Ms. Hamilton:

As a result of discussions at the workshop with Commission staff and intervenors held on December 9, 2008 pursuant to Order G-167-08, and pursuant to Letter L-59-08 amending the Regulatory Timetable, ICBC is filing revised Terms of Reference for an Independent Third Party (ITP) review.

ICBC's revised Terms of Reference are enclosed and contain the following amendments:

Under the heading "Background"

- The Terms of Reference now excerpt the full text of part 5.0, Commission Determination, from the Commission's April 2008 Decision on the Regional Claim Centres Allocation (the RCCA).

Under the heading "Requirements"

- The list of materials to be provided to the ITP now specifically includes the appendices to the Commission's April 2008 Decision and materials describing the current RCCA work effort methodology, including materials filed with the Commission from ICBC's 2002 Transaction Costing Study up to and including the 2007 update to the work effort study.
- At the workshop, the participants discussed whether to add to the Terms of Reference a provision that the ITP be provided with materials filed by intervenors in previous applications relating to allocation matters (e.g., materials provided by IBC's witnesses Michael Ross and Barb Addie in the 2004 allocation proceeding). ICBC advised that if such materials were provided to the ITP, the ITP would need to be given the entire evidentiary record, not just excerpts (e.g., the cross-examination of Ross and Addie). ICBC considers that the exercise being undertaken by the ITP is not an appeal or reconsideration of past Commission decisions regarding cost allocation. Rather, the ITP is providing a "fresh look" at the allocation matters specified in the Terms of Reference for future benefit. ICBC believes that it would not be an effective use of the ITP's time to read all previous materials and that the associated costs would not provide value for Basic insurance policyholders. ICBC further believes that the application materials and the Commission's decisions will

.../2

provide appropriate background and context. Further, the provision in the Terms of Reference allowing the ITP to request from ICBC materials from past proceedings before the Commission or used by ICBC in the work effort study as necessary will ensure that the ITP is allowed to access the materials it requires for its review. As such, ICBC has not amended its Terms of Reference to specifically state that the ITP will be provided with materials filed by intervenors in previous applications relating to allocation matters.

Under the heading "Qualifications"

- The requirement for a firm to have experience with the automobile insurance business has been revised so that the ITP is not required to have experience with Canadian automobile insurance.
- A revision has been made so that two or more firms may partner together to provide the services, with one firm on lead to provide overall accountability.

Under the heading "Scope" – Examination of the RCCA Work Effort Study

- The scope of the ITP review of the RCCA has been amended to provide that the ITP will meet with the work effort study group to understand the work effort study process and evaluate that process in meeting the objectives of a fair and equitable allocation of costs. Meeting with the work effort study group will provide opportunity for the ITP to meet the group members, understand their respective experience levels, and see how the data was used as a basis for informed judgment. If it deems necessary, to gain a better understanding of ICBC's overall business and operations, the ITP may also meet with appropriate ICBC Claims Division and Finance Division staff outside of the work effort study group.
- The scope of the ITP review of the RCCA has also been amended to reflect that the ITP will provide advice on the reasonableness of the composition of the work effort study group and on whether the conclusions reached by the group were reasonable based on the data provided. The ITP will also provide advice on whether the data examined by the group was reasonable and the same type of data typically used in transaction costing exercises.

Under the heading "Scope" – Review of Specified Allocation Functions

- The description of the work done by PricewaterhouseCoopers (PWC) for ICBC has been moved and the description of the nature of PWC's work has been deleted.
- As discussed above, ICBC considers that the exercise being undertaken by the ITP is not an appeal or reconsideration of past Commission decisions in which cost allocation was addressed. As such, ICBC has not amended the scope of the review of specified allocation functions to include issues already reviewed and approved by the Commission.

Under the heading "Time Frame"

- The time frame for the ITP's review has been extended to reflect the revised regulatory timetable agreed to by the parties and approved in the Commission's Letter L-59-08. The time frame also accounts for ICBC's regulatory requirements in 2009 and allows preparation time in July and August 2009 for the ITP to review the materials provided in advance of meeting with the work effort study group.

Conclusion

ICBC believes that the approach of meeting with Commission staff and intervenors and then proposing amendments based on discussion at the meeting has worked effectively and efficiently as a regulatory process thus far. ICBC looks forward to concluding the process of obtaining Commission approval of the Terms of Reference.

Yours truly,



Kathy Parslow
Director, Regulatory Affairs and Planning

Cc: Bill Grant, Consultant, BC Utilities Commission
Doug Chong, Director Strategic Services, BC Utilities Commission
Registered Intervenors
Donnie Wing, CA, Senior Vice President, Insurance, Marketing and Underwriting, ICBC

Enclosure



BACKGROUND

The Insurance Corporation of British Columbia (ICBC) operates three lines of business: Basic insurance, Optional insurance, and Non-insurance. ICBC's Basic insurance line of business is regulated by the British Columbia Utilities Commission (the Commission) pursuant to section 49 and Division 2 of the *Insurance Corporation Act* (the *ICA*).

To maintain economies of scale, ICBC operates as an integrated business. One purpose of ICBC's financial allocation methodology is to identify the operating costs associated with each line of business so that the required Basic insurance premium rates can be determined and the Commission can ensure that premiums from Basic insurance cover only those costs attributable to Basic insurance.

ICBC's current financial allocation methodology was approved by the Commission in its January 2005 Decision.¹ The Commission approved a fully allocated costing, or pro-rata, methodology as the most appropriate methodology for allocating costs among ICBC's three lines of business. The pro-rata method incorporates the principles of cost causality. Eighty-five percent of ICBC's total costs are claims incurred, premium taxes, and commissions, which are primarily directly attributed to one of ICBC's three lines of business. The remaining 15% are operating costs. Of these operating costs, 21% are direct costs. For indirect costs, which make up the remaining 79% of ICBC's operating costs, ICBC uses the principles of cost causality to determine the appropriate basis of allocation so that these costs are allocated in a fair and equitable manner.

In its January 2005 Decision, the Commission directed ICBC to conduct a workshop within 60 days to review the details of seven allocation functions, including the Regional Claim Centres allocation (the RCCA). ICBC allocates Regional Claim Centres costs using work effort based on transaction costing. The Commission also directed ICBC to address another seven allocation functions in subsequent revenue requirements applications. In regard to the allocation of ICBC's administrative operating costs, the Commission concluded that the fairest allocation method is to allocate the costs equally between Basic insurance and Optional insurance, after deducting the costs allocated to Non-insurance. This was on the basis that these cost categories are required by both Basic and Optional insurance and are truly joint costs of ICBC's business.² Administrative operating costs represent 18% of ICBC's operating costs (2.7% of ICBC's total costs).

A negotiated settlement process (NSP) on the initial seven allocation functions including the RCCA was held in April 2005. In its letter approving the May 2005 negotiated settlement agreement (NSA), the Commission stated that it was satisfied that the workshop and ensuing settlement process had correctly and comprehensively dealt with the seven allocation functions of particular concern identified in its January 2005 Decision.³ The Commission also confirmed ICBC and the intervenors' agreement to the use of the work effort allocator based on transaction costing for the RCCA. The RCCA represents 25% of ICBC's operating costs, or 3.8% of total costs. ICBC was directed to file an updated work effort study in 2007, including any revisions that ICBC proposed for the RCCA.

¹ January 2005 Decision, page 25.

² *Ibid.*, pages 42-43.

³ Commission letter dated May 18, 2005, Order No. G-46-05.



Terms of Reference for an Independent Third Party Review of Regional Claim Centres Allocation and Specified Allocation Functions

ICBC filed information regarding seven additional allocation functions, as directed in the January 2005 Decision,⁴ in its 2006 Revenue Requirements Application. The Commission approved the allocators for these allocation functions and addressed other allocation matters in its July 2006 Decision.⁵ Additional allocation matters including two more allocation functions, the use of the premiums written allocator, and reorganizations were addressed in the 2007 Revenue Requirements proceeding.⁶ In total, the matters specifically addressed by the Commission, including administrative operating costs and the RCCA, represent 62% of ICBC's operating costs.

As required by the Commission, ICBC submitted a filing on the RCCA including an updated work effort study in December 2007. ICBC and intervenors participated in an NSP and in the NSA reached in February 2008 parties agreed on the allocation of Regional Claim Centres compensation and other operating costs on the basis of overall work effort percentage.⁷

Following the RCCA NSP, some intervenors submitted comments to the Commission expressing concern with the lack of independent validation of the work effort study.⁸

In its April 22, 2008 Decision, the Commission directed ICBC as follows:

The Commission Panel acknowledges the concerns expressed by IBC and Mr. Sykes regarding the independence of the Work Effort Study and the validation of the Work Effort Study and the proper allocation of costs between Basic and Optional Insurance. The Commission Panel determines that these issues are to be addressed by ICBC in the course of preparing for its next application with respect to financial allocation methodology. The Commission Panel considers that the importance of appropriate cost allocation between Basic and Optional Insurance indicates a need for an independent professional assessment. The Commission Panel determines that, for the purposes of this proceeding, the internal work undertaken by ICBC in support of its application, together with the results of the negotiated settlement process are adequate to support Order No. G-73-08. The Commission received a number of Letters of Comment that accepts the 2008 NSA with one dissent. **The Commission approves for ICBC the February 20, 2008 NSA, attached as Appendix B to this Order.**

The Commission directs ICBC to prepare and file an application for approval of a Proposal Plan for the identification and selection of an independent third party ("ITP") to review, report on and make recommendations with respect to ICBC's financial allocation methodology. The Proposal Plan should address proponent qualification criteria, the detailed scope of the work required including a review of the Work Effort Study, and the time frame for

⁴ January 2005 Decision, pages 38-39, 41.

⁵ July 2006 Decision, pages 57, 60, and 61.

⁶ January 2008 Revenue Requirements Decision, pages 20-24.

⁷ Facilities costs related to the "tubes" in claim centres are allocated on the same basis as the collision/property damage transaction type rather than the overall work effort percentage.

⁸ Letters of comment expressing concern with the lack of independent validation of the work effort study were submitted by intervenors Russell Sykes and the Insurance Bureau of Canada (IBC). IBC also submitted another letter on March 27, 2008 directly to the Commission, after the time for comment had ended, which is referenced in the Commission's April 2008 Decision.



the review. The Proposal Plan application is to be filed with the Commission no later than October 31, 2008.

In ordering this independent review of the current cost allocation methodologies employed by ICBC, the Commission Panel is not directing a full cost allocation study. The current allocations will stay in place until amended by the Commission as a result of any second comprehensive cost allocation study. The purpose to be served by the ITP study would be to provide objective third party analysis that would address some of the concerns raised in this proceeding and provide a base for the Commission to evaluate whether or not a second full cost allocation proceeding is required.⁹

This Terms of Reference is the Proposal Plan directed by the Commission.

OBJECTIVES

- The primary objective of the ITP review, arising in response to specific concerns raised by intervenors about the RCCA work effort study, is to have an ITP provide independent validation that the approach used by ICBC resulted in a fair and equitable allocation of costs, and to provide advice on the specific issues identified below.
- A secondary objective is to have an ITP review and comment on ICBC's selection and application of the allocators used for the specified allocation functions identified below.

REQUIREMENTS

- ICBC will provide the ITP with the following materials:
 - Materials describing the current RCCA work effort methodology including materials filed with the Commission from ICBC's 2002 Transaction Costing Study up to and including the 2007 update to the work effort study.
 - Materials describing the current allocators used for the specified allocation functions.
 - PricewaterhouseCoopers' annual audit report (described below) regarding ICBC's compliance with the criteria in the *ICA* for allocating costs and revenues to the Basic insurance, Optional insurance, and Non-insurance lines of business, dated March 3, 2008.
 - The following Commission decisions and orders:
 - January 19, 2005 Decision approving the principles of ICBC's financial allocation methodology.
 - Commission letter dated May 18, 2005, Order No. G-46-05, approving the April 2005 NSA.
 - Excerpts of the July 13, 2006 Decision relating to allocation.
 - Excerpts of the January 2008 Revenue Requirements Decision relating to allocation.
 - April 22, 2008 Decision approving the February 2008 RCCA NSA (including appendices), the letters of comment filed by intervenors following the NSP, and the letter filed by the Insurance Bureau of Canada directly with the

⁹ April 2008 Decision, pages 4-5.



Terms of Reference for an Independent Third Party Review of Regional Claim Centres Allocation and Specified Allocation Functions

Commission, after the comment period had ended, which is referenced in the Commission's April 2008 Decision.

- Relevant legislation defining the Commission's jurisdiction and ICBC's responsibilities with respect to financial allocation.
- The ITP will review the materials provided, obtain any further information necessary for its review, as required, from ICBC, and prepare a written report addressed to ICBC and the Commission. The report will address the two objectives outlined above and provide appropriate analysis and explanation for any recommendations.
- In making any recommendations, the ITP will consider the legal requirement to keep sensitive Optional insurance data confidential.¹⁰
- The review will be completed in approximately two weeks over a two month period after the ITP agrees to the Terms of Reference and has been provided with the above information from ICBC to begin its assessment. The report will be due one month after the ITP's completion of the assessment.
- The ITP will address questions on the contents of the report from the Commission and intervenors in writing or in person as required by the Commission.
- The ITP will complete the work in a cost-efficient manner.

QUALIFICATIONS

ICBC is seeking the services of a firm with one or more individuals with the following qualifications:

- Significant and related experience with cost allocation methodologies in a regulatory environment.
- Significant experience working for organizations (but not intervenors) operating in a regulatory environment.
- Significant experience with the automobile insurance business in the tort environment, in particular experience with claims servicing roles and processes.
- Capable of completing the review and issuing a final report within the time frames.
- Ability to abide by ICBC's and the B.C. government's terms and conditions regarding confidentiality of information obtained as a result of the engagement.
- Not in a conflict of interest position due to recent work for ICBC, the Commission, an intervenor, or a competitor of ICBC.

A firm may partner with one or more other firms to provide the services in the Terms of Reference. In such a case, one firm will be the lead to provide overall accountability for the services provided.

SCOPE

The scope of the ITP review will consist primarily of an examination of the RCCA work effort study, but will also include a limited review of the allocators used for specified allocation functions, as set out below.

¹⁰ Per section 4(2) of *Special Direction IC2 to the BC Utilities Commission, BC Regulation 307/2004* in determining, under section 12 of the *Utilities Commission Act*, whether disclosure of information with respect to ICBC's Optional insurance business is necessary for the administration of the *Utilities Commission Act* as it applies to ICBC, the Commission must consider the effect of disclosure of the information on ICBC's ability to compete in the Optional insurance market on a basis similar to its competitors and the harm to ICBC's competitive position that may result from the disclosure of the information.



- 1) Examination of the RCCA work effort study:** The ITP will provide independent validation whether the approach used by ICBC for the RCCA, which is based on transaction costing, resulted in a fair and equitable allocation of costs. The transaction costing process involves having a team of experienced ICBC Claims personnel (the work effort study group) meet to determine the percentage of work effort of employees at a regional level, by identified job categories, with respect to the specific types of transactions undertaken. The team determines work effort percentages on the basis of data provided to the group in advance of the session and the team's experience and knowledge of ICBC's claims handling processes and the work being performed in each region.
- The ITP will meet with the work effort study group to understand the work effort study process and evaluate that process in meeting the objectives of a fair and equitable allocation of costs. If it deems necessary, to gain a better understanding of ICBC's overall business and operations, the ITP may meet with appropriate ICBC Claims Division and Finance Division staff outside of the work effort study group.
 - The ITP will also provide advice on the following issues:
 - The reasonableness of the composition of the work effort study group.
 - Whether the conclusions reached by the work effort study group were reasonable based on the data provided, and whether the data was reasonable and the same type typically used in transaction costing exercises.
 - Where proxies for work effort are used to allocate the costs between lines of business, whether the proxies selected reasonably reflect work effort.
 - For the bodily-injury-represented and bodily-injury-litigated transaction types, whether there is a requirement to allocate a portion of the work effort to Optional insurance for claims settling under \$200,000.
 - For the Material Damage-collision/property damage and Material Damage-customer care transaction types, whether file count is an appropriate proxy and reasonably reflective of relative work effort for the purpose of allocating costs among the lines of business.

2) Review of specified allocation functions:

- ICBC uses four types of allocators for indirect costs: averages, claims, premiums, and work effort. The ITP will review one pre-selected allocation function from each of these categories, as follows:
 - Averages: Fraud Management (Weighted average – cost centres)
 - Claims: Call Centre Department (Newly opened exposures – TCD)
 - Premiums: Chief Underwriter (Premiums written with exception)
 - Work effort: Field Broker Support
- For each of the specified allocation functions, the ITP will review and comment on ICBC's selection and application of the allocator.

PricewaterhouseCoopers (PWC) conducts an annual audit of ICBC's compliance with the criteria established by sections 23(1)(c)(ii) and 49 of the *ICA* for attributing revenue and costs to ICBC's Basic, Optional, and Non-insurance lines of business (the PWC Audit). The last PWC Audit report was rendered on March 3, 2008.



Terms of Reference for an Independent Third Party Review of Regional Claim Centres Allocation and Specified Allocation Functions

TIME FRAME

Based on the ITP being finally retained on or before early July 2009, the ITP's review will begin in September 2009 and conclude no later than October 31, 2009. ICBC expects that the review will take approximately two weeks of actual work time over a two month period, depending on the availability of ICBC personnel and the ITP.

The ITP will report its findings and any recommendations to the Commission and ICBC by November 30, 2009.