

October 24, 2018

2019 GENERAL RATE APPLICATION
Undertaking #11 Transcript Page 631

Undertaking #11

Mr. Makarchuk to provide an explanation of what the inflation volatility assumption of 2.6 percent, what model it applies for and what it is used for.

RESPONSE:

Mercer provided the following response:

As discussed in PUB 1-83, our inflation volatility assumption is based on our analysis of historical data on Canadian inflation. The historical distribution of inflation has tails fatter than a lognormal distribution (high kurtosis). It is also asymmetric (it is skewed to the right). Another key characteristic of inflation is its high serial correlation. Simply put, years of high inflation tend to be followed by years with similarly high inflation, and the same with periods of low inflation. Because of serial correlation, the modeled annualized volatility of a future period increases with the length of the period. 2.6% volatility corresponds to the compounded annualized volatility over the next 10 years.

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. The inflation volatility assumption was not explicitly used in our modeling.