Cushions, Comfort and Accountability: Regulatory Independence and Captive Rate Payers

Closing Submissions of the Public Interest Law Centre on Behalf of CAC Manitoba

October 31, 2018

Part 1: Irony

An Ironic Application

- MPI seeks a $20 M rate cushion (the CMP) during the same GRA it announces a $20 M write-off of imprudent information technology expenditures
- A monopoly that claims a commitment to fiscal prudence calculates the $20 M CMP via a MCT target that expressly provides an eight figure cushion for “inadequate or failed internal processes”
- A crown monopoly entering a “new age” of accountability and transparency presents an “It Wasn’t Me” information technology panel

The Irony is Not Lost on our Clients

- External experts who consumers trust to be independent forego basic elements of a "fulsome" NPV calculation (Gartners) or allow their best estimates of future interest rates to be materially suborned by their client's choices (Mercers)
- A crown monopoly which professes a low risk tolerance for its investment decisions assumes away long term inflation and real interest rate risk in the portfolio generally and the bond portfolio specifically without testing the consequences of its decisions (failing to test for "material" tracking error and choosing not to undertake the stress tests recommended by Mercers)
- An era of "operational independence" and freedom from "political interference" for Manitoba Crowns is accompanied by overt hints to the PUB that it should follow the wishes of the MPI Board and the Government exercising its independent rate setting function (CAC Exhibit 18 and CAC Exhibit)

Crown Monopolies and Captive Ratepayers

- Basic and extension consumers – highly vulnerable:
  - Statutory monopoly basic
  - De facto market dominance extension

Efficiency Signals are Muted for Crown Monopolies

Two key consequences of Crown Monopoly:

1. Consumer choice is effectively nullified
2. Efficiency signals are muted for a crown monopoly as compared to publicly traded, private sector companies in a competitive marketplace:
   a) No risk of ratepayer flight – unlike OSFI regulated entities (Graham, 216)
   b) No efficiency signals sent through price of shares in the marketplace (Graham, 217)
   c) Sole shareholder subject to many political pressures

Ratepayers rely upon their independent regulator

- To ensure that monopoly power is not abused through unjust and unreasonable rates
- To send the efficiency signals that the market place cannot

Regulatory Independence and Monopoly

- The Public Utilities Board of Manitoba (PUB) is an **independent, quasi-judicial administrative tribunal** (http://pubmanitoba.ca/v1/about-pub/index.html) (See also Graham 218-219)
- No change in rates for services shall be made and no new rates for services shall be introduced without the approval of The Public Utilities Board (CCGAA, 25(1))
- *The Public Utilities Board Act* applies with any necessary changes to a review pursuant to this Part of rates for services (CCGAA, 25(3))
- The board may, by order in writing after notice to, and hearing of, the parties interested fix just and reasonable rates (PUB, s. 77a)

The Just and Reasonable Standard

- The Board has characterized the key elements of its independent review function and rate-setting role as follows:
  - Ensuring that forecasts are reasonably reliable;
  - Ensuring that actual and projected costs incurred are necessary and prudent;
  - Assessing the reasonable revenue needs of an applicant in the context of its overall general health;
  - Determining an appropriate allocation of costs between classes; and
  - Setting just and reasonable rates in accordance with statutory objectives. (Order 98/14, p.28)

The Puzzling Case Theory of Manitoba Public Insurance

- Forgive us for the myriad and expensive challenges in the management of complex claims and information technology projects because we acknowledge past mistakes
- Insulate us from accountability for future mistakes by giving us a $20 M rate cushion notwithstanding provincial concerns with fiscal prudence
- Give us a cushion for stable rates as we define them because the provincial government has concerns about net income volatility
- Take a hands off approach to the investment portfolio because our Board claims to have low risk tolerance

Crowns are entitled to make imprudent mistakes:

- To rely on BI3 technology and take a passive approach to complex claims management
- To have IT staffing levels far higher than the industry average
- To enter into lengthy information technology adventures relating to Physical Damage Re-engineering (including CCRS) without appropriate business cases and without disclosing material information to external third party advisor who with the Public Utilities Board and consumers are trusting to provide "independent" advice
- To assume away real interest rate risk in the design of its minimum risk portfolio (nominal liability benchmark) without testing for tracking error or undertaking stress tests recommended by its external third party advisor
- To cherry pick an interest rate forecast other than the preferred estimate of its external third party advisor

But the PUB is not obliged to pass those costs on to ratepayers

- The independent regulatory is not obliged:
  - To build a cushion for imprudence into the rates; or
  - To pass on imprudent and unreasonable costs on to ratepayers

Outline of Submissions

- Implication of Rate Application for individual consumers
- Ensuring that forecasts are reasonably reliable;
- Ensuring that actual and projected costs incurred are necessary and prudent;
- Assessing the reasonable revenue needs of an applicant in the context of its overall general health;
- Determining an appropriate allocation of costs between classes; and
- Moving forward on consumer engagement
- Setting just and reasonable rates in accordance with statutory objectives (Order 98/14, p.28).

Part 2: Implications of the Rate Application for Individual Consumers

Price and Value Proposition for MB Ratepayers

- Price related variables have strong impact in the value proposition for MB ratepayers (Oct 18, Giesbrecht, 848)
- The strongest driver is stable and fair rates (Oct 18, Giesbrecht, 848)
- But MPI has not explored how Manitobans define stable rates (Giesbrecht, 840-841) and whether the concern relates to the individual ratepayer or on average (Oct 18, Giesbrecht, 847)
- Another important driver of the value proposition is the cost of vehicle insurance (Oct 18, Giesbrecht, 848-849)

MPI has no formal definition of rate shock despite the avowed purpose of the RSR – Five Percent as a Proxy for Rate Shock

- We put 5 percent in the DCAT. So the only kind of guidance I have is that those DCAT assumptions (Johnston, 877-878)

Rate Shock is an Individual Experience not an Average

- *But I'm not going to pretend that, you know, 5 percent or a hundred dollar increase for a customer isn't a – tough for them to swallow* (Johnston, 838)
- *So I would guess that consumers are most – more concerned about their own bills* (Johnston, 839)

Rates for 300,000 vehicles will increase over 5%

- Almost 290,000 vehicles or 25 percent of the vehicle population will experience a premium increase of between 5 and 10 percent
- Another 40,000 vehicles will experience increases of between 10 to 15 percent
- Whether one looks in terms of the percent change over 5% or premium increases over $50 that accounts for over 25 percent of vehicles

(Johnston, 834-836)

The CMP is making a significant contribution to rate shock

- *Let's say we didn't do the capital maintenance provision which maybe what you're interested in, would all shift down by 2 percent essentially* (Johnston, 837)

Recommended Findings

- Rate shock is an individual experience, not an average
- Over 300,000 vehicles will experience rate shock level increases if the rate application is approved with the CMP load being a significant factor

Part 3: Ensuring that forecasts are reasonably reliable

Interest Rates – has MPI met its onus?

What change in circumstance or new evidence is the Corporation aware of that would support its position in the use of the naïve interest rate forecast?

(BRIEF PAUSE)

MR. LUKE JOHNSTON: <u>I'm struggling with the right answer</u> to – like, how to give this answer, but like our is – is responsible for all the forecasting, not – not the banks

,,,,

Mr. MARK GIESBRECHT:….<u>there is not really any significant changes</u> maybe in the environment of the marketplace…(McCandless to Johnston, Giesbrecht 365-367, emphasis added)

CAC Manitoba begs to differ

- There has been further changes in marketplace which cast additional doubt on the naïve interest rate forecast:
  a) Rapid US Growth (CAC 14)
  b) Bank of Canada rate has moved upwards five times in the last two years and twice in the last four months (CAC 26, slide 13)
  c) Canadian economy approaching full capacity (Simpson, 1314-1315)
  d) Lowered trade tension with US
  e) Bank of Canada concern about inflation more palpable as is its willingness to increase rates (Simpson, 1314-1315)

Dr. Simpson on the Material Change of Circumstances

Do you believe then that this latest pattern is a meaningful departure from that of the earlier periods?

DR. WAYNE SIMPSON: Yes, I think there's no question in the sense that the long period of a low policy rate and low interest rates has ended and the last two (2) years the period where the – the overnight rate or policy rate has begun to rise. The economy has moved – moved towards capacity and listening to the latest comments by the Bank of Canada Governor, Stephen Poloz, is pretty much considered to be at capacity now and <u>inflationary pressures are beginning to drive concerns that interest rates need to be higher</u> (Watchman to Simpson, 1314-1315, emphasis added)

The Material Change in Circumstances Reflected in Recent Forecasting Results

Here are the last two (2) years, the 2017/18 GRAs, the <u>SIRF has clearly outperformed the naïve</u> forecast which you would expect because this is the period when interest rates have begun to recover in the fashion that's been predicted for a long period of time by the SIRF and the results of that is going to be that naïve forecast is going to be an understatement of interest rates

…

So not only has the naïve forecast being considerably – the errors have been considerable larger, the forecast errors, but they've also been consistently in the direction of underestimating interest rate growth as the economy recovers

(Simpson, 1202-1203, emphasis added)

MPI Advisors on Interest Rates

- Only Cleary (2016) has spoken to rate forecasting

<u>Cleary</u>

Dr. Cleary's advice was 50/50 (Bunston, 671) (CAC Exhibit 15, slides 17 & 18)

<u>Cheng</u>

Mr. Cheng confirmed that his opinion on the use of the naïve forecast was in the context of a DCAT investigation of Basic satisfactory financial condition and specifically not on a Basic rate setting context (Johnston, 355-356)

Mercer rejects a naïve forecast for asset liability modelling

Dr. Byron Williams: In doing an analysis like this, as opposed to using the forward curve or the standard interest rate forecast, Mercers would not recommend using – doing such analysis – analysis, assuming that interest rates stayed flat?

MR. DAVID MAKARCHUK: <u>We would not recommend doing analysis, assuming interest rates stay flat or constant</u>

DR. BYRON WILLIAMS: Why not?

MR. DAVID MAKARCHUK: The curve is made up of many different points, our expectation – our standard interest rate forecast, which all of our investment professionals or actuarial professionals across Canada use are based on our national assumptions. They were part of the package. We assume as a firm that there will be a gentle rise in the yield curve over the next few years returning to equilibrium, at some point, that's our firms view (Williams to Makarchuk, 649, emphasis added)

Dr. Simpson’s Recommendation

The SIRF is better than the naïve forecast, and that it should be part of the interest rate forecast and that existing Board order for 50/50 is certainly better than the naïve for that reason (Simpson, 1256)

Responding to the existing conditions, which is, is the Board Order for 50/50. And perhaps a little bit of caution, as I said in presentation, if I were allowed to pick weights, that they probably wouldn’t be 50/50. But I would give more weight to the SIRF than the naïve (Simpson, 1257-1258)

When I wrote this it was slightly less apparent to me that events were moving towards a higher – immediate higher interest rates. Since then, we’ve had an actual rate increase. We’ve had some very good economic news in terms of growth an unemployment. We’ve also had some news that inflation is beginning to push the 3 percent boundary, at least the consumer price index. And so that information wasn’t available to me at the time, I suspect – I can say that if I wrote this today I would – I would argue for the standard interest rate forecast rather than the 50/50 (Simpson, 1320-1321)

Care should be taken with claims that MPI undertook a vigorous response to interest rate risk

- MPI was ill equipped from a financial modelling perspective to confront the great recession and unexpected changes to interest rates
- MPI didn't even have the capability to model interest rate impacts, and that was a concern of the PUB and MPI (Johnston, 661)

MPI had to be Pushed by the PUB

- It is reasonable to conclude that over a number of years the PUB had to push MPI:
  a) To address the asset/liability mismatch
  b) To cease gambling on the mismatch in the hopes that interest rates would rise
  c) To improve protection for basic as opposed to corporate
  d) To provide a proper ALM study rather than the compromised AON study
  e) To provide a new ALM study (Mercer) on a timely basis (CAC Exhibit 16)

PUB Concerns 2013-2017

- **2013**
  - Order 151-13 expressed the view that Corporation's current approach to duration mismatching was making it too vulnerable to interest rate risk (Johnston, 663)
- **2014**
  - Order 135-14 advised MPI to seek to substantially immunize itself from the impact of changing interest rates (Johnston, 663)
- **2016**
  - Order 162/16 – ongoing concern with exposure to interest rate risk of Manitoba Public Insurance (Johnston, 664) especially as it relates to Basic (Johnston, 664)
- **2017**
  - Order 130/17 – concern with continued exposure to interest rate risk and a view that an ALM study should be conducted more frequently (Johnston, 665)
  - Manitoba Public Insurance did not file an updated asset liability matching study (Johnston, 665)

Recommended Finding

- MPI has not discharged its onus to demonstrate that the naïve forecast should replace the 50/50 forecast for rate setting purposes
- A material change in circumstances over the last two years suggests that greater reliance should be placed on the SIRF than the naïve forecast

Part 4: Ensuring that actual and projected costs incurred are necessary and prudent

Critical Issues of Prudence and Reasonableness

a) Is the proposed MPI investment portfolio for basic and pensions biased in favour of short-term rate stability at a risk of higher long-term rate instability and the cost of lower average rate level?

b) Are MPI ratepayers facing current and ongoing rate pressures as a consequence of the corporation's passive approach to long term claims management in the aftermath of BI3?

c) Are information technology staffing budget levels excessive as compared to relevant peers?

d) Did MPI imprudently manage large information technology projects related to Physical Damage Re-engineering and the Customer Claims Reporting Service?

4) a) Asset Liability Matching

Liability Risk: Cash flows well beyond 10 years – Viola – Mercer and Johnson agree

- A lot of the cash flows we're worried about are longer than ten years - *roughly half of them are shorter than ten (10) years, and roughly half of them are longer than ten* (10) - some claimants are still quite young, probably some could be as long as fifty years (MAKARCHUK, 639/40)
- Forty eight percent of total ultimate paid for accident benefits, weekly indemnity (indexed) extends beyond ten years (Johnston, 640-641)
- Thirty nine percent of the total ultimate paid accident benefit other indexed ten (10) years and beyond (Johnston, Oct 17, 640-641)

Liability Risk: Many long lived liabilities linked to inflation – Viola, Makarchuck and Johnston agree

Much of the obligation -- many of the obligations were linked to future inflation (Makarchuck, 313)

a significant portion would be tied to Manitoba's CPI, but there's other benefits that are tied to industrial average wage, but I would say the -- the vast majority would be Manitoba's -- like, so, income replacement benefits indexation (Johnston, 480-481)

Viola, Mercer, and CPPIB agree that Minimum Risk (Liability Benchmark) Portfolios are a critical first step

- Determining Minimum Risk Portfolio (MRP) is first step (i.e., Liability Benchmark Portfolio (LBP) composition) (CAC Exhibit 28, slide 11)
- MRP: benchmark for RANVA* (e.g., Scotia Capital RRB Index at CPPIB*), (CAC Exhibit 28, slide 161)
- One element is the development of a liability benchmark portfolio as a proxy for liabilities to identify and measure the risks [MAKARCHUK, p. 641-642]

*Risk adjusted net value added

The Purpose of developing a liability benchmark is to identify and measure the risk of the liabilities

- “Risk-free” assets (LBP) should reflect risks in liabilities (e.g., duration, inflation) (CAC Exhibit 28, slide 14)
- Liability benchmark portfolio is for “the purpose of identifying and measuring risk” (MAKARCHUK, p. 624)

The Liability Portfolio is not an investment decision – it is a reflection of reality

- We were trying to find a liability benchmark that best represented the obligation (MAKARCHUK, p. 625)

Do not conflate the design of the Liability benchmark with the ultimate portfolio selected

- LBP Composition should not depend on Capital Market Expectations (CAC Exhibit 28, slide 5)
- The ultimate choice in optimizing the portfolio may be not to invest in the same assets as those in the liability benchmark portfolio (MAKARCHUK, Oct 17, p. 641-642)

DR. BYRON WILLIAMS: And so it's important to maintain analytic distinction between those two (2) steps, sir?

MR. DAVID MAKARCHUK: Right. The liability and modeling decision is separate from the asset class investment decisions. (MAKARCHUK, Oct 17, p. 641-642)

The Liability Benchmark is Critical to the Outcome of the Optimizing Exercise

MR. DAVID MAKARCHUK: The liability benchmark is an important foundation for the discussion of an optimized portfolio (MAKARCHUK, Oct 17, p. 641-642)

The optimal asset allocations that flow from an optimizing process depends materially on whether a nominal or real liability benchmark is selected **(not a direct quote but there is information on this from Monday)**

(Viola)

Risk has been misidentified and mismeasured in the nominal liability portfolio

- BIG SIMPLIFICATIONS BY BOTH MPI AND MERCER:
  - MPI: based ... low risk assessment of inflation primarily upon ... expected level rather than ... volatility of inflation (CAC (MPI) 2-2);
  - Mercer: support to "hedge nominal ... risk before ... real ... driven more by ...views on ... expected level of future inflation than ... volatility" (CAC (MPI) 2-4)
  - But risk depends on volatilities and correlations (not levels/averages);
  - A 4.5% tracking error from simplification is material as admitted by Mercers (CAC/MPI 2-3)
  - Especially given MPI's low risk tolerance (i.e., 4.5% error ~ 3.8% volatility or risk = 118% difference) (CAC Exhibit 28, slide 12)

Assuming away risk does not mean less risk

By not capturing this inflation risk properly we're not properly measuring the true risk of having nominal bonds support real liabilities. (Viola, 1460)

MPI's process for defining contents of "Risk-free Bucket" very questionable (CAC Exhibit 28, slide 14)

In the context of a inflation linked asset of long duration, Ontario Teachers concludes:

Main source of liability risk is a drop in real interest rates (CAC Exhibit 28, slide 17)

Modeling liabilities is not an investment choice

MR. STEVE SCARFONE: And one (1) of the decisions, as we've heard, that had to be made before selecting asset classes for the Basic claim liability portfolio, was whether to model the liabilities using a real liability benchmark versus using a nominal liability benchmark.

That too was an investment decision.

MR. VALTER VIOLA: I disagree.

MR. STEVE SCARFONE: Okay. You won't go with me on that one?

MR. VALTER VIOLA: That goes back to the framework, I would suggest. It's -- it's -- in my words, the liabilities are what they are, regardless of how you decide to take risk in relation to them. (Viola, 1516)

The Focus on Nominal Interest Rate Risk misses the Greater Risk of Real Interest Rate Risk and long term inflation risk

Changes in real yields –
important because of longer horizon

Longer duration fixed income portfolio –
if inflation is higher than expected or real yields do not behave the same way, nominal bonds will do poorly in that environment (Viola, Oct 30)

Policy focused more on shorter-horizon and inflation component (less risky), rather than capital gain/duration effects from longer-term changes related to both inflation and changing "real" interest rates ("really" risky)

FOCUS/PROCESS CONCERN

- Policy focused more on shorter-horizon and inflation component (less risky), rather than capital gain/duration effects from longer-term changes related to both inflation and changing "real" interest rates ("really" risky)
- Like focusing on dividend yield component of stock returns (low and stable), rather than capital gain component (larger and more volatile), per below

nominal yield	~	real yield	+	inflation	(2): Fisher Equation
return on stocks	=	capital gain (loss)	+	dividend yield	(4): Dividend Discount Model ("DDM")
		↑ **"Really"** Risky		↑ **Less** Risky	

Like focusing on dividend yield component of stock returns (low and stable), rather than capital gain component (larger and more volatile),

Tracking Error not Considered

- The tracking error or the variation in future returns between the nominal liability benchmark and the real Liability benchmark as summarized via the anticipated volatility (MAKARCHUK, Oct 15, 644)
- *I don't believe we specifically calculated the difference in the volatility between the two* (MAKARCHUK, Oct 15, 645)
- Tracking error not analyzed until response to CAC 2-3
- Focusing on the long term risk associated with inflation linked assets MPI is taking a material gamble in the design of a liability benchmark portfolio by ignoring real interest rate risk and long term inflation risk

Due Diligence Stress Tests not Undertaken

Mercer provided the following response:

On review of our file notes, the stress tests outlined on Slide 24 of Appendix 17, Attachment A were discussed following the November 8, 2017 meeting. Due to time constraints, it was agreed on November 22, 2017 to first proceed with the following 3 scenarios.

- 1. Market Correction: 33% decline in equity return, decline in yields
- 2. Inflation Shock: High inflation, higher yields and lower P/E Ratios
- 6. Deflation

Unfortunately, we were unable to complete the stress tests in advance of the Investment Committee meeting on November 28, 2017. Our modeler indicated that there were quality control issues with the first three stress tests on November 28, 2017. Given that the investment committee meeting had occurred and given concerns regarding overall modeling costs, peer review of the results was not completed and the results were not finalized. (MPI Exhibit 44)

Sophisticated Porfolios are not afraid of Real Return Bonds

- Teachers' long standing commitment between 16 and 19 percent over recent years (Exhibit 28, Exhibit 29)
- SAAQ investment portfolio about 10 percent in real return bonds (Johnston, 650)
- If an investor wants to guarantee a real return then -- and a real return bond is an excellent way to ensure that they get that real return, that after inflation return. (Makarchuk, 612-613)
- If an investor indicated to me that protecting themselves to inflation risk was a priority, my first recommendation would be real return bonds as a starting point. (Makarchuk, 481)

Based upon a proper measurement of risk – real return bonds significantly improve performance at lower levels of risk

Assuming a real liability benchmark for modelling removing Real Return Bonds significantly reduces an opportunity for improvement at lower risk levels (MPI Exhibit 15, p. 12)

At “current” risk levels Mercer’s efficient frontier suggests that the expected excess return above the Liability Benchmark drops by ~ 0.8% when RRBs are removed (CAC Exhibit 28, slide 36)

When I see break-even inflation of something south of two (2), that means that if you actually get inflation of two (2), which is what the Bank of Canada assumes, you're actually doing better by buying the real return bonds, as I understand their definition of break-even. So while it's not turning 4 percent or 5 percent real, it's the spread between nominal that matters, and the break-even tells you that issue. And it -- to me it looks like it's not a huge cost for taking risk off the table and taking it elsewhere, and getting better returns. (Viola, 1564-65)

MPI is gambling that Mercer's preferred interest rate forecast is wrong

Mercer's standard interest rate forecast not accepted by MPI

Forecast based upon the forward curve was substituted (Makarchuck, 646)

Use of Mercer's standard interest rate forecast resulted in capital losses for the fixed income holdings.

Agreed?

MR. DAVID MAKARCHUK: Correct. (MAKARCHUK, 646)

MPI is gambling that Mercer's preferred interest rate forecast is wrong

The curve is made up of many different points, our expectation -- our standard interest rate forecast, which all of our investment professionals or actuarial professionals across Canada use are based on our national assumptions. We assume as a firm that there will be a gentle rise in the yield curve over the next few years returning to equilibrium, at some point, that's our firm view (Makarchuk, 649)

Expected 10 year return of nominal liability portfolio assuming Mercers assumption is 2.1 (Bunston, 1382-1384)

Expected 10 year return of nominal liability portfolio with MPI substituted view 2.8 (Bunston, 1382-1384)

A 33% difference in expected outcomes (.7/2.1) due to rejected of external experts' preferred view

Viola's Ultimate Assessment – the MPI "risk free" bucket has material risk over the long term

Two key challenges

a) the Minimum Risk Portfolio is fundamentally compromised by a misidentification and mis-estimate of risk - No RRBs in Liability Benchmark Portfolio (LBP) - understates risk of inflation and real interest rate risk - Makes duration management less effective

b) LBP Composition was compromised by Capital Market Expectations – liabilities define themselves – they are not a function of risk tolerance - LBP: long term and inflation-sensitive - decision to accept or hedge risk quite separate (CAC 28, slide 5)

But I think it's questionable, very questionable, to link your forecast about inflation, either the level or the volatility, with how you define what that risky bucket is. (Viola, 1435-1436)

The MPI bucket is a risky bucket over the long term

Any constraint shifts the curve (Viola, 1528-1529, emphasis added)

Elements of higher risk

No Real Return Bonds leads to poor liability protection against unexpected inflation, real rate risk and less effective duration management

The real risk for an inflation sensitive portfolio with roughly half its liabilities beyond 10 years is not 3 percent inflation for four years but less amounts over a longer duration (modelling assumption is appropriate for DCAT given time duration and purpose of RSR – not appropriate for analyzing risks to portfolio)

Fewer Real Assets (real estate, infrastructure) yields less diversification

Real rate risk, inflation risk, credit risk and, some illiquidity risk concentrated in Fixed Income (CAC 28, slide 5)

From a total portfolio perspective, low-risk assets and really risky assets together usually give -- not usually, they do give better risk return trade-offs than being concentrated in either one (1) bucket -- within a bucket, a risky bucket (Viola, 1435-1436, emphasis added)

Short term focus at the expense of long term risk and long term rates

Short-term Rate Stability at cost of long-term opportunity and at risk of higher long-term rate instability (CAC 28, slide 5)

We noted that there seemed to be a focus more on the short-term, as opposed to the long- term, and -- and particular concern about rate stability at the expense of a longer-term horizon that perhaps had a focus of the full portfolio <u>designed to mitigate longer horizon risks and get higher returns</u> by taking different kinds of risks in a prudent fashion (Viola, 1397, emphasis added)

I would be worried about a lesser change but sustained for longer period of time (Viola, Oct 30 Tr)

MPI has not demonstrated mastery of investment issues

- MPI explanation of modelling exercise in rebuttal is contradicted by Mercer analysis - the inflation volatility assumption of 2.6% is implicitly related to the capital market volatility assumptions outlined in Appendix 17, Attachment C (in particular, page 18) for each asset class (Viola, Oct 30) (MPI Exhibit 38)

MPI has not demonstrated mastery of investment issues

DR. BYRON WILLIAMS: Thank you. And, sir, in your initial affidavit you had suggested that the ra -- rejected portfolio really being the real liability benchmark had a much higher risk of 3 perfect; agreed?

MR. GLENN BUNSTON: Agreed.

DR. BYRON WILLIAMS: And you subsequently amended that assessment to suggest that the real liability benchmark showed a risk of 0 percent; agreed?

MR. GLENN BUNSTON: Correct.

DR. BYRON WILLIAMS: And, sir, with that amended information when you compared the -- in this affidavit being paragraph 3, the estimated risk of the real liability benchmark of 0 percent as against the risk of the nominal portfolio selected of 1.32 percent, you concluded that the risk related to the real liability benchmark was lower?

MR. GLENN BUNSTON: It is lower, yes.

DR. BYRON WILLIAMS: Sir, just directing your attention to paragraph 5 for a second. Here again, sir, you're clarifying and correcting your suggestion that the MPI selected portfolio had lower risk when it -- what you're suggesting here, in fact, it had higher risk?

MR. GLENN BUNSTON: That's correct. (Bunston, 610-611)

Assessment of Expertise:

Viola

- Many of 2016 recommendations adopted
- Teachers and CPIB – among most sophisticated
- Highly regarded North American practice

Mercer

- Reasonable qualifications
- Role circumscribed
- Best estimate of future interest rates rejected
- Did not test for tracking error
- Scenario testing not undertaken
- Compromised by assuming away inflation risk and real interest rate risk based upon inflation level rather than inflation volatility

MPI Board

- Constrained inputs – constrained outputs (return/risk tradeoffs)
- Not qualified for this proceeding as experts or subject to testing of views

Asset Liability Management – A Significant Gamble

- Without even testing for tracking error between nominal and real liability benchmarks or undertaking scenario testing, assume away interest rate risk
- Substitute its judgement for best judgement of Mercer on interest rates

Recommended Findings

- ALM was not conducted in a reasonable and prudent manner:
  Assumptions:
  - It is not prudent to assume away inflation risk in the liabilities
  - It is not prudent to fail to even test for tracking error (basis risk) between the real and nominal benchmark portfolios
  - It is not prudent to conflate the purpose of Liability Benchmark and to insert capital market assumptions into the Liability Benchmark
    It is not prudent to fail to undertake risk scenarios for your ALM

  Characterization or Construction:
  - It is not prudent to substitute your opinion for the best estimates of your experts regarding future interest rates
  - It is not prudent to concentrate risk (i.e. inflation, credit risk and illiquidity) within fixed income in the Basic portfolio, rather than to diversify the sources of risk (real assets as well as equities)
- There are significant risks of long term rate instability as well as the likely prospect of lower returns associated with MPI's proposed asset allocations resulting from the ALM process

4 b) Are MPI ratepayers facing current and ongoing rate pressures as a consequence of the corporation's passive approach to long term claims management in the aftermath of BI3?

Adverse Experience on Long Term Claims

- Corporation is experiencing adverse experiences in the post-BI3 era in terms of claims that are longer than twenty-four (24) months (Johnston 852-853)
- Growth in retained claims has been occurring since 2008. Influences include the implementation of BI3, a reduction in staff, and challenges with complex claims
- Claims with psychological factors have increased by 10% from 2009 to 2016 (Appendix to CAC 1-36 a)

Challenges in claims management and reserving flowed from BI 3 initiative

- Claims staff cut, not proactive in recoveries (CAC 1-36, Appendix, slide 8,)

There are ongoing costs to adverse claims

- Claims that lasts longer, whether through anyone's fault or not, all other things being equal, that means more costs to the Corporation, (Johnston 853)

Passive Claims Management

Corporation believes incremental claims costs were incurred as a result of reducing case management employee base and the process changes, that created a more passive approach to injury management since 2010 (CAC 1-57 c) (See also Johnston, 854)

There was very clear evidence that there were less employees in this area number of positions eliminated immediately on implementation of the system in 2010, and there some under -- other indicators that indicate that a more passive strategy, or less -- or the opposite, less aggressive claims management strategy was being employed at that time. (Johnston 854)

Passive Claims Management Affects Claims Retention and Costs

- Complex claims were only being actively managed in the later stages of the claim (Johnston, 862)
- The idea if you don't get on these claims early and immediately they will become issues. (Johnston, 862)
- Not getting on the claims early affects claim retention and there is a cost to claims retention (Johnston 862)

Challenges with Complex Case Management Skill Set

- Majority of current case managers come from physical damage, primarily adjusters and are ill-equipped to manage the complexity of claims (Appendix to CAC 1-36 a)

MPI Still Struggling with Complex Claims Closure Rates

Despite efforts to improve complex claims management:

> *I can tell you that at least in the area I'm most concern with the -- the longer term, I'm not seeing any substantial improvements, at least to date.* (Johnston, 863)

A Benchmarking Framework is Being Created

- A more formal kind of monitoring compliance, benchmarking framework is being created
- Which Manitoba Public Insurance would be in a position to share that for the purposes of the next General Rate Application (Johnston 865-866)

Recommended Findings

- MPI ratepayers are facing current and ongoing rate pressures as a consequence of the corporation's passive approach to long term claims management in the aftermath of BI3

Complex Claim Recommendations

That:

- MPI provide an update for the next General Rate Application on steps to improve the handling of complex claims and status of complex claims as measured against pre-BI3 benchmarks or existing benchmarks
- MPI provide the complex claim or PIPP claim benchmarking framework discussed at transcript 865-866 as part of its next GRA filing

4 c) Are information technology staffing budgets excessive as compared to relevant peers?

- MPI spends 62 percent of the IT budget on personnel, as compared to 45 percent for peers
- 32 percent of MPI IT staff is made up of contractors versus 24 percent for the peers (Lazarko, 1064)

Recommended finding

That:

- As compared to peers, MPI information technology staffing budgets appear excessive

4) d) Did MPI imprudently manage large information technology projects related to Physical Damage Re-engineering and the Customer Claims Reporting Service?

Modern Value Management Principles are not Rocket Science

- *us adopting a bit more an industry standard approach to how ops will actually work on some of these projects and -- and work with our IT groups* (Wennberg, 975-976)

- *all big projects now go through some expected rigour where we look internally for all costs and all benefits to be -- to be explicit* (Wennberg, 909-910)

- *MPI exec management have to be accountable for the NPV integrity* (Wennberg, 912)

Failed Projects have real impacts on retained earnings, foregone opportunities and wasted ratepayer money

WILLIAMS: […] You recall a conversation you had with the Chairperson regarding the impairment of deferred development costs in the range of $20 million?

MS. CYNTHIA CAMPBELL: Yes.

DR. BYRON WILLIAMS: And following that impairment those items are no longer assets of Manitoba Public Insurance; agreed?

MS. CYNTHIA CAMPBELL: Correct.

DR. BYRON WILLIAMS: And, in essence, that is reflected in a writeoff or reduction of equity, correct?

MS. CYNTHIA CAMPBELL: Correct. (Campbell, 832-833)

CCRS is a failed project

MS. KATHLEEN MCCANDLESS: And so I understand that if MPI determined that there was no future value related to the expenditure, or if the expenditure rate -- rate -- related to investigative platform or software the company had decided not to go forward with then it was part of the -- the differed or the impairment, yes?

MR. JOHN REMILLARD: Correct.

…

MS. KATHLEEN MCCANDLESS: And the vast majority of the writeoff at line 4 relates to customer claims reporting system, yes?

MR. JOHN REMILLARD: It does, yes.

MS. KATHLEEN MCCANDLESS: That's $15.6 million for the record, yes?

MR. JOHN REMILLARD: Correct (Remillard, 1046-47)

PDR - a very deep negative

- MR. CURTIS WENNBERG: *PDR -- the overall PDR is -- is a $65 million project. I'd say the core of it was moving off a paper basis of estimating and faxes -- we're getting faxes back and forth from our repair shops, and that just didn't make sense…*

- *And this is easy to say as an armchair quarterback a few years later down into the road of this project, but -- but that's probably the summary of it, that the overall, it's a -- it's a very deep negative.*

(Wennberg, 918-919)

The $81 Premium is Unreasonable

- This type of premium payment is not undertaken by other Crown or private jurisdictions; (Wennberg, 1145-1146)
- While other Crown and private jurisdictions preceded MPI in implementing similar programs, they did so without similar premium payments. (PUB (MPI) 2-29)
- industry standard is not to pay a premium for this type of estimating service (PUB 1-67)

Lost Opportunities - we are still waiting on a CARS legacy project

We should update our system. It is in dire need. (Graham, 119)

DR. BYRON WILLIAMS: And what this -- MPI had also undertook a -- a fit assessment with FINEOS to determine it's fit both for a first notice of loss application, as well as replacement of the C-A-R-S, CARS, legacy system replacement; agreed?

MR. JOHN REMILLARD: At that time, that's correct.

- (Remillard, 1119-1120)

CARS replacement was to be almost half of initial PDR budget?

DR. BYRON WILLIAMS: And if we go out to the extreme right we'll see that the estimate for -- for optimized adjusting at that point in time was around $32.6 million, sir?

MR. JOHN REMILLARD: Correct.

DR. BYRON WILLIAMS: Almost half of the total project cost?

MR. JOHN REMILLARD: Agreed. (Remillard, 1120-1121)

Consensus that Operating Costs should be included in a NPV Calculation for IT projects

Henry

but yes, to be a fulsome NPV analysis it -- it should include the ongoing operating costs. (Henry, 1133-1134)

Graham

THE CHAIRPERSON: We just heard that the business case didn't include operating costs. From your experience was that something you saw as normal, or did you find that surprising?

MR. BEN GRAHAM: I would find that surprising. (Graham, 1149-1150)

Bunko

in my mind a -- a full business case needs to include all the associated initiative and ongoing costs for the program. (Bunko, 950-951)

Major Capital Projects did not include an evaluation of operating costs as part of the evaluation of the total costs of operation

- *With respect to business cases. I guess the -- the difficulty or -- in answering that question is that right or wrong, we weren't incorporating those [operational] costs.*

(Remillard, 971-972)

Operational Costs were not included in the PDR NPV Analysis of Gartner Group

MS. KATHLEEN MCCANDLESS: So with -- with that in mind, having review those two (2) Board Orders, it appears then that MPI or Gartner did not include the cost of operating and maintaining the PDR program in the -- in the two (2) analyses filed previously to the one that you authored; is that right?

MR. CHARLES HENRY: Yeah, correct. (Henry, 1018-1020)

Should Gartner group have filed a NPV analysis to the PUB knowing that a fundamental building block was missing?

Gartner acknowledges

- *the lesson learned for us is that we should have been much clearer in our conclusions that the high level numbers showed, you know, the 13.7 million NPV, but that further analysis was required, and we should have been stronger in making the point* (Henry, 1025-1026)

Gartner evaluations went from positive in 2016 and 2017 to highly negative

- *So obviously, there's a significant difference in some of the costs, and the benefits, and the overall NPV. And there's three (3) things: Obviously, some cost that should have been attributed to PDR in the past weren't.*

- *Secondly, that new evidence shows that some of the benefits of the PDR were -- are going to be lower than what was projected.*

- *And thirdly, that MPI's using this 6 1/2 or 9 1/2 percent discount rate, 9 1/2 percent for high risk projects, and that causes the NPV numbers to change. So those are the -- kind of the three (3) big changes between our '17 analysis and MPI's '18 analysis.*

  (Henry, 931)

A Failure to Identify and Disclose Relevant Information to the Third Party Evaluator

THE CHAIRPERSON: Mr. Henry, Gartner, in your testimony, Gartner said -- Gartner -- sorry. In your testimony, you indicated Gartner didn't receive requested details.

MR. CHARLES HENRY: Correct.

THE CHAIRPERSON: You also said that Gartner was not aware of some of the ongoing costs, is that correct?

MR. CHARLES HENRY: That's correct.

THE CHAIRPERSON: Further, you weren't aware of the eighty-one dollar ($81) premium.

MR. CHARLES HENRY: In 2017, that's correct.

(Henry, 1154-1155)

Who was responsible for the failure to provide the needed information to Gartner Group

MS. KATHLEEN MCCANDLESS: So it's a -- it was the responsibility and continues to be the responsibility of MPI to provide the information that Gartner requires?

MR. CHARLES HENRY: Correct.

(Henry, 1025-1026)

The Explanation for Non-Compliance

THE CHAIRPERSON: If I could ask MPI, and I don't know -- I don't know if it's Mr. Bunko or Mr. Remillard, why was Gartner not provided that information? The requested details, ongoing costs, included eighty-one dollar ($81) premium impending CCRS decision. Those are pretty big items.

. . .

Mr. Remillard:

. . .

Ultimately, when we looked at our -- our business case for PDR at that time, we were very benefit stream oriented. Right or wrong, that was how we were measuring success. We did have some of the costs in the background available to us. Ultimately, there was some contractual aspects of the licensing agreements that at that time didn't allow us to -- to share it. We were trying to -- to work on that. Could that have been expedited? Potentially, sir.

(Remillard, 1155-1157)

It is difficult to reconcile the Corporate response on PDR (including CCRS) with the warnings of the PUB and Stakeholders

2015

DR. BYRON WILLIAMS: And, sir, would it be fair to say that before Gartner did its first report, i.e., the 2016 Report, concerns were being expressed about the PDR business case by the Public Utilities Board? Would that how you -- would that be how you interpret the decision, sir?

MR. BRAD BUNKO: I do see you requesting definitely more analysis on the project (Bunko, 1125)

. . .

DR. BYRON WILLIAMS: So does that mean, sir, you were not concerned with the status of PDR in terms of the feasibility of its business case [in 2015]?

MR. BRAD BUNKO: That's correct. (Bunko, 1126-1127)

It is difficult to reconcile the Corporate response on PDR (including CCRS) with the warnings of the PUB and Stakeholders

2016

DR. BYRON WILLIAMS: Turning to page 37 of that same decision, Mr. Bunko, in the second paragraph there, you would -- you see the Board expressing concerns with the lack of business cases in the IT area, sir? MR. BRAD BUNKO: Yes.

DR. BYRON WILLIAMS: And at the top of that page you also saying -- see the Board expressing its understanding that the scope of the PDR has changed, yet there's no -- no change in the overall budget, sir? Do you see that reference?

MR. BRAD BUNKO: Yes.

DR. BYRON WILLIAMS: And Mr. Bunko, from your perspective the findings of the -- sorry, not the findings but the observations of the Board did not cause you to question the viability of the PDR business plan case, generally?

MR. BRAD BUNKO: Again, the -- the benefit stream still looked very positive, which was the -- culturally the focus at MPI. The -- the need for improved business cases I believe had started to be evaluated and it was probably the early stages and us maturing business case methodology.

(Bunko, 1134-1137)

There were sufficient caveats in the Gartner Group reports for senior managers and board members to identify issues

DR. BYRON WILLIAMS: And sir, so as we look at the Gartner report in its totality, we have both observations about it, a net present value analysis, as well as warnings that -- that there is not an estimate for ongoing support and maintenance cost underlaying that analysis, would that be fair?

MR. CHARLES HENRY: Correct.

. . .

DR. BYRON WILLIAMS: And sir, I'm not speaking about what was actually done, but in that type of role, providing advice to MPI management.

MR. CHARLES HENRY: So I can say, yes, in other circumstances where I have been engaged we would say that there's elements missing of the analysis.

(Henry, 1133-1134)

The Board of Directors had opportunities to become knowledgeable about PDR

PUB decisions are publicly available (CAC Exhibit 24)

Gartner's 2016 and 2017 report have sufficient warnings

One of the key risks is Mitchell's ability to deliver the expected outcomes of the FNOL Project. (2016 Report, PUB Exhibit 19, p. 21)

> *The FNOL project entails the implementation of an innovative and fairly complex accident profiling approach which is new to the industry and requires the development of net new software to support same* (2016 Report, PUB Exhibit 19, p. 21)

> *While there is a budget for the one-time expense of implementing the program, there is not an estimate for ongoing support / maintenance cost* (2016 Report, PUB Exhibit 19, p. 25)

Geffen presents to Committee in January 2017

- AUDIT, FINANCE & RISK COMMITTEE MINUTES Gartner Strategic Initiative Assessment January 26, 2017
- 2 of 9
- *Mr. Martin Geffen presented Agenda Item B.1 "Gartner Strategic Initiative Assessment". As part of the IT oversight, Gartner provided advice on security and risk management of IT, along with a risk assessment of strategic initiatives. Following discussion, Members received the report as information*. (CAC Exhibit 22)
- See also Board of Directors Minutes, Minute 17-023, (CAC Exhibit 22)

Significant Expenditures took place after there was ample warning in the public domain

- $3.4 M in 16/17
- $5.0 M in 17/18 (PUB 2-25)

There is an ongoing need to improve business maturity

- MPI has increased its Maturity across the board, but can still improve in areas such as Business Process Management Increasing Maturity in these areas will improve the efficiency and effectiveness of both IT and MPI overall. (BMK Attachment A, slide 16)

Recommended Findings

That:

- there was a failure to adhere to standard good business practices in the development and evolution of the PDR business
- as a consequence, the CCRS was a failed project and PDR is best characterized as a "deep negative" project with a significant negative NPV
- the $81 premium for the 2018/19 year payable to repair industry is not consistent with industry practice and is inconsistent
- the quality of NPV analysis presented to the PUB by MPI and the Gartner group was not consistent with the expectations of the Board
- MPI has taken a number of steps to introduce standard good business practices to its management of IT expenditures including the application of more robust NPV analysis to the PDR including the CCRS

Part 5: Assessing the reasonable revenue needs of an applicant in the context of its overall general health

Client Belief No. 1 - The Corporation as a whole is strong

- *de jure* monopoly on the basic side
- *de facto monopoly* on the extension side
- access to the legislature in the event it experiences adverse developments (ie no fault legislation) (complex claims initiatives)
- significant reserves in basic
- reserves significantly over target for Extension and SRE
- *And the 96 percent market share that we enjoy, basically, stems from the fact that if people were to go and make a claim, they understand that it is just a lot easier to go to MPI to make a claim as compared to recover on Basic and then recover from somebody else for the other component of their insurance coverage* (Graham, 235)

Client Belief No. 2 - Another Manitoba Advantage is Vigourous, Independent Regulation

a) Regular, Evidence based - self-correcting mechanism for overall revenue requirement– regular unlike Saskatchewan – less politicized with government directives than BC

b) Evidence based – self correcting mechanism in terms of rate relationship among ratepayers – sends powerful signals and is credible and seen as independent (evidence based, defensible position for consumer volatility concerns)

c) Evidence based DCAT to set RSR – based on Manitoba data – responds to Manitoba risks rather than formulaic MCT

d) PUB aversion to rewarding bad management bad management (CAC Exhibit 17, Board Order 151/00)

Client Belief No. 3 – Rate Setting Stays Healthy When Government Stays out of Rate Setting

- *Government who have been very clear to our Board and to myself that they want a reduction in volatility.* (Graham, 120)

- *I can guarantee you that there has never been a discussion in relation to [rates], what those [rates] should be and we are very much in compliance with the Crown Corporation Governance and Accountability Act.* (Graham, 1112-1114)

Client Belief No. 4 – A Well Cushioned Crown Monopoly is Bad for Efficiency

- Absence of financial models in the early 2010s
- Asset/Liability Duration Mismatch of the early 2010s
- Struggles to respond to Great Recession
- Ill managed BI3 and PDR by-products of the over-collection era
- Absence of standard value management protocols

The Over-Collection Era – 04/05 – 2010/11

Fiscal Year Net Income (b)

2003/04	$3,358,000
2004/05*	$59,943,000
2005/06	$85,703,000
2006/07	$47,783,000
2007/08	$69,040,000
2008/09	($8,165,000)
2009/10	$87,773,000
2010/11*	$283,855,000
2011/12	$22,278,000
2012/13*	($63,103,000)
2013/14	($69,162,000)
2014/15	$2,440,000
2015/16	($56,050,000)
2016/17	($123,070,000)
2017/18	$34,424,000

*Restated

CMMG 1-11 (excerpt)

Volatility in this Proceeding is Poorly Defined

- Ratepayer’s perspective – what they pay on their bill
- Crown Monopoly’s perspective – the optics of an overall average rate increase (why they conflate a RSR rebuilding fee with rate shock)
- Government’s perspective – annual results (Graham, 1112-1114) – no evidence from MPI that adverse results are affecting affordable access to capital (Order 59/18)

Client Belief No. 5 – Some Volatility is Inescapable and Good Management is the Best Response to Volatility

- Volatility in terms of individual rates is a natural result of CLEAR and DSR
- Over collection of rates from present day consumers is not an appropriate response to concerns about revenue volatility
- From a regulatory perspective, the best answer to volatility whether up or down is good practice forecasting and prudent management
- Over-collection is not a long term solution

Client Belief No. 6 - The RSR is to prevent rate shock not rate volatility

- The RSR is to prevent rate shock
- Moderate RSR rebuilding fees are not rate shock
- And few ratepayers reject rebates

Client Belief No. 7 - After a thoughtful and evidence based dialogue we have arrived at the DCAT

- *The consensus was then built on this methodology that would be something that was transparent and consistent with established risk tolerance practices, again, centered around this 1:40 year standard. And the DCAT -- its strength, I think, is it provides a direct connection of specific and justifiable risks posed as these adverse events that are based on the historical evidence to future financial condition. And I think we've had some very productive both technical conferences and exchanges in proceedings that have helped to clarify what evidence is useful and what evidence is not and where the best scenario constructions are -- are more compelling than in others.* (Simpson, 1187-1188)

But MPI has linked the CMP linked to MCT

- Capital Maintenance Provision, it is not linked to the DCAT. It is linked exclusively to the MCT ratio. (Johnston, 678)

Client Belief No. 8: The MCT calculation is not appropriate for the purpose of the RSR

- it addresses a different problem for a different marketplace (insolvency, consumer flight and economic disruption)
- given the solvency concerns, it shields imprudent behaviour such as operational risks which are controllable with good management
- by necessity its risk tolerances are calibrated to insolvency questions and risk scenarios are more extreme - *OSFI has elected 99% of the expected shortfall (conditional tail expectation or CTE 99%) over a one-year time horizon as a target confidence level* (Johnston, 683-684) (see also OSFI, 1.1.1)
- as compared to the DCAT – it does not dynamically respond to evolving Manitoba risk or provide insight into the evolutions of those risks

The MCT has been rejected by the PUB for Good Reason

- *2005 MPI introduced the Minimum Capital Adequacy Test, the MCT, and recommended an RSR range of 50 to 100 percent MCT in the 2007 GRA. It was pointed out then, and it's still pointed out, that it -- the MCT is recognized by OSFI to assess capital required for a private company in a competitive industry to forestall insolvency.*

- *At that time, concerns were expressed and still are expressed that it's not clear how something that applies to private insurers in competitive markets has much to say about the risk profile faced MPI which is a Crown corporate monopoly.*

- *In addition to that, the MCT does not address the specific risk faced by MPIC. It certainly doesn't itemize them and evaluate them.*

  (Simpson, 1186)

The MCT has been rejected by the PUB for Good Reason

- *The MCT is formulaic with risk margins that are set to ensure private companies do not go insolvent and this is to protect the Canadian economy.*

- *The risk margins within the MCT were not set for a monopoly Crown Corporation. Again, they were set for private companies to ensure they don't go insolvent.* (Sherry, 1197)

The MCT has been rejected by the PUB for Good Reason

- *And it's difficult using MCT levels whether they be 50 and 100 percent or 35 percent and 85 percent to attach any meaning in terms of specific risks and associated risk tolerance levels that are consistent with some sort of a statistical or scientific approach to risk assessment.* (Simpson, 1188-1190)

MCT Provides a Significant Cushion for Imprudent Operational Behaviour

- Office of the Superintendent of Financial Institutions defines operational risk is the risk of loss resulting from inadequate or failed internal processes, people, and system, or from external events. (Johnston, 679)

- Operational risk margin ranging from 64.6 million to 77.3 million, recognizing proviso of a divide by one point-five (Johnston, 680)

A Failed IT Project is Shielded by the MCT

DR. BYRON WILLIAMS:

So the -- as the MCT contemplates it, sir, operational risk is associated with a failed information technology program? Would that be contemplated?

MR. LUKE JOHNSTON:

At my fingertips, I don't recall everything included in there as described by OSFI. But my understanding is it would be for things like -- of that nature. (Johnston, 682-683)

But MPI says the RSR should not go to funding bad choices

- *the intent of a CMP is by no means to take away the accountability or the responsibility of management.* (Giesbrecht, 514, lines 11 – 24)

- *So if -- if we did something that deteriorated our -- our MCT ratio, it wouldn't be right to ask ratepayers to pay for that, like, in -- in the maintenance provision, because that's -- that's a conscious choice by us* (Johnston, 514)

And the PUB says the RSR is not intended to fund matters within the control of MPI

- *In Board Order 154/98 the Board did not agree that each risk component is perfectly correlated or additive. Instead, an actual correlation was to be used. Furthermore, the Board directed that investment risk should be included as a risk factor, and at least some operating expenses should be excluded, as these were controllable by management.*

- *In both Board Orders 154/98 and 177/99 the Board stated the inclusion of all operating expenses was inappropriate as these were at least partially controllable by management.*

(CAC Exhibit 20)

Objectivity with limited relevance is of limited value

- as we learned during the Hydro GRA, simplistic mechanisms such as debt equity ratios offer little insight into the health of Corporations unless we dig deeper

- telling us that BC has a MCT target of 100% MCT tells us little about the health of the corporation or whether its ratepayers are vulnerable to rate shock (ie have they been setting rates properly or setting rates politically)

Was there an evidence based process leading to the adoption of the MCT targets in Saskatchewan, BC and Quebec?

- or were there political processes and cabinet directives?

The CMP is intended to address a problem MPI has not defined?

DR. BYRON WILLIAMS: . . . we're switching to issues related to the Capital Maintenance Provision and CAC-2-20(b). And to the second page of that response, without asking MPI to elaborate, and focusing on part 2(b)(2), one (1) of the described purposes of maintaining a certain capital level associated with the Capital Maintenance Provi -- Provision is to protect ratepayers from potential rate shock from future unforeseen adverse events. You see that reference?

MR. LUKE JOHNSTON: I do.

DR. BYRON WILLIAMS: And Mr. Johnston, for the purposes of this application, how is Manitoba Public Insurance defining rate shock?

[…]

MR. LUKE JOHNSTON: We -- we don't have a -- a formal definition of what defines a rate shock for MPI.

A RSR Rebuilding Fee is not Rate Shock

DR. BYRON WILLIAMS: Mr. Johnston, would it be fair to say that Manitoba Public Insurance does not consider a 2 percent rate increase to equate with rate shock?

MR. LUKE JOHNSTON: That -- that's fair, yes.

DR. BYRON WILLIAMS: Assuming a zero overall rate increase and a 2 percent RSR rebuilding fee, would it be fair to suggest that Manitoba Public Insurance does not consider that type of event to be rate shock?

MR. LUKE JOHNSTON: I would not consider a 2 percent combined rate increase and capital maintenance fee to be considered rate shock. I think -- although we -- we -- we'll do our --obviously, do our best to control costs, that is basically inflationary type increase(Johnston, 675-677)

Pre-collecting for the CMP is inconsistent with Intergenerational Equity

But again, due to the yearly process in Manitoba if that does occur, then they can ask -- MPI could ask for a rate increase at that time to increase their capital instead of asking for it now which separates the capital need from the people -- the policies that would be in place in the year that the capital need is actually required. (Sherry, 1198-1199) (see also Sherry, 1296- 1298)

Is it analytically credible to characterize MPI portfolio risk as ever increasing?

what the DCAT is showing in recent years is precisely that that's not correct. In other words, you said other things held the same ceteris paribus assumption, but other things are not the same. The risk challenges facing MPI are changing and the claims scenario, the high loss ratio scenario has now become the most important scenario in place of the interest rate decline scenario, which in turn replaced the equity decline scenario. (Simpson, 1233-1236)

The Saskatchewan CMP Cushion is not Analogous

MS. ANDREA SHERRY: *So really speaks to my main point is that MPI comes to the Public Utilities Board every year with the full analysis of their results, a full analysis of their capital position and can every year ask the Public Utility Board for a rate increase if they need more capital, or -- really, if they need more capital. So -- or their rates are inadequate at that time.*

My point is that the SGI, the Saskatchewan Government Insurance, they do not go every year to any sort of Public Utility Board for a rate increase or to do a full analysis of their program. They don't have an application anywhere near of the -- anywhere near the thoroughness of MPI's and, again, they don't -- they don't produce any application every year.

So I can't speak to Saskatchewan Government Insurance's particular situation but they don't get that opportunity every year to ask for a rate increase. So, potentially, they need some sort of Capital Maintenance Provision because there are years between rate applications. It's -- it's two (2) very different situations. (Sherry, 1271-1272)

The CAC Manitoba Interdisciplinary Approach

- inter-disciplinary approach - applied micro-economics (theory of the firm and risk), econometrics, the actuarial sciences – not just math (Simpson and Sherry)
- experience with risk analysis with other regulated industries (Simpson)
- extensive (and senior) experience both with crown monopolies and firms that are not insulated from the market place – firms that have to face insolvency and consumer flight risk (Sherry)
- actuarial experience with the broader North American marketplace and with private sector property and casualty firms that are larger than MPI (Sherry)
- Significant weight should be given to their findings

Recommended Findings:

That:

- A Shield for Bad Management is Not Appropriate for the RSR
- Given the purpose of the RSR, confirm the MCT analysis should not be linked to any determination of rates associated with the RSR
- The CMP cushion developed for Saskatchewan was developed in a very different context for a very different regulatory process
- The goals of efficiency and intergenerational equity are better served by rejecting the CMP cushion

Part 6: Determining an appropriate allocation of costs between classes

The DSR Review and Dramatic Disruption

- the logic of the residual risk model is that it would be aimed at the risk associated with driver behaviour (Johnston, 870)

- *the idea that maybe more of the premium should be charged on an individual's driver's license, perhaps a lot more, would be pretty dramatic change to this model and it would -- you know, it would take some -- we would have to be very cautious in its implementation*. (Johnston, 867-868)

- *So if you were getting at the driver ability through the license [via a residual risk model], then agreed that the need for a vehicle premium percentage discount would likely be dramatically reduced.*
  (Oct 18, Johnston, 869)

Driver Safety – Customer Research

- The Corporation will conduct customer research before proposing any significant changes to the Driver Safety Rating Program. (CAC (MPI) 1-51)
- The potential for dramatic disruption heightens the impetus for engagement with stakeholders and consumers

Part 7: Going Forward on Consumer Engagement

An Archaic Approach to Consumer Engagement Related to Rate setting

- The rate setting process and accompanying technical conferences are an important part of accountability and good practice engagement
- But what is missing largely is ratepayer engagement
- Engagement is more than an opinion poll, a 15 minutes consumer presentation (after trying to make sense of a 5,000 page rate filing)
- Are there evolving good practices in other jurisdictions?

Engaging with Ratepayers is not a Primary Focus

- Engaging with its ratepayers in terms of the rate setting process and application is not “a primary part” of the MPI examination of the customer experience (Wennberg, Oct 15, 221)

Advice on how to engage with ratepayers on issues related to rates is just a phone call away

Part 8: Setting just and reasonable rates in accordance with statutory objectives

- **Recommendation that the PUB adopt Standard Interest Rate Forecast (SIRF) or 50/50 interest rate forecast:**
  - Issue settled by PUB in 2018 GRA, supplemented by expert evidence in 2019 GRA
- **Recommended range for the Reserve Stabilization Reserve: $122M-$250M**
  - Based on Exhibit MPI-26, Figure 7, PUB approved methodology, 50/50 interest rate forecast

- **Recommendation regarding ALM study:**
  - MPI Board should be asked to revise current ALM study in light of Mr. Viola's 8 recommendations
  - If MPI chooses not to revise current ALM study – a 0.5% annual reduction in rates should be ordered until such time as MPI can establish it selected investment portfolio in a reasonable and prudent manner (does not reflect opportunity cost at comparable risk)
  - Further external experts retained by MPI who are testifying before PUB should be directed to identify whether in their professional judgment the methodology is consistent with professional best practice

- **Recommendation that the Capital Maintenance Provision (CMP) be rejected:**
  - Provides an inappropriate cushion for a monopoly Crown corporation which is inconsistent with prior regulatory direction:
    - Tied to Minimum Capital Test which is expressly linked in part to a formulaic allocation that is a solvency measure to hold management accountable and to protect consumers in the context of private P&C companies.
  - It effectively allows for the MCT to replace the DCAT as the primary driver of rates relating to capital reserves, notwithstanding the express rejection of the MCT by the PUB
  - For 2019/20 fiscal year, total equity is forecast to be above the RSR range (PUB approved methodology and 50/50 interest rate forecast) with a 0% rate increase.
    - See PF.10: with a 0% rate increase, total equity is projected to be $257,241

- **Recommendations regarding Complex Claims:**
  - MPI provide an update for the next General Rate Application on steps to improve the handling (adjudicating, reserving, and managing the return to health process) of complex PIPP claims and status of complex PIPP claims as measured against pre-BI3 benchmarks or existing benchmarks
  - MPI provide the PIPP claim benchmarking framework (complex claims) discussed at transcript pages 865-866 as part of its next GRA filing

- **Recommendation regarding Information Technology (IT):**
  - Given material challenges with the implementation of major IT programs including BI3 and PDR and ongoing effects on ratepayers, that MPI be directed to report to a technical conference on the business case for Legacy IT Systems (ie. AOL, CARS, etc. including the interfaces to other systems) renewal prior to the next GRA filing. The Legacy IT Systems renewal business case should include examples of NPV analysis demonstrating adherence to good business practice.

- **Recommendation that MPI be directed to report back to the PUB on efforts to bring staffing budgets in line with peers**

- **Recommendation regarding Driver Safety Rating (DSR):**
  - Given the potential dramatic changes to DSR which could result from the residual risk approach, MPI should be directed to engage with stakeholders, including CAC Manitoba, CMMG, CAA and Bike Winnipeg, regarding best practices for consumer engagement and their recommendations on DSR.

- **Recommendation regarding experts:**
  - In the future, any external expert retained by MPI and providing evidence to the PUB should be directed to expressly identify any aspects of their evidence that do not conform with best practice

- **Recommendation regarding engagement with consumers:**
  - Prior to the next GRA, MPI should be directed to consult with stakeholders, including CAC Manitoba and CMMG, on potential tools to better engage ratepayers outside the formal hearing process (i.e. focus groups on pricing issues such as stable rates)
    - Good practice includes:
      - Consumer engagement before (when an issue arises), during (ideas are put to consumers on how to resolve the issue) and after (feedback is sought on how the solution is performing).
      - Consumer and stakeholder input should be recorded and, where ideas are not or cannot be used, explanations of why not should be made publicly available for accountability and transparency purposes.
  - Budget approvals for interveners should contemplate costs for public engagement presented to the PUB as evidence

- **Recommended rate: - 1.75%**
  - See Exhibit MPI-26:
    - Figure 3: Breakeven rate indication using 50/50 interest rate forecast and including RSR investment income is -1.75%
  - Recommended rate takes into account the rejection of the CMP, the use of the SIRF or 50/50 and the inclusion of the RSR investment income
  - A further rate reduction could be ordered based on foregone investment opportunities.