Public Utilities Board (PUB)

2020 GRA Information Requests on Intervener Evidence of the Consumers' Association of Canada (Manitoba) (CAC)

September 26, 2019

PUB (CAC) 1-1

Document:	**Protecting Consumers Against Risk: How Far Should It Go?**	**Page No.:**	**4-5**
PUB Approved Issue No.:	**7.a. Capital Rate Request**		
Topic:	**Target Capital Level**		
Sub-Topic:			

Preamble to IR (If Any):

Dr. Simpson and Ms. Sherry state that: "It is also concerning that the focus has returned to a target capital level rather than a target capital range." and that "Reverting to a target capital level invites rate instability…"

Question:

Assuming the Reserves Regulation is not invalid, do Dr. Simpson and Ms. Sherry have an interpretation of that Regulation and a modification to the proposed Capital Management Plan that would, in effect, support the use of a Basic target capital range?

Rationale for Question:

To understand the opinion of Dr. Simpson and Ms. Sherry on the compatibility of the Reserves Regulation with a target capital range.

RESPONSE:

The following response was prepared by Dr. Simpson and Ms. Sherry:

To be consistent with the Capital Management Plan, we expect that a target capital range would have to be based on the MCT and, more specifically, on the 100% MCT standard, despite its lack of connection to the risks facing MPI as identified by the DCAT Report. MPI has previously argued for the 100% MCT standard to be used to set the *upper threshold* for the RSR range, although we feel that this is still an excessive amount of reserves based on the DCAT Report, and we would not support any RSR range centered on the arbitrary 100% MCT standard. In the 2019 GRA (RSR.2, p.3) MPI proposed a more appropriate RSR range associated with MCT levels of 34% and 85% which at least referenced the DCAT analysis, i.e. a lower threshold of 34% MCT (a forecasted Total Equity balance of $143 million) based on a 1-in-40 probability DCAT scenario and an upper threshold of 85% MCT (a forecasted Total Equity balance of $305 million) based on a 2 year, 1-in-40 DCAT scenario with no management action.

The following response was prepared on behalf of CAC Manitoba:

CAC Manitoba notes that it is not within the expertise of Dr. Simpson and Ms Sherry to interpret the *Reserves Regulation.* While CAC Manitoba does not accept that the *Reserves Regulation* as is relates to the RSR is valid or binding upon the PUB for the purposes of rate approval, it notes that the mandatory language of the *Reserve Regulations* would necessarily lead to the conclusion that a minimum threshold of any range for the RSR must be 100% MCT.[1]

CAC Manitoba also notes that the record in this hearing with regard to the status of analogous provisions in Canada as set out in the response to CAC (MPI) 2-7 appears to be incomplete. In the British Columbia context, Special Direction IC2, which contains similar wording to the *Reserves Regulation,* was suspended for the 2018-2021 policy years for ICBC rate setting when it became apparent that ICBC could not maintain reserves at a 100% MCT level.[2]

[1] Section 2 of the *Reserves Regulation* states: "For the purpose of section 18 of the Act, the **minimum amount** the corporation **must maintain** (a) **in its rate stabilization reserve** is the amount determined using a **MCT ratio of 100%.** [emphasis added].

[2] See Insurance Corporation of British Columbia 2017-18 Annual Service Plan Report, p. 14, online: https://www.icbc.com/about-icbc/company-info/Documents/ar-18.pdf. Specifically, please see the following excerpt:

"Performance Measure 2.1:Minimal Capital Test The Minimum Capital Test (MCT) ratio is an industry measure set by the Office of the Superintendent of Financial Institutions (OSFI) for federally regulated insurance companies across Canada. It is calculated as the ratio of capital available to capital required, and is used to assess financial risk and long-term financial stability. **The 2017/18 corporate MCT ratio was 31 percent**, primarily due to lower capital available as a result of ICBC's net loss for the year caused by rapidly increasing claims costs and not being able to set Basic insurance rates to cover costs.

- **On February 26, 2018, Government issued direction to temporarily suspend the Special Direction IC2 (IC2) requirement to maintain Basic MCT at 100 percent and requirement for capital maintenance. This suspension is effective until March 31, 2022.**
- Legislative changes have been made to ICBC's Basic insurance product that are intended to mitigate rising claims costs and support the long-term sustainability of the Corporation." [emphasis added]

In addition, an independent review by Ernst and Young has recommended that ICBC, in conjunction with the government, should consider a lower target capital position for the Basic product more in line with other jurisdictions and that consideration should also be given to whether the OSFI MCT ratio is the appropriate framework for setting capital for the Basic product.[3]

RATIONALE FOR REFUSAL TO FULLY ANSWER THE QUESTION:

In addition, the Insurance Corporation of British Columbia 2019 Revenue Requirement Application Decision confirms there is currently no minimum capital requirement for Basic insurance: see pdf p 45, online: https://www.bcuc.com/Documents/Decisions/2019/DOC_55119_ICBC-2019-RRA-Decision.pdf.

[3] Ernst & Youg, "ICBC Affordable and effective auto insurance – A new road forward for British Columbia, p 85-86, online: https://www.icbc.com/about-icbc/company-info/Documents/Affordable-and-Effective-AutoInsurance-Report.pdf#search=ey%20report. In particular, please see the following excerpt:
"As a government-owned monopoly insurer of the Basic product, ICBC is not required to adhere to OSFI's MCT guidelines. Reasons government-owned monopoly insurers would consider having lower capital target levels than would be required for private insurers include the following:

- Capital surplus above target levels may be put to better use by the government for the broader benefit of the Province rather than being tied-up in investment assets of the insurer.
- Whereas a sole private insurer would face bankruptcy in the event of insufficient capital, leaving policyholders and claimants at risk of not being fully indemnified for their losses, a government insurer is implicitly backed by the government, meaning this risk is minimal in comparison.
- Increased capital levels require higher premiums auto owners need to pay, and it can be argued that in light of the above two points there is no need to have higher premiums.

[…]
In light of the above discussion, ICBC, in conjunction with the government, should consider a lower target capital position for the Basic product more in line with other jurisdictions. Consideration should also be given to whether the OSFI MCT ratio is the appropriate framework for setting capital for the Basic product.

PUB (CAC) 1-2

Document:	**Application Part I - Overview**	**Page No.:**	**39**
PUB Approved Issue No.:	**7. Capital Management Plan**		
Topic:	**Capital Build and Release**		
Sub-Topic:			

Preamble to IR (If Any):

Question:

a) The Corporation's proposed Capital Management Plan appears to embed any resulting Capital Release Provision into the proposed Basic rates. From the consumer perspective, do Dr. Simpson and Ms. Sherry foresee any compelling advantages or disadvantages to this approach, vs. the alternative of issuing distinct rebates to policyholders?

b) Considering the fairness in rating objective, do Dr. Simpson and Ms. Sherry have any concerns that the proposed Capital Management Plan will apply Capital Build Provisions and Capital Release Provisions as a percentage of premium? In other words, is it appropriate that the build and release provisions will vary with each policyholder's underlying claims risk categorization?

Rationale for Question:

To understand Dr. Simpson and Ms. Sherry's opinion on the proposed Capital Management Plan.

RESPONSE:

a) It is our opinion that any Capital Build or Release Provision should be calculated separately from the actuarial rate calculation. The calculation of the actuarially indicated rate should not be complicated by Capital Build or Release decisions. The investment income from the investment portfolio backing the Basic insurance portfolio at the amount it is expected to be for the rating year in question should be part of the actuarial rate indication calculation.

b) It is our opinion that the Capital Release or Build Provision should be calculated separately from the actuarial rate indication. The Capital Release or Build Provision should be a percentage to maintain the integrity of the rate segmentation plan.

RATIONALE FOR REFUSAL TO FULLY ANSWER THE QUESTION:

PUB (CAC) 1-3

Document:	**An Assessment of the Capital Management Plan of MPI for the 2020/21 GRA** **PUB (MPI) 2-11**	**Page No.:**	
PUB Approved Issue No.:	**7.a. Capital Rate Request**		
Topic:			
Sub-Topic:			

Preamble to IR (If Any):

Question:

Considering the target profit provisions embedded in the Extension rate indications in recent years as provided in response to PUB (MPI) 2-11, does this additional context lead to any revisions or changes in emphasis in Mr. Todd's evidence on Generally Accepted Regulatory Principles?

Rationale for Question:

To further understand Mr. Todd's recommendations regarding approach in rate-setting.

RESPONSE:

The target profit provisions embedded in the Extension rate indications provided in the response to PUB (MPI) 2-11 imply that Extension has been highly profitable in the years since the overall Profit Target was introduced in 2012. It is reasonable to expect that profit levels in line with the recent Overall Profit Target will be sustainable.

The profitability of a non-regulated utility service is not a factor that is typically a consideration in the treatment of the revenues from those services unless the non-regulated utility service is failing to recover its costs. That circumstance does not appear to be relevant in the case of MPI's Extension line of business.

In the case of a non-regulated utility services being unprofitable, for example when natural gas utilities in British Columbia and Ontario developed natural gas vehicle fueling services as non-regulated utility services, regulators have typically declined to permit those services to be cross-subsidized by the utility services. As a non-regulated services, the regulators did not address the issue of the rate that should be charged, but they did determine that costs that could be included in the utilities' total revenue requirement could not exceed the revenues that were recognized as an offset for purposes of setting rates for their regulated services. The effect of this regulatory approach was to require shareholders to absorb the under-recovery of costs. As shareholder owned companies, the regulated entities discontinued the money-losing non-regulated utility services.

Given the way in which regulators have treated non-utility services, whether profitable of unprofitable, the response to PUB(MPI) 2-11 does not lead Mr. Todd to any suggest any revision or change in emphasis on Generally Accepted Regulatory Principles.

RATIONALE FOR REFUSAL TO FULLY ANSWER THE QUESTION:

PUB (CAC) 1-4

Document:	An Assessment of the Capital Management Plan of MPI for the 2020/21 GRA	Page No.:	8
PUB Approved Issue No.:	7. Capital Management Plan		
Topic:	Extension Operating Results and Rate Setting		
Sub-Topic:			

Preamble to IR (If Any):

Mr. Todd writes: "In other cases, utilities are permitted to offer competitive services as well as the monopoly services, but the income and expenses related to competitive operations are included in the revenue requirement that is used to [set] the rates for regulated services. In effect, the net income, in excess of the allowed return on investment is used to reduce rates for the regulated monopoly services."

Question:

a) Please provide a list of utilities which are subject to a regulatory framework that includes non-regulated competitive services in the determination of regulated rates.

b) Please provide a description of the mechanism(s) in place in each case, and the authority for the regulator to make a determination that includes non-regulated competitive services.

Rationale for Question:

To understand regulatory schemes in other jurisdictions referred to by Mr. Todd.

RESPONSE:

a) and b)

Canadian examples of utilities which are subject to a regulatory framework that includes non-regulated competitive services in the determination of regulated rates and a description of the mechanism is provided below. Mr. Todd has not addressed the authority for the regulator to make a determination that includes non-regulated competitive services since that is a legal question.

Manitoba Hydro

Hydro includes in its General Rate Applications its Statement of Income. See for example Manitoba Hydro, 2017/18 and 2018/19 General Rate Application, Tab 6 https://www.hydro.mb.ca/docs/regulatory_affairs/pdf/electric/general_rate_application_2017/06.0_tab_6_statement_of_income_analysis_actual_and_forecast.pdf

Hydro's Statement of Income includes Extraprovincial Revenue in section 6.2.2. As Manitoba Hydro's application states:

> *Extraprovincial revenue includes revenues from US and Canadian export sales as well as revenues from other associated export market activities such as merchant sales, transmission credits and renewable energy certificates.*

These revenues would not be earned in the absence of Hydro's utility operations. This opportunity is analogous to MPI's Extension line of business.

All of Hydro's extraprovincial revenues are used to reduce the revenue requirement that Hydro seeks to recover from domestic customers and both the direct costs and the common costs (e.g., the cost of generation and transmission costs that are used to serve both the domestic and export markets) are included in Hydro's revenue requirement.

Hydro's extraprovincial revenues are earned through export sales that are priced on a competitive market basis whether derived from contractual firm sales of spot market sales. Domestic customers therefore receive the full benefit of the margin earned on these sales and, in effect, subsidize export sales if they are made possible through incremental investments that are not fully recovered in the export price. Since extraprovincial revenues and costs are incorporated into Hydro's rate-setting process before the regulator, the PUB addresses issues such as the way in which the profitability of these non-regulated utility activities should be determined (e.g., based on incremental or fully allocated costs) and how the benefits should be allocated to the domestic customer classes.

In addition, some of Hydro's Other Revenue is earned from providing services to customers on an unregulated basis. See Manitoba Hydro, 2017/18 and 2018/19 General Rate Application, Tab 6, section 6.2.3, page 13 of 55. Other services include:

- *Third party revenue for the provision of services for the use/rental of Manitoba Hydro owned assets.*
- *Revenues received for work the corporation undertakes on customer owned plant on a fee-for-service basis.*
- *Electrical inspections performed by Manitoba Hydro on customer owned facilities.*
- *Gains on sale of land to external parties. Gains are calculated as the sale price less historical acquisition costs and costs of disposal.*

Like extraprovincial revenues, these revenues would not be earned in the absence of Hydro's utility operations. All revenues are used to reduce the revenue requirement that Hydro seeks to recover from domestic customers.

All Distributors regulated by the Ontario Energy Board

The Ontario Energy Board, Filing Requirements for Electricity Distribution Rate Applications - 2018 Edition for 2019 Rate Applications - Chapter 2, Cost of Service sets out in section 2.3.3 the filing requirements for Other Revenue at pages 26-18. See https://www.oeb.ca/sites/default/files/Chapter-2-Filing-Requirements-20180712.pdf.

The requirements include "The balances recorded in Account 4375, Revenues from Non Rate-Regulated Utility Operations" as stated on page 27.

The OEB's Accounting Procedures Handbook describes account 4375 as follows:

4375 Revenues from Non Rate-Regulated Utility Operations

A. *This account shall include revenues applicable to operations which are non-utility in character but nevertheless constitute a distinct operating activity of the enterprise as a whole, such as the operation of a department where such operation is not defined as a utility, or the operation of a service organization for furnishing supervision, management, engineering, and similar services to others.*

B. *This account shall also be used to record the revenues arising from the provision of streetlighting services and any administrative fee revenue that the utility earns for administering the streetlighting program on behalf of a municipality, etc. while the related expenses are reflected in Account 4380, Expenses from Non Rate-Regulated Utility Operations.*

C. *Revenues arising from operation or management of water or sewage services on behalf of a municipal corporation that owns directly or indirectly the utility, may be recorded in this account.*

D. The accounts shall be maintained so as to permit ready summarization of revenues by activity.

The revenues and expenses of permitted non rate-regulated utility operations are used to offset the revenue requirement that must be recovered in the distributors rate-regulated utility activities. This treatment is essentially the same as the treatment of Manitoba Hydro's non rate-regulated utility operations such as extraprovincial sales.

New Brunswick Power

New Brunswick includes in its General Rate Applications for cost allocation and rate setting purposes two categories of services that are treated as customer classes for cost allocation purposes although the rates are set by NB Power on the basis of competitive considerations rather than allocated costs: Street Lights and Unmetered and Water Heaters.

The Street Lights and Unmetered class relates primarily to street light services provided to municipalities but also includes other types of unmetered services. Water Heating involves the provision to its customers a water heater rental service. Both of these categories are competitive services with net revenues being treated as an offset to the revenue requirement that is recovered from customers in the rates for electricity.

The regulatory treatment of NB Power's non rate-regulated utility services can be seen by reviewing its cost allocation evidence. For example, see NB Power 2019-2020 General Rate Application (Matter 430) Exhibit NBP9.01, section 9.

NB Power's GRA evidence is available at by searching under Matter 430 at:
https://filemaker.nbeub.ca/fmi/webd/NBEUB%20ToolKit13

This regulatory treatment of these non-rate regulated utility services is apparent through reference to the tables in section 9 which show revenue to cost ratios for these service categories that are will above the target range for other classes (0.95 to 1.05). The overall revenue to cost ratio is 1.00; hence, the revenue to cost ratio for all rate-regulated services is below full cost recovery (i.e., below 1.00).

Conclusion

These are three readily available examples of the standard practice of Canadian electricity and natural gas utilities offering services on a non-rate-regulated and often competitive basis with net revenues being used as an offset against the revenue that is collected from customers for the rate regulated services.

RATIONALE FOR REFUSAL TO FULLY ANSWER THE QUESTION:

PUB (CAC) 1-5

Document:	An Assessment of the Capital Management Plan of MPI for the 2020/21 GRA	Page No.:	11
PUB Approved Issue No.:	7. Capital Management Plan		
Topic:	Extension Operating Results and Rate Setting		
Sub-Topic:			

Preamble to IR (If Any):

Question:
Please have Mr. Todd elaborate on how excess profits should be defined, in determining which benefits should be transferred to Basic insurance for rate-setting purposes. Please contrast with what MPI is proposing with respect to transfers from Extension.

Rationale for Question:
To further understand Mr. Todd's opinion as set out in his report.

RESPONSE:

The term “excess profit” as used by Mr. Todd reflects the standard use of the term in economic textbooks. That is, it refers to any profit that exceeds a normal market rate of return, or in the case of a regulated utility under a rate-base rate-of-return rate-setting model, it would be any profit in excess of the return that is allowed by the regulator for purposes of determining the revenue requirement for rate-setting.

Relating the standard definition to the context of MPI, implies that excess profit would be defined as any profit in excess of level normally allowed for rate regulated insurance products. As the term is used in Mr. Todd’s evidence, it would most appropriately refer to revenue in excess of that required to maintain a prudent level of reserves as determined by the methodology approved by the PUB. This definition of excess profit is consistent with the definition of excess revenues that appears at page 14 lines 17 – 22 of Mr. Todd's evidence

RATIONALE FOR REFUSAL TO FULLY ANSWER THE QUESTION:

PUB (CAC) 1-6

Document:	An Assessment of the Capital Management Plan of MPI for the 2020/21 GRA	Page No.:	11-12
PUB Approved Issue No.:	7. Capital Management Plan		
Topic:			
Sub-Topic:	Extension Operating Results and Rate Setting		

Preamble to IR (If Any):

Mr. Todd states: “Unless it can be demonstrated that from an insurance risk perspective a higher Extension RSR Target can be justified for Extension than is justified for Basic, it is inconsistent with common practice to permit a regulated utility to earn excess profits on non-utility services. This result is generally accomplished by including all costs of the utility in its revenue requirement ...This approach automatically deducts the net income earned on the non-utility services from the net revenue requirement that is recovered for utility services.”

Question:

a) Please have Mr. Todd explain his view as to how MPI should assess or determine the level of required reserves for Extension for Basic rate-setting purposes.

b) Please have Mr. Todd provide an illustrative example of how the proposed profit-sharing scheme would work in the context of this Application, and how such an approach could be used to determine the indicated Basic rate.

Rationale for Question:

To understand the implications of adopting an alternative regulatory framework for establishing Basic rates.

RESPONSE:

a) Consistent with footnote 14 in the evidence of Mr. Todd the level of required reserves should be based on actuarial considerations that are approved by the PUB as being prudent. The footnote states "I note, however, although it is not my area of expertise, that I would assume that the methods used to determine the RSR Target, whether MCT or some other method, would establish target levels that take into account any risk differences."
Since the determination of the required reserves for Extension for Basic rate-setting purposes is an actuarial matter, Mr. Todd has no opinion on how it should be assessed by MPI.

b) Mr. Todd has not proposed a revenue sharing mechanism to be used by MPI. The discussion at page 12 makes explicit reference to the rationale for an earnings-sharing mechanism relates to shareholder-owned utilities. MPI is a crown corporation, not a shareholder-owned utility; hence, none of the rationales for implementing a profit-sharing scheme are applicable to MPI. The point being made was simply that it would be consistent with Generally Accepted Regulatory Principles to allow a utility to earn more than a normal return, or in the case of a regulated insurer, base rates an more than the standard reserve ratio provided it is determined that it is in the interest of the regulated customers, and consistent with the regulatory objectives, to do so.

RATIONALE FOR REFUSAL TO FULLY ANSWER THE QUESTION: