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August 15, 2019

Public Utilities Board of Manitoba
Darren Christle
Executive Director & Board Secretary
400-330 Portage Avenue
Winnipeg, MB R3C 0C4

Dear Mr. Christle:

Re: Manitoba Public Insurance – 2020 General Rate Application (2020 GRA) – Motion to Compel Round 1 IR Responses

Overview

Pursuant to s. 15 and 16 of the PUB *Rules of Practice,* CAC Manitoba is applying for an order compelling Manitoba Public Insurance to provide responses to the following information requests and on the following grounds:

- **CAC (MPI) 1-8** requested briefing materials within MPI regarding the merits of a 100% MCT target for MPI. **CAC (MPI) 1-14** requests information providing a rationale for maintaining the Extension reserve at a MCT ratio of 200%. MPI claimed cabinet privilege for both these information requests. The information sought is relevant and material to Issues 7 and 18 in PUB Procedural Order 92/19, as it will relate to the questions regarding: i) the legality of the Reserves Regulation, in which the 100% MCT target is imposed, ii) whether the Board must ensure that rates comply with the Reserves Regulation and iii) whether the Regulation should remain a relevant factor to be considered when setting rates for service. MPI should be compelled to provide all internal briefing materials, which are not subject to cabinet privilege.

- **CAC (MPI) 1-15 d)** requested any DCAT analysis undertaken for the test year assuming a 1-in-40 risk tolerance. MPI argues that such a request is unreasonable and unnecessary given that MPI has a mandated capital target of 100% MCT, coupled with the onerous request of completing a DCAT at a new risk tolerance. Pursuant to issues 7 and 18, should the Board find that i) the Reserve Regulation is not valid or ii) it does not have to ensure that approved rates for service comply with the Reserves Regulation or iii) the Regulation is considered not to be a relevant factor for rate-setting, the 1-in-40 scenario in the DCAT would be relevant to set capital targets, as has been done in past PUB orders.

- **CAC (MPI) 1-29 a)** requested detail on the PIPP presumption of full-time income loss determined at 180 days for non-earners and part-time earners without demonstrated intent of employment, full-time or otherwise. MPI claimed cabinet privilege. Given the financial implications for claims incurred flowing from this presumption regarding PIPP claims for non-earners and part-time earners, MPI should be compelled to provide all internal briefing materials, which are not subject to cabinet privilege.

- **CAC (MPI) 1-23 and CAC (MPI) 1-24 e)** requested information relating to MPI's investments, and specifically the Shadow Portfolios ordered in PUB Order 159/18. MPI refused to answer the questions, stating that it has already complied with the relevant PUB Order and that the information required to answer does not currently exist and cannot be reasonably obtained. The information sought is relevant and material in order to assess the methodologies used, assumptions made, and any additional constraints imposed in developing the Shadow Portfolios, given the objective established by the PUB in Order 159/18 (i.e. assist in determining whether the portfolio selected by the Corporation provided optimal returns). In particular, based on CAC Manitoba's review of MPI's application, it appears that the Shadow Portfolios were subject to at least one material constraint (i.e. maximum real return bond ("RRB") allocation) which is inconsistent with the intent of the PUB Order.

The Rules of Practice

The Public Utilities Board's Rules of Practice and Procedure impose an obligation on MPI to provide full and adequate responses to information requests, except in circumstances where it contends the information request is not relevant, the answer is not available or cannot be provided with reasonable effort, the information is confidential or where it relies on other grounds.[1]

The Information Requests and the Reasons for Refusal

Cabinet Confidentiality

In information request CAC(MPI) 1-8, CAC Manitoba requested:

> Please provide all briefing materials within MPI regarding the merits of a 100% MCT target for MPI which address the merits of asking basic ratepayers to contribute to a target imposed by regulation rather than independently determined target.

In CAC(MPI) 1-14, CAC Manitoba requested:

> Please provide any analysis, report or other information that provides a rationale (other than the Regulation) for maintaining the extension reserve at a MCT ratio of 200%,

1 *Rules of Practice*, s 15-16.

In CAC(MPI) 1-29 a), CAC Manitoba requested:

> Please elaborate and comment in detail on the PIPP entitlement and coverage review including the claims incurred impact of "the presumption by the plan of full-time income loss determined at 180 days for non-earners and part-time earners without demonstrated intent of employment, full-time or otherwise."

For the three information requests above, MPI has claimed that the information requested is subject to cabinet confidentiality.[2] Specifically, MPI responded:

> Without addressing the narrow specifics of the requested information, generally speaking information related to creating a regulation is contained in Cabinet Submission documents. Information in Cabinet Submissions is subject to Cabinet Confidence and MPI is not permitted to release such information.[3]

Production of New Evidence

In information request CAC(MPI) 1-15 d), CAC Manitoba requested:

> Please provide any DCAT analysis undertaken for the test year assuming a 1-in-40 risk tolerance.

In CAC(MPI) 1-23 CAC Manitoba requested:

a) **Efficient Frontier:** Why was an Efficient Frontier for Basic not shown on page 1,693? Can the Efficient Frontier be provided?
b) **Basic.5 Portfolio Construction:** Please explain i) the rationale for constructing the Basic.5 portfolio, ii) the process for constructing its asset mix composition (e.g. an optimization), and iii) the basis for its construction (i.e. in nominal or real terms)?
c) **Optimal RRB Allocation:** Based on the Efficient Frontier above, what would the optimal asset allocation to RRBs be at the actual level of **real** surplus risk that MPI selected (i.e. ~ 4.3% real surplus volatility for Basic.3)?
d) **Principles:** What principles or other considerations guided the process for developing the composition of the various Shadow Portfolios? Were these principles applied consistently across the four Shadow Portfolios? If not, why not?
e) **Risk Components:** Why was **credit** risk, rather than **surplus** risk, a specific consideration in the selection of Basic Shadow Portfolio 1, noting that **credit** risk is only one component of **surplus** risk? (Other components of surplus risk may include inflation risk, real interest rate risk, currency risk, active risk or tracking error, and liquidity risk.)
f) **RRB Market Considerations:** PUB Order No. 159/18 says "it would be beneficial for the Corporation to inform itself and the Board as to how the Basic and Pension portfolios would perform had the Corporation not imposed those constraints."

2 See Letter from Michael Triggs to Darren Christle dated August 12, 2019.
3 See responses to CAC (MPI) 1-8, 1-14, 1-29 a).

i. Why are the "RRB Market Considerations" in Mercer's Appendix relevant in determining the **composition** of the Shadow Portfolios (as distinct from determining the **returns** of the Shadow Portfolios)? Isn't this inconsistent with the objective underlying PUB Order No. 159/18?
ii. Instead of constraining the RRB **weight** in Shadow Portfolios (e.g. to 24% in the case of Basic Shadow Portfolio 1), wouldn't it be more appropriate to make an adjustment to the RRB Index **returns** to account for any market impact acquisition costs that MPI/Mercer believe would be incurred to establish the policy weights in the Shadow Portfolios?
iii. Wouldn't any cost adjustment or penalty, noted above, be relatively small (measured on an annualized basis), given the one-time nature of any RRB acquisitions and the very long holding period over which any such cost could be "amortized" (i.e. decades)?
iv. While Mercer's Appendix regarding considerations mentions **daily volumes** (~ $20M), was the size of periodic **RRB auctions**[4] also considered, noting there have been two auctions of RRBs so far in 2019 (February and May) totaling $1.1 billion?[5]

g) **Basic.3 and Policy Portfolios:** Why are there differences between the Basic.3 portfolio "selected during the AL Study" (per page 1,692) and the Policy portfolio for Basic in the Investment Policy Statement (page 1,635)? e.g. Did the MPI Board approve an asset mix for Basic that has a longer duration than was reflected in the Mercer Study?

h) **Basic.5 vs Fixed Income Mixes (for Shadow Portfolio 1):**
i. On page 1,692, what is the difference between Basic.5 and Fixed Income Mixes (for Shadow Portfolio 1) in terms of asset mix?
ii. On page 1,666, do the asset mix weights represent those for Basic.5 or Fixed Income Mixes (for Shadow Portfolio 1)? (It appears that the weights for Basic.5 were used in calculating the returns.)

i) **Basic.5 as Shadow Portfolio 1:** On page 1,692, Mercer said "BASIC.5 is a variation of Basic.3, if the Real Liability Benchmark is selected and similar credit risk is taken".
i. Why was BASIC.5 chosen to represent Shadow Portfolio 1 when it has significantly less **real surplus** volatility than Basic.3 (i.e. 3.2% compared to 4.5%, on page 1,692, or a difference of 29%)?
ii. Isn't the approach for developing Shadow Portfolio 1 inconsistent with MPI's surplus risk tolerance, given the 29% lower risk in **real** terms noted above, and 69% higher risk in **nominal** terms on page 1,695 (i.e. 2.2% surplus risk for Basic.5 and 1.3% for Basic.3)?
iii. If Mercer's return assumptions are realized, on average, won't Basic Shadow Portfolio 1 have the **same** average return as MPI's Policy portfolio (i.e. 3.1%) over a reasonably long period of time?
iv. Shouldn't Basic Shadow Portfolio 1 be constrained to have the **same surplus risk** that MPI actually selected during the AL Study (i.e. 4.5% real surplus risk for Basic.3), rather than having the **same expected return** (i.e. 3.1% for Basic.3)? i.e.

4 Source: https://www.bankofcanada.ca/markets/government-securities-auctions/
5 According to the Bank of Canada, the allocation (real) yields from the auctions were 0.7% on $400M and 0.588% on $700M.

Wouldn't the performance of a Shadow Portfolio based on the same risk tolerance/level actually selected by MPI better measure the difference in returns underlying PUB Order No. 159/18?

j) **"Middle (C)" as Shadow Portfolio 2:** On page 1,697 Mercer said "Middle (C) modestly increases return and decreases risk".
   i. Why was a different approach used to develop Shadow Portfolio 2 ("Middle (C)"), compared to the approach used for Shadow Portfolio 1, where neither expected return nor risk were kept constant in Shadow Portfolio 2?
   ii. Wouldn't the selection of B (Same Return) for Shadow Portfolio 2 have been more consistent with the approach used for developing Shadow Portfolio 1?
   iii. Why was the "Current" portfolio used as an "anchor" for defining "Same Risk (D)" and "Same Return (B)"? Doesn't the Current portfolio represent the pre-Mercer asset allocation (3.8% real risk), rather than the portfolio selected by MPI as a result of the Mercer Study (4.5% real risk)? i.e. Shouldn't any "anchor" be related to "Basic.3 (E)", not "Current"?
   iv. Would Mercer/MPI agree that if the Shadow Portfolio 1 approach for Basic were used to develop the Shadow Portfolio 2 for Basic, the risk of Shadow Portfolio 2 would be **significantly different** (i.e. < 1% real risk, rather than the 4.5% for the Basic.3 portfolio)?
   v. Would Mercer/MPI agree that if **risk** (rather than **return**) were kept constant in developing the Shadow Portfolios, the expected return premium (over Basic.3) would be > 110 bps[6] for Basic Shadow Portfolio 1 and ~ 220 bps for Basic Shadow Portfolio 2?

k) **Updated INV Attachment A:** Please provide an updated INV Attachment A, reflecting any changes arising from the information requests and questions related to it.

In CAC(MPI) 1-24 e), CAC Manitoba requested:

> **Updated INV Appendix 10:** Please provide an updated INV Appendix 10, reflecting any changes arising from the information requests and questions related to it.

For the three information requests above, MPI has claimed that "[t]he information requests seek the production of new evidence, for which the time and cost exceed the value."[7]

Specifically with respect to CAC (MPI) 1-15 d), MPI indicated that:

> In the past, MPI has completed these requests as the DCAT was also used for setting capital targets. Given that MPI has a mandated capital target of 100% MCT, coupled with the onerous request of completing a DCAT at a new risk tolerance, MPI believes that such a request is unreasonable and unnecessary.[8]

6 Without an Efficient Frontier, the magnitude of this figure is not available.
7 See Letter from Michael Triggs to Darren Christle dated August 12, 2019.
8 See response to CAC (MPI) 1-15 d).

Specifically with respect to CAC(MPI) 1-23 and 1-24 e), MPI indicated it respectfully refused to answer this question for a number of reasons, including, but not limited to the following:

- MPI has already complied with Directive 11.17 of Order 159/18; and
- MPI cannot answer these questions as the information required to do so does not currently exist and cannot be reasonably obtained.[9]

The Information Sought is Relevant and Material

CAC(MPI) 1-8 and CAC (MPI) 1-14

The information sought will assist the PUB in its assessment of Issues 7[10] and 18.[11]

The validity of the Reserves Regulation is an issue to be canvassed in this proceeding, provided that notice is provided pursuant to The Constitutional Questions Act. At this time, and as previously indicated, CAC Manitoba is anticipating filing a Notice of Constitutional question. It is expected that the information requested in CAC(MPI) 1-8 and CAC (MPI) 1-14 will assist our client to determine both the scope and content of such notice.

Further, the information requested relates to the issues of whether the Board must ensure that approved rates for service comply with the Reserve Regulation and whether the Regulation is a relevant factor to be considered when setting rates for service. Information relating to the merits of using the MCT to set capital targets is relevant to this determination.

Recognizing cabinet privilege, MPI should be compelled to provide all internal briefing materials, which are not subject to cabinet privilege.

CAC(MPI) 1-29 a)

The information sought will assist the PUB in its assessment of Issue 10.[12]

9 See response to CAC (MPI) 1-23.

10 As per PUB Order 92/19, Issue 7 is: Capital management plan and update of Dynamic Capital Adequacy Testing;
a. Capital rate request based on man. Reg. 76/2019, the Reserves Regulation.

11 As per PUB Order 92/19, Issue 18 is: Proposed Capital Management Plan, the proposed Basic capital build or release provisions, and the proposed mechanisms for capital transfers from other lines of business, including but not limited to the results of the Capital Management Plan Technical Conference directed in Order 159/18;
In the event that notice is provided to the Attorneys General of Manitoba and Canada pursuant to The Constitutional Questions Act:
a. Is the Reserves Regulation invalid;
If the Reserves Regulation is not determined to be invalid:
b. Must the Board ensure that approved rates for service comply
If compliance is not required:
c. does it remain a relevant factor to be considered when setting rates for service;
If compliance is required:
d. does the Proposed Capital Management Plan comply with the Reserves Regulation;
If the Reserves Regulation is determined to be invalid:
e. target capital analysis and the target Basic total equity threshold levels.

12 As per PUB Order 92/19, Issue 10 is: Claims forecasting (including PIPP).

The presumption by the plan of full-time income loss determined at 180 days for non-earners and part-time earners without demonstrated intent of employment, full-time or otherwise is significant in terms of financial implications for claims incurred relating to PIPP claims.

MPI should be compelled to provide all internal briefing materials not subject to cabinet privilege.

CAC(MPI) 1-15 d)

The information sought will assist the PUB in its assessment of Issues 7 and 18.

Should the Board find that i) the Reserve Regulation is not valid or ii) it does not have to ensure that approved rates for service comply with the Reserves Regulation or iii) the Regulation is considered not to be a relevant factor for rate-setting, the 1-in-40 scenario in the DCAT would be relevant to set capital targets, as has been done in past PUB orders.

CAC(MPI) 1-23 and 1-24 e)

The information sought will assist the PUB in its assessment of Issues 8[13] and 19.[14]

Over the past few years, CAC Manitoba has identified a number of issues related to how risk is defined by MPI, as well as how risk is both measured and managed. PUB Order 159/18 appeared to acknowledge CAC Manitoba's concerns, and required MPI to develop Shadow Portfolios and to report on their performance.[15]

In Round 1 Information Requests, CAC Manitoba developed 22 questions (a to k) in CAC (MPI) 1-23 that relate to the PUB Order. However, MPI refused to answer any of the 22 questions. Instead, MPI applied a single broad brush as the rationale for not responding to any of the questions.

The information requested is relevant and important for the purposes of the PUB's assessment of MPI's application. Additionally:

- much of the information requested is available; and
- many of the questions require a simple, short answer.

The preamble to CAC (MPI) 1-23 included the following excerpts from the Board's Findings in Order 159/18:

13 As per PUB Order 92/19, Issue 8 is: Performance of the investment portfolio and the composition of i) the portfolio, ii) benchmark portfolio(s) on a market value basis (e.g. asset mix).

14 As per PUB Order 92/19, Issue 19 is: Asset Liability Management Study, including the implementation thereof, comparison to the shadow portfolios directed by the Board in Order 159/18, the disposition of the existing portfolio to fund new investment classes, interest rate risk exposure changes, investment income reporting changes including the allocation methodology for balance sheet, investment income and Investment Policy Statement changes.

15 See PUB Order 159/18 at pp 9, 89, 107.

> *… the Board directs that the Corporation set up … shadow portfolios*
>
> *… file … a report comparing … returns of the shadow portfolios with those selected by MPI. The Board expects … the … comparison will be of assistance in determining whether the portfolio selected … provided optimal returns.*
>
> *… the Corporation … put constraints on the Mercer ALM study.*
>
> ***… it would be beneficial for the Corporation to inform itself and the Board as to how the Basic and Pension portfolios would perform had the Corporation not imposed those constraints …***[16]

The last point above, regarding constraints, is worth highlighting because the Shadow Portfolios were subject to at least one material constraint (i.e. maximum real return bond ("RRB") allocation), and, based on CAC Manitoba's review of MPI's application, it appears that the imposition of this constraint is inconsistent with the intent of the PUB Order.

The questions in CAC (MPI) 1-23 were designed to obtain answers to three (3) broad questions:

1. **How were the Shadow Portfolios developed?**
    a. What key **principles** were used to determine the return/risk level(s) to be "targeted"?
    b. What key **assumptions** were made?
    c. What key **constraints** were applied to any asset class weights?
    d. What **other key considerations** were taken into account?

2. **Was the approach for developing the Shadow Portfolios applied consistently across the various portfolios?**[17]

3. **Was the approach and its application consistent with the intent of PUB Order 159/18 in measuring the returns?**

CAC (MPI) 1-23 provided this rationale for the questions:

> To assess the methodologies used, assumptions made, and any additional constraints imposed in developing the Shadow Portfolios, given the objective established by the PUB in Order No. 159/18 (i.e. assist in determining whether the portfolio selected by the Corporation provided optimal returns).[18]

We address below specific elements of MPI's rationale for refusing to fully answer the question.

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16 CAC (MPI) 1-23, p 1.
17 This assumes that "consistency" in application is a desired principle.
18 CAC (MPI) 1-23, p 6.

As a first broad rationale for not answering the question, MPI states that it **has already complied with Directive 11.17 of Order 159/18**.[19]

In our respectful view, compliance with its orders is a matter for the PUB to decide. However, even assuming that MPI complied with the order, which CAC Manitoba does not concede, compliance alone should not preclude CAC Manitoba and parties from a) raising questions about the information presented by MPI related to the Shadow Portfolios and b) requesting additional information related to the Shadow Portfolios.

Elaborating on this first broad rationale, MPI states that:

> Exploring one of a myriad of possible variations on the existing shadow portfolio has very limited prospect of providing valuable insight, particularly since the shadow portfolio analysis can only identify forgone opportunities through hindsight, based on knowledge that was not available to the Board of Directors at the time the investment strategy was adopted (that knowledge being the then-future shadow portfolio returns).[20]

While CAC Manitoba agrees that there may be a “myriad” of possible shadow portfolio compositions, there are likely only a few (e.g. 2 – 3) alternatives that would meet any reasonable set of principles to be applied in meeting the intent of the Shadow Portfolios. The rationale for Question d), for example, was to identify the principles used by MPI/Mercer in developing the different Shadow Portfolios so that in its analysis, CAC Manitoba and the PUB could be satisfied that the principles were appropriate in the circumstances and that the principles were applied consistently across the various portfolios.

Based on its review of MPI's application, CAC Manitoba believes that there is inconsistency in how the different Shadow Portfolios were developed. CAC Manitoba also believes that there is at least one error in the Shadow Portfolio’s calculated returns, given MPI’s response to Question c) in CAC (MPI) 1-24.[21]

MPI argues there is “very limited prospect of providing valuable insight”. CAC believes that there are only 2 – 3 reasonable alternatives from which to choose, and that the “insights” depend critically on the return/risk assumptions used to provide an “anchor” for return comparisons that are most meaningful, and that meet the intent of PUB Order 159/18.

The Shadow Portfolio analysis should measure foregone opportunities, much like any “benchmark” or “reference”[22] portfolio does. If MPI is correct about its conclusion regarding “hindsight” related to Shadow Portfolio performance, the same conclusion could be drawn

19 CAC (MPI) 1-23, p 6.
20 CAC (MPI) 1-23, p 7.
21 Note: CAC (MPI) 1-24 covers questions related to Shadow Portfolio Returns, rather than the Shadow Portfolio Compositions
22 The Canada Pension Plan Investment Board, for example, developed a “Reference Portfolio” and integrated it into its approach for minimizing the unintended exposures and uncompensated risks. Source: http://www.cppib.com/en/how-we-invest/

related to the use of any benchmarks/reference portfolios. This argument is inconsistent with the PUB Order to run shadow portfolios to inform itself and the Board as to how the Basic and Pension portfoios would perform had the Corporation not imposed constraints on the Mercer ALM study.

In order for value to be gained from the PUB's order to run Shadow Portfolios, the Shadow Portfolios need to be made as transparent as possible and as soon as possible, noting that any delay in doing so runs the risk of being influenced by "hindsight" (i.e. realized returns). Developing the most appropriate Shadow Portfolios, reflecting appropriate principles, assumptions, and constraints would avoid having to re-state previously reported figures that may contain errors, reflect inconsistently applied approaches, etc.

MPI states that "the PUB recognizes that it has no authority to direct MPI's investment decisions."[23] In our respectful view, this is not a relevant consideration. CAC Manitoba's questions, and the intent of the PUB Order, relate to **performance measurement and attribution**, rather than direction over MPI's decisions.

CAC Manitoba disagrees with the assertion by MPI that "[t]he shadow portfolios, and the associated returns are fictional."[24] The Shadow Portfolios and their associated returns are similar in nature to those of benchmark portfolios or "reference" portfolios, which are not "fictional". Instead, benchmark, reference, and Shadow Portfolios enable the measurement of opportunity costs that support performance evaluations. Measuring the returns on the Shadow Portfolio serves the intent of the PUB Order. The intent is not to direct MPI's investment decisions, but to assess those decisions based on return/risk tradeoffs as they are realized over time in the future.

MPI's second broad rationale for refusing to answer is that **it cannot answer these questions as the information required to do so does not currently exist and cannot be reasonably obtained**.[25]

Based on our review of MPI's application, many answers to the questions currently exist. Much of the information can be provided by reviewing INV Attachment A in Part VI. With few, if any, minor exceptions, all of these questions could be answered without any new evidence. Given the importance of this issue for the PUB's assessment of issues 8 and 19, CAC Manitoba would be satisfied to receive any responses that require several weeks delay to be provided when they can be reasonably obtained.

MPI asserts that "[m]any of the details of requested information, such as market impact acquisition costs, and the details surrounding Bank of Canada auctions, are so granular, as to be trivial in the context of the PUB's stated intent of the Shadow Portfolio"

CAC Manitoba disagrees strongly that market impact acquisition costs are too granular/trivial, given a) the intent of the Shadow Portfolio and b) the arguments made by MPI in the past

23 CAC (MPI) 1-23, p 7.
24 CAC (MPI) 1-23, p 7.
25 CAC (MPI) 1-23, p 7.

related to the low liquidity of RRBs.

Question f) essentially questions MPI's rationale for imposing constraints regarding RRB allocations in the Shadow Portfolios. MPI's arguments appear to be based on daily (secondary market) liquidity concerns, while CAC Manitoba poses a question related to material new (primary) issues of RRBs (totaling $1.1 billion) that may have been available to investors, including MPI.

Conclusion

Thank you for your consideration of this motion.

For purposes of this motion, CAC Manitoba is prepared to rely on its written submissions. However, counsel remains available to appear in person, subject to the Board's discretion.

Please contact the undersigned or Mr. Byron Williams at (204) 985-8533, should you have any questions.

Yours truly,

Katrine Dilay

Katrine Dilay
Attorney
KD/ab