MANITOBA PUBLIC UTILITIES BOARD

Re: MANITOBA PUBLIC INSURANCE CORPORATION (MPI)

2018/2019 GENERAL RATE APPLICATION

HEARING

Before Board Panel:

Robert Gabor, Q.C. - Board Chairperson

Michael Watson - Board Member

Carol Hainsworth - Board Member

Allan Morin - Board Member

Robert Vandewater - Board Member

HELD AT:

Public Utilities Board

400, 330 Portage Avenue

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APPEARANCES

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Roger Cathcart	)Consultant
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Matthew Ghikas	)Insurance
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Katrine Dilay	)
Raymond Oakes (np)	)CMMG
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--- Upon commencing at 1:04 p.m.

THE CHAIRPERSON: Good afternoon. If everybody is ready we'll start. Today we'll start with the Consumer Association of Canada witness, Dr. Simpson.

Ms. Dilay, would you like to start or...

MR. MATTHEW GHIKAS: Mr. Chairman, I actually have a few -- a few --

THE CHAIRPERSON: Oh, okay. I'm sorry, Mr. Ghikas.

MR. MATTHEW GHIKAS: No, no, no, that's okay. It's -- the first thing that I wanted to deal with, Mr. Chairman, was MPI Exhibit 40 was the response to Pre-Ask PUB-5. And there -- it was missing some appendices last week. Then we circulated an electronic version this weekend that was also missing appendix. So we are -- we now have a version of MPI Exhibit Number 40 that is complete, and we are circulating it. And that would just simply be a replacement for MPI Exhibit 40, as I understand from what we discussed with My Friend Ms. McCandless earlier.

The second thing, it was just in going

through the -- the materials notice to -- that in the GRA in the DCAT section, there was actually one (1) figure where another figure had been replicated twice rather than having a separate figure. So we caught that in the process and we thought we may as well, just to make the record clean, file an errata. And so we had -- this would be MPI Exhibit 54. And there is a black lined version and -- and a clean version, and it just simply replaces DCAT Figure 64 with what should have been there to begin with. And that's, that's all I have today.

MR. STEVE SCARFONE: And, Mr. Chairman, I have one (1) matter to address as well. So Board counsel was good enough to point out that a mistake was made that has been captured in the transcript from Friday's proceedings. And it -- it concerned the redirect that I did for Mr. Yien.

During that re-examination of Mr. Yien I had put to him that Mr. Geffen gave evidence -- Martin Geffen gave evidence about having experience on projects the size of PDR. You'll recall that and -- and that I had said to Mr. Yien that Mr. Geffen's evidence in that respect was that he could count on one (1) hand the number of projects the size of PDR in his entire career.

But that was -- that evidence that I put to him was improper -- not improper, but there was a mistake there because, as Ms. McCandless pointed out, the evidence of Mr. Geffen was that it wasn't in his career, but rather in one (1) year. And I don't know if Mr. Chair picked up on that, but that was your question, sir.

THE CHAIRPERSON: I -- I did pick up on it at the time. And --

MR. STEVE SCARFONE: Yes.

THE CHAIRPERSON: -- but I didn't want to interrupt. I wanted to make sure I was -- it was -- I was correct. But I -- I think the question was: In an average year, or something like that --

MR. STEVE SCARFONE: Yes.

THE CHAIRPERSON: -- or on a yearly basis how many times.

MR. STEVE SCARFONE: And so that's an important distinction because I do recall Mr. Yien saying to me I was -- he was surprised that Mr. Geffen had only experienced that in his entire career. And, of course, that's not the case.

THE CHAIRPERSON: Right.

MR. STEVE SCARFONE: It was just over the past -- in one (1) year.

THE CHAIRPERSON: yeah.

MR. STEVE SCARFONE: So we wanted to make the -- the record -- clear the record up on that.

THE CHAIRPERSON: Thank you, sir. Appreciate that. Ms. Dilay.

MS. KATRINE DILAY: Thank you, Mr. Chair.

Good afternoon, Dr. Simpson, and thank you for joining us. So I'll be doing the direct examination for Dr. Simpson this afternoon. Before starting I'd like to introduce the exhibit for the PowerPoint presentation of Dr. Simpson, which we believe will be filed as Exhibit CAC-22. And we have distributed electronically, as well as paper versions.

--- EXHIBIT NO. CAC-22: Presentation of Dr. Simpson

MS. KATRINE DILAY: So before starting, I believe that Dr. Simpson has to be affirmed or sworn for the record.

CAC PANEL 1:

WAYNE SIMPSON, Sworn

EXAMINATION IN-CHIEF BY MS. KATRINE DILAY:

MS. KATRINE DILAY: Thank you, Mr. Crystal. So good afternoon, Dr. Simpson. It's our understanding that you have already been pre-qualified with the Board and that your curriculum vitae has already been filed. But before you begin your presentation, I'd like to ask you a few questions to highlight your qualifications as they relate to your testimony today, as well as the written evidence you have already provided in this proceeding.

So in terms of your education, Dr. Simpson, you received an MSC in economics from the London School of Economics in 1974?

DR. WAYNE SIMPSON: That's correct.

MS. KATRINE DILAY: And a PhD from the London School of Economics in 1977?

DR. WAYNE SIMPSON: Yes, I still remember that. Yes.

MS. KATRINE DILAY: That's good. And you are currently a full professor in the Department of Economics at the University of Manitoba?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: And you taught there since 1979?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: You've served as department head on two (2) separate occasions from 1997 to 2008? Is that right?

DR. WAYNE SIMPSON: That's correct.

MS. KATRINE DILAY: And in terms of your experience, so your areas of academic expertise in specialization include labour economics, applied econometrics, applied microeconomics, and economic and social policy analysis?

DR. WAYNE SIMPSON: Yes. Self declared.

MS. KATRINE DILAY: You have co-authored or authored three (3) books and more than sixty (60) peer-reviewed articles on these and related topics?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: Among those peer-reviewed articles are two (2) papers on the impact of risk on the behaviour of the firm. Is that correct?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: And you are currently on the editorial board of Canadian Public Policy?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: And that would be

Canada's foremost peer-reviewed academic journal for economic and social policy, right?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: And you have served on the executive council of the Canadian Economics Association?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: You were also the 2014 recipient of the McCracken award for the development and analysis of economic statistics for the -- from the Canadian Economics Association, correct?

DR. WAYNE SIMPSON: That's correct.

MS. KATRINE DILAY: You have worked at the Bank of Canada, the Federal Department of Labor, as well as the Economic Council of Canada. Is that right?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: You have also served as a consultant both to the private sector and government, primarily in the areas of labour economics and policy evaluation. Is that right?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: And you have served as an expert advisor to Prairie Research

Associates and Human Resources and Skill Development Canada. Is that right?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: Now, in terms of your experience before the Public Utilities Board in the context of MPI hearings, you testified in the 2007, 2010, 2013, 2014, and 2016 GRAs on an evidence-based approach to setting the RSR on considerations in looking at interest rate forecasting and on issues relating to investments?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: And you have been qualified as having expertise in both applied microeconomics and applied econometrics before the PUB on a number of occasions. Is that right?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: In terms of your qualifications in this proceeding, Dr. Simpson, you have been pre-qualified as an expert in applied econometrics, applied microeconomics, and quantitative methods.

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: Just the kind of walk our way through that, applied economic -- econometrics is the study of the behaviour of individual agents, whether firms or households, in the market using modern theory and empirical methods. Is that right?

DR. WAYNE SIMPSON: Yes, applied microeconomics and applied econometrics. Yes. They both cover that field. Yeah.

MS. KATRINE DILAY: Okay. And applied econometrics seeks to apply that analysis we just discussed to practical problems such as risk management and investment strategies?

DR. WAYNE SIMPSON: Yes, that's one (1) of the areas.

MS. KATRINE DILAY: And applied econometrics uses specific statistical techniques, particularly regression methods, to analyze and predict econometric -- economic behaviour and to apply it to practical social problems.

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: Dr. Simpson, would you agree that your professional expertise in applied microeconomic and applied econometrics provides a foundation for the analysis of issues related to the management of risk by firms, and to the assessment of risk using modern economic and statistical techniques?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: And just a final few questions in terms of the evidence that you have prepared for this proceeding, Dr. Simpson. You were the primary author of the written evidence filed as exhibit CAC-5 entitled, "Does the RSR need to be so large?", correct?

DR. WAYNE SIMPSON: That's correct.

MS. KATRINE DILAY: You were also responsible for responses to Information Requests contained within exhibit PUD-11?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: And can you confirm that the written material was prepared under your direction and control, and is accurate to the best of your knowledge and belief?

DR. WAYNE SIMPSON: Yes.

MS. KATRINE DILAY: Thank you, Dr. Simpson. And now I will pass it on to Dr. Simpson for his presentation.

PRESENTATION BY DR. WAYNE SIMPSON:

DR. WAYNE SIMPSON: Okay. Well, thank you for allowing me to speak once again on this topic. I'll try not to repeat myself excessively. There are some things that come up that bear repeating, but I'll try to limit that. And I'll try to take a somewhat broader perspective on this in recognition that the -- that the issue goes beyond the simple business interests of MPI to the broader social interests, and the reflection of the fact that there's some sort of balance to be achieved between the intr -- business interests, the legitimate business interests of MPI in stabilizing rates and protecting against risks, and the value to consumers, ratepayers, of having money in their pockets to spend and invest. So that balance has to be recognized.

Next slide. Thank you. So we have a fairly significant increase. I tried to represent a balloon, but my computer graphics failed me, so those are circles. It's getting bigger. The increase in the RSR range, according to what MPI asked the last time, 181 million is the lower threshold, and 404 million is the higher threshold, up to 201 million for the lower threshold this time, and 438 million for the upper threshold, or increases of 13.8 and 8.4 percent. And indeed, if you look at -- the Board ordered a lower threshold of 159 million. The increase is substantially higher, in the range of 26 percent increase. So that's quite substantial.

The benchmarks, I think, that are

legitimate here are 1) Inflation, which is expected to be around 2 percent, but in fact, in Manitoba right now, it's more like 1.2 percent, and the rate request, which is a 2.7 percent increase. And so the questions I asked are around, Why does the RSR have to be so large in the context of what risk factors would account for this kind of -- of increase.

So the purpose -- next slide, please. The purpose of the RSR, again, this is not controversial. It's been repeated over and over, and there's some slight changes the last time around, but it's to protect motorists from rate increases due to unexpected variances from forecasted results and events and losses revised -- rising from nonrecurring events or factors. And the two (2) bolded words, my bolding, are key, I think, and the -- the event should be unexpected, and therefore nonrecurring in the sense that they shouldn't be predictable for the fact, and they shouldn't be repeating themselves over and over again.

And this is important, because it then connects this definition to the -- what I call a standard statistical concept of risk or uncertainty arising from a set of outcomes with assigned probabilities of occurrence, resulting in an expected outcome, best-case scenario, if you wish, and a set of unexpected outcomes favourable and unfavourable with specified probabilities, the unfavourable ones being the -- the adverse events that form the -- the basis of the DCAT analysis beyond the best case scenario.

And I think this is a crucial foundation in the basis on which I was enthusiastic about using the DCAT in a collaborative and transparent way to -- to look at the RSR range, and I think CAC was willing to go along, at least with that opinion.

Next slide, please. So using the DCAT to determine the RSR, the idea of the DCAT, then, is to identify the risks of unexpected, nonrecurring events -- in other words, find out which risks are -- are what we call major risks in the DCAT -- to quantify the -- the probabilities of their occurrence from available historical data, where possible, and to achieve some degree of consensus, not agreement, but certainly, discussion and the meaningful collaboration whether we agree or not among MPI, the PUB, and the stakeholders on these methodological issues.

And indeed, there was a technological conference this year on using the DCAT to establish the RSR range, where a number of issues were discussed around interest rate forecasting and other things, some of which I referred to below.

And I going to focus on three issues with the DCAT report and the RSR thresholds. These -- first of all, returning to the issue of the MCT to set the upper threshold. Secondly, the determination of the base DCAT scenario, the best -- best case, if you will, expected value, and thirdly, the formulation of interest rate and decline -- interest rate decline in combined scenarios that are the core of the determination of the -- of the RSR range, the lower bound.

Number 1, use of the MCT to set the upper RSR threshold, MPI continues these -- this argument for a 100 percent MCT criterion for the upper threshold of the RSR. They argue that it is a standardized test used by the property and casualty insurance industry and its regulators, although MPI itself is a Crown monopoly insurer, which is not in a competitive market, and has no real possibility of bankruptcy, and I'll come back to this in the context of an ICBC report in a minute or two (2).

They argue that it's a risk-based approach that better reflects the riskiness of individual property and casual insurers. When I read this, I was very curious as to what "better" meant in the sense of, is it better than the DCAT? The link to risk is certainly far more opaque.

And the hundred percent MCT criterion was rejected, I think, quite sensibly by the PUB last time, the 2017 GRA, where the Board stated that they were concerned that the degree of conservatism implied may be excessive based on the Corporation scenario testing. And I think -- and -- let's see. PUB-MPI-2-26.

There were questions about just what degree of conservatism is implied, and they state that based on the DCAT modelling, the estimated probability level that will exhaust the proposed maximum upper RSR target of 438 million, which is the hundred percent MCT level, without management action is a 1:2,000, although I would say it's greater than 1:2,000, because they then go on to say the DCAT modelling did not identify any adverse scenarios with management action that exhausted the $438 million upper target.

So essentially, it's unknown, but a lower bound of 1:2,000 is placed on it with management action. And I relate this kind of conservatism, if you will, to things like the Floodway, which is a major concern about risk, as opposed to a much more minor concern with Autopac rates, and there, the -- the standard is now 1:700, so quite a bit lower than -- than 1:2,000.

Then we have the Ernst & Young report for ICBC, which I think further supports the Board's position. It states that -- this is just a portion of what I have in the report I -- I made. As a government-owned monopoly insurer of the base product, ICBC is not required to adhere to OSFI's MCT guidelines. Reasons government-owned monopoly insurers would consider having lower tactile -- capital targets than would be required for private insurers include 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. That's my point about the balance between the insurer and the more broader -- broader social interests.

And 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 other words, the risk of -- of bankruptcy is minimal.

And increased capital levels require higher premiums auto owners need to pay. And it can be argued in the light of the above two (2) points, there is no need to have higher premiums. So again, this is the balance between what auto owners need to pay and what the Crown insurer needs to ensure secure financial operation.

Consideration should also be given to whether the OSFI MCT ratio is the appropriate framework for setting the Basic product. And I think we certainly agree with that statement, and think that the DCAT should be used consistently for setting both the upper and the lower thresholds.

And then -- so what is a better way? Well, a better way, in fact, is recognized, I think by the PUB Board Order 162/'16: "Beyond which -- beyond what percentile level," they say.

This is about excess conservatism.

> "Is it no longer reasonable and appropriate for the Corporation to hold funds against possible adverse circumstances instead of rebating these excess funds back to ratepayers? The Board directs that the next application will include

the appropriate scenarios in support of this proposed upper threshold for the Basic target capital range. This includes testing of at least the 99th and 99 point -- point 5th percentile outcomes."

So the 1:100 and 1:200 cases. And in fact, this echos something that the Andrea Sherry and I submitted in -- in 2016, illustrating how the DCAT could be used to consistently develop the appropriate RSR range. We developed based on the -- on the DCAT, a wide range and a narrow range. The wide range would use percentile levels of tolerance of 1:10 to 1:200, and the narrow range, 1:20 to 1:100, both spanning a target midpoint of 1:40, which is the -- the target that's been accepted by both sides in terms of -- of what we're aiming for.

So CAC-MPI second round interrogatory 2-45, we have the figures which give us those numbers. The wide range yields a lower threshold of 152 million and an upper threshold of 268 million, the narrow range yields a lower threshold of 185 million, and the upper threshold of 249 million, which I think are reasonable in the context of the lower threshold of 159 million granted by the Board last time and 181 million requested by MPI.

But -- and if you look at the upper threshold of 268 million and 249 million, well below the MPI requests of 438 million, which is not surprising, because the risk tolerance levels that are now being applied of 1:100 and 1:200 are considerably below the implied tolerance levels of in excess of 1:2,000 for the hundred percent MCT benchmark of 438 million.

And there's an argument -- some argument for a wider range, since there -- an issue has been made of this that the range is too narrow by greater risk tolerance levels. Not 1:2,000, but maybe 1:500. But again, we now start to see that we're right up there with the Floodway. And the question, then is: Do ratepayers want to protect themselves as much from a catastrophic flood as they do from a -- a rate shock? And I -- I think the answer to that is no. I think 1:200, for example, is a reasonable level of protection.

So now the second point is determination of the DCAT base scenario. Again, this -- the DCAT always starts with the definition of the base scenario as a realistic set of assumptions to forecast the insurer's financial position over the forecast period. And normally, the base scenario is consistent with the insurer's business plan. It has a set of assumptions that are used to -- obviously, to make that -- set up that base scenario over the -- the four (4) year horizon; volume growth, vehicle upgrades, inflation, interest rates, and so on. And the two (2) bolded, inflation and interest rates, are the two (2) that I am going to look at in this -- in this presentation.

So interest rates first. Here, we have a revised methodology. The problem we had coming out of the -- the so-called Great Recession of 2008, which wasn't much of a recession in Manitoba, we were -- got off rather luckily in that respect; were -- far more harsh elsewhere in the world, and -- and even --even elsewhere in Canada -- is that interest rates have stayed relatively low, and growth has been relatively sluggish. And that has restrained any efforts by the Bank of Canada to restore interest rates to normal levels.

And the standard interest rate forecast, which is the consensus forecasts from banks and other financial institutions of interest rates, which was used for many years, has consistently understated interest rates. The solution to that in the last DCAT was to adopt a 50/50 average of the SIRF, the Standard Interest Rate Forecast, and a naive constant current forecast, because interest rates have remained what I call uncharacteristically low.

But that strict reliance on the naive forecast for 2018/'19 is really coming at just the wrong time. It's coming at a time when interest rates are now beginning to ari -- to rise, and the -- this naive Government of Canada ten-year bond forecast in the DCAT of 1.64 percent, based on the February 28th figure, would have to be compared to current interest rates, which are considerably higher, which I'll come to in a minute.

As a collaborative process, including the April technical conference, I think there's been no agreement on the 50/50 or naive forecast going forward. And indeed, at the April technical conference, I made the argument that the zero lower bound on interest rates was a real thing, that there was a real lower bound in interest rates, and the notion in the SIRF that interest rates were going to eventually rise, and the Bank of Canada was going to act as soon as growth became less sluggish, is -- is coming to fruition. That's exactly what is now -- now happening. So I feel good about that -- that statement, anyway, that forecast, if you will.

So the SIRF continues to predict interest rates will begin to rise, and hence, that a naive forecast would be unrealistic. And sure enough, the Bank of Canada announced increases in its overnight or policy rate to .75 percent in July, and 1 percent in September. And these were followed quite directly by interest rate increases at the Canadian banks and in the bond markets.

So the Government of Canada ten (10) year bond rate, I have two point o-seven (2.07) as of September 14th. It's settled at 2.10 percent as of October the 11th, I think is the last time I looked. The reference is in the paper -- the -- the website, and that's an increase about of point four-six (.46) basis points over the 1.64 percent that's in the DCAT, and roughly .5 percent, exactly what the Bank of Canada has done with its policy rate.

But moreover, I think there's -- there's good reason to believe that interest rates will continue to rise, that the Bank of Canada will respond to what has been characterized as the best Canadian six (6) month growth in fifteen (15) years, to what the IMF and the -- the World Bank have characterized as the -- the excellent growth prospects for Canada, well ahead of any other -- of the other countries in the G7, and the Bank of Canada can be expected to lean against the wind to try to dampen inflationary expectations that come out of that kind of growth and increase the policy rate further. I'd expect some increases in the fall, at least one (1), maybe even two (2) increases, and if not, then -- then in the winter.

The lower interest rates have the translated into lower total equity, all else the same. MPI argues that forecasted interest rates did not materialize and resulted in $163 million in premiums deficiencies in recent years that presented significant financial challenges. And we therefore asked if there is a change in interest rates, it results in a material impact on the DCAT base scenario?

MPI replied to our request. The applied-for rate indication and indicated DCAT, lower RSR rate, then it would be appropriate for the Corporation to update the DCAT figure.

So they've agreed in this IR that, in fact, there is a -- a need to update the interest rates if they have a material impact. I'm not sure what "material impact" means, but interest rates have risen a half percent, and will increase further during the first year, and I suspect in subsequent years of the -- of the DCAT. Certainly, the SIRF continues to project that kind of trajectory for interest rates.

And I ask, Wouldn't even an up-to-date naive forecast perform as well as the SIRF consensus forecast of interest rate experts going forward, as interest rates begin their upward climb? The reason I state this is because this is not a question that's even considered in the DCAT. The DCAT proceeds with the naive forecast. It doesn't even consider the 50/50 forecast that was used last year, or the SIRF forecast that was used in previous years, despite the fact that interest rates are now rising.

Now in the defence of that, this wasn't as apparent in February when the growth numbers would not of been out even for the first quarter, as it is now, but certainly, the case for the naive forecast and for the DCAT relying on it is much weaker, given current events.

Turning now to the inflation assumptions. As someone who lived through the -- the stagflation of the 70s, where we had high unemployment and high inflation, it's -- it's nice to see a relatively low inflation and relatively stable inflationary expectations over time. The unemployment rate has also, although sluggishly, begun to come back to what are considered pretty reasonable levels. Employment growth and -- and growth in general is now proceeding fairly well.

So in this era of kind of stable inflation and inflationary expectations, I find it odd that the base scenario assumes no increase in the third and fourth years. And even in the second year they characterize an increase of two (2) per -- project an increase of 2 percent as an RSR increase. Whereas, I would project those increases as the kinds of increases in costs you would expect of an operation, wages and other things, and the kinds of -- of increases that ratepayers would be expecting in this period.

In other words, rate shock might be 5 or 6 percent or 7 percent, but it wouldn't be 1 or 2 percent given that there's been a slow increase in prices of that range, and a slow increase in salaries of -- of that range or a little bit more. So we asked in CAC-MPI-189: Why is it a realistic assumption to assume no rate increases in the base scenario beyond 2018/'19? And MPI's response, in part, was that a 1 percent rate increase in -- in '19/'20, would lower the RSR target from 201 to 191 million.

Well, a better anchor for inflation would really be 2 percent. This is a projection, you know, of the Bank of Canada and the banks, and every -- just about everybody else, including that which is reflected in the base case scenario. So a 2 percent rate increase to reflect anticipated cost inflation would reduce the RSR lower threshold to about 181 million, which is MPI's revised request in the 2007 GRA.

So to summarize, what are the implications of interest rate and inflation assumptions? The combination of one (1) on rising interest rates, and two (2) the premium rate increases in line with forecast inflation would produce significantly higher total equity for the base scenario in 2018/'19 and beyond, essentially repeating what MPI is telling us. And I'm projecting that the higher total equity in the base scenario should significantly reduce the low RSR lower and upper thresholds in the DCAT for the same level of risk tolerance, subject to them working through the details of that.

The third point is the determination of the interest rate and combined scenarios. Again, historically low interest rates have posed a forecasting challenge. They've remained sluggish and low as growth has remained sluggish and low. That's now changing. But the interest rate decline scenario that has evolved to attempt to capture this -- this risk is one (1) that lacks any base to historical fact. That's not a fault. We don't have -- we don't have any historical fact to lean on and not -- therefore no probabilistic methodology.

And it has to be recognized as not credible in the sense that, say, the equity decline scenario, which is another one (1) of the major risks they talk about, is -- is based on historical fact. So it lacks the kind of credibility in terms of the evidence gathered and the way in which it's constructed. And we say that -- we've said in the past that it produces virtually identical total equity results regardless of the specified risk.

The probability level, which plays an important part in other scenarios and in the purported advantages of using the DCAT methodology, simply does not matter in the presence of the floor that is applied to interest rates. And now that interest rates are rising, the rising interest rates will then improve the financial position of the Corporation as reflected in the base scenario, and will affect the lower threshold calculation of the RSR. This is a question we asked.

Now, while that seems like a reasonable conclusion from the rising interest rates that are now occurring, MPI says on the basis of the existing interest rate decline scenario -- and I think this is more a reflection of our point that this is not really a credible scenario -- it says, not necessarily because the lower RSR target would increase as interest rates rise. Interest rate risk is capped by the assumption of an interest rate floor. This is what drives the interest rate decline scenario.

The risk immediately -- the scenario immediately drives to the interest rate floor, which at the moment is quite low 1.64 percent. If interest rates increase significantly there would be an increased risk of a decline in interest rates, creating the need for additional RSR.

To us this only makes sense when the interest rate decline scenario is driven by an ad hoc interest rate floor arbitrarily anchored to the lowest monthly Government of Canada ten (10) year bond yield from 1989 -- which I think I said one-point-six-four (1.64), but it's substantially less than that. I -- I can't pull out -- the figure out of my mind right at this moment -- to the present that lacks any probabilistic assessment of adverse events.

Now -- and then finally, in the past the combined scenario has really restricted itself to the -- the three (3) major risks and it -- the interest rate decline scenario, I think in recent years, has driven the combined scenario. And so that's one (1) of the reasons that I've concentrated on -- on discussion of it because I think that risk scenario is -- is badly flawed.

But this year, in addition, they've introduced a corporate bond default risk because they've added corporate bonds -- more risky corporate to the investment portfolio. And they've said that allocation to corporate bonds is a material change in the risk profile of the Corporation's asset portfolios which should be modelled in this scenario. The introduction of a fourth risk to the combined scenario has not been raised at any point with the stakeholders, and doesn't represent the kind of collaboration that I think anybody would expect in a -- in the process.

It's also not clear how such investment risk should be independently introduced into the scenario, bearing in mind that there are risk premiums attached to more risky investments, such as corporate bonds, and those are reflected in the yields and in the investment decisions that MPI would make and its investment advisors and managers would make in deciding to include these bonds in their portfolio. I simply don't know how this should be dealt with, but I think it's something that should be considered further.

So recommendations. One (1), the DCAT analysis is the best vehicle to assess the risks facing MPI, should continue to be used independently -- or consistently, I'm sorry, and collaboratively to determine the lower and upper thresholds for the RSR; that the MCT criterion used to set the upper threshold for the RSR should again be rejected by the Board; that the appropriate methodology for setting the upper RSR threshold resides in the use of the DCAT in a comparable fashion to the methodology used to establish the lower threshold for the RSR, involving testing of at least the 1:100 and 1:200 outcomes, and certainly not the outcomes as large as 1:2000.

Strict use of the naive forecast in the DCAT be replaced with at least the 50/50 forecast, which was used in the previous DCAT and is more relevant to the current interest rate environment, certainly, than it was last year. The MPI -- that MPI undertake to assess the 50/50 forecasts in the light of rising interest rates. I think it's crucial that they update their interest rate forecasts and consider what has happened since February.

The DCAT base scenario assume a 2 percent rate increases in 2019/'20, '21/'22 as expected future cost and price inflation, and as the anchor to what ratepayers might expect. Results for the interest rate decline combined scenarios in the DCAT should be discounted because of the ad hoc nature of the interest rate decline scenario. And that MPI consider revising the interest rate decline scenario in future DCAT reports to reflect rising interest rates, and use forecasting methods that take account of -- of the historical evidence as interest rates move into charted territory from the uncharted territory they've been in recently, and inclusion of the -- of the risk of corporate bond default risk in the combined scenario be reviewed.

MS. KATRINE DILAY: Thank you, Dr. Simpson. Thank you. Dr. Simpson is now ready for cross-examination as well as questions from the Board.

THE CHAIRPERSON: Mr. Scarfone...?

MR. STEVE SCARFONE: Mr. Chair, I know we've only been going for forty-five (45 minutes), but would it be possible to take a five (5) minute break before we begin cross-examination?

THE CHAIRPERSON: Sure. We can take a -- we'll take a fifteen (15) minute break.

MR. STEVE SCARFONE: Oh, thank you. Thank you.

THE CHAIRPERSON: How about that?

--- Upon recessing at 1:45 p.m.
--- Upon Resuming at 2:05 p.m.

THE CHAIRPERSON: Thank you. Mr. Scarfone, you can begin.

MR. STEVE SCARFONE: Thank you, Mr. Chair.

CROSS-EXAMINATION BY MR. STEVE SCARFONE:

MR. STEVE SCARFONE: Good afternoon, Dr. Simpson.

DR. WAYNE SIMPSON: Good afternoon.

MR. STEVE SCARFONE: I'm Steve Scarfone, counsel for MPIC. We just shook hands.

DR. WAYNE SIMPSON: Pleased to meet

you.

MR. STEVE SCARFONE: I just have a couple of questions for you. Before we begin the cross-examination proper about your qualifications that appear at Appendix A attached to your paper.

DR. WAYNE SIMPSON: M-hm.

MR. STEVE SCARFONE: Dr. Simpson, I've reviewed this. Is it fair to say, sir, that you're an economist, not a practitioner, but a professor in the social science discipline of Economics?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: And the CV, sir, or the -- the appendix indicates herein that you've written three (3) books in this capacity; is that correct?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: And, sir, I think you'll confirm that none of these books relate to finance and capital market conditions?

DR. WAYNE SIMPSON: That's correct.

MR. STEVE SCARFONE: And the books also don't relate to the insurance industry; is that correct?

DR. WAYNE SIMPSON: No.

MR. STEVE SCARFONE: They are -- is it

fair to say, sir, that those books are almost exclusively focused on labour economics?

DR. WAYNE SIMPSON: Broadly defined, yes.

MR. STEVE SCARFONE: And, sir, your CV also lists sixty (60) peer-reviewed articles; is that correct?

DR. WAYNE SIMPSON: Rough estimate, yeah.

MR. STEVE SCARFONE: Including two (2) papers as My Friend indicated on the impact of risk on the behaviour of the firm; is that correct?

DR. WAYNE SIMPSON: That's correct, yes.

MR. STEVE SCARFONE: Just for my own edification, sir, what does that mean; the risk on the behaviour of the firm?

DR. WAYNE SIMPSON: How the firm responds to risky situations where there's a change in the amount of risk.

MR. STEVE SCARFONE: Okay, thank you. And so I expect, sir, that most of the other 50 plus articles focused on labour economics and social and economic policy?

DR. WAYNE SIMPSON: Yes. Although in

recent years, I've done a number of other pieces that would not be in that category. For example, papers like balanced-budget analysis or -- what else have I done in recent years. I'm doing some work on provincial finances and so on. So the -- there's a fairly broad application of the ideas, but earlier on in my career that would be primarily focused on labour and social -- economics and social policy, yes.

MR. STEVE SCARFONE: Thank you. And I guess none of the papers re -- relate directly to finance or capital market conditions then?

DR. WAYNE SIMPSON: Subject to check -- well, I've -- I've got some published work on balanced-budget legislation which does relate to provincial finances, yes.

MR. STEVE SCARFONE: Okay. And none of those papers would relate directly to the insurance industry; is that fair?

DR. WAYNE SIMPSON: No. I agree with you.

MR. STEVE SCARFONE: Yes. Yes.

DR. WAYNE SIMPSON: Not -- not I don't agree with you, no, I agree with you.

MR. STEVE SCARFONE: And would the same answer apply to certain -- any peer-reviewed journal -- journal articles on economic and social policy, that none of those relate to the insurance industry?

DR. WAYNE SIMPSON: They do not.

MR. STEVE SCARFONE: And lastly, sir, if you look in the third paragraph of that appendix, it that speaks to you having worked as a consultant to the private sector and government.

Again, none of those in the areas of finance and capital market conditions?

DR. WAYNE SIMPSON: No. No, other than -- than that which I've done for these hearings.

MR. STEVE SCARFONE: Yes.

DR. WAYNE SIMPSON: In those other years.

MR. STEVE SCARFONE: And your work as a consultant to the private sector and government not in relation to the industry -- insurance industry other than the work and testimony that you've given here in prior proceedings; is that correct?

DR. WAYNE SIMPSON: I think that would be correct, yes.

MR. STEVE SCARFONE: And lastly, sir, concerning your qualifications, you're not an actuary; correct?

DR. WAYNE SIMPSON: No.

MR. STEVE SCARFONE: And so to the extent that your -- your paper touches upon actuarial science, you will defer to your co-author Ms. Andrea Sherry in that respect, correct?

DR. WAYNE SIMPSON: I -- I can try to answer questions to the best of my ability but she probably can add things that I can't, that's correct.

MR. STEVE SCARFONE: Okay. Thank you. And I can assure you, sir, that I don't intend to engage you here today in an economic quarrel.

So on to the paper, sir. It's entitled, Does the RSR Need To Be So Large. You'd agree with me, sir, that it deals -- it also deals with interest rate forecasting, in addition to the RSR; correct?

DR. WAYNE SIMPSON: That's right, because interest rate forecasting is an important part of some of the DCAT scenarios and the best -- the best case scenario.

MR. STEVE SCARFONE: And it also deals with, as you've just said, the interplay between interest rates and the DCAT; correct?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: Yes. Dr.

Simpson, I assume you've been ma -- been made aware, generally speaking, of the relief that MPI is seeking in this year's General Rate Application?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: So you're aware, sir, that the -- the Corporation would like the Board to set to certain targets or thresholds, as you call them in your paper, for the rate stabilization reserve?

DR. WAYNE SIMPSON: Yes, I prefer thresholds because, first of all, you can't have two (2) targets or won't hit either of them probably.

MR. STEVE SCARFONE: So I'll -- I'll try and make use of your terminology.

DR. WAYNE SIMPSON: Target thresholds would be acceptable.

MR. STEVE SCARFONE: Okay. Lower target threshold of 201 million; you aware that's some of the relief that MPI is seeking?

DR. WAYNE SIMPSON: That's right, yes.

MR. STEVE SCARFONE: Yes. And an upper threshold of 438 million?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: And you're also aware, sir, that the Corporation would like to grow the rate stabilization reserve use -- using investment income from the reserve itself; correct?

DR. WAYNE SIMPSON: I hope that that's what they would do with the money, yes.

MR. STEVE SCARFONE: Yes. And that MPIC would like an operating range and the range between those two (2) numbers we just spoke of is 237 million?

DR. WAYNE SIMPSON: Right.

MR. STEVE SCARFONE: In which there would be no rebates or rebuilding fees provided the RSR was below 438 and above 201.

You're aware of that?

DR. WAYNE SIMPSON: Yes, I was kind of curious as to why the increase projected. I think in the base case scenario, as I read it, was 0 percent plus 2 percent RSR. I'm -- I'm not sure why that was there as a projection, given what you've just said but -- but I agree with what you've just said.

MR. STEVE SCARFONE: Okay. And you also agree, sir, that a situation where you are issuing rebates one year followed by a rebuilding fee the next is, generally speaking, a situation that one should avoid for the benefit of the -- of the ratepayers?

DR. WAYNE SIMPSON: I suppose that's -- that's true. You'd need pretty substantial fluctuations to get that kind of a scenario but those fluctuations cannot be ruled out.

MR. STEVE SCARFONE: Correct. But those fluctuations in that scenario, sir, is -- is -- is more likely to be avoided with a wider range, you'd agree with that?

DR. WAYNE SIMPSON: Of course, the wider the range the less likelihood of -- the greater likelihood that you'll fall within the range and, therefore, have neither happen.

My point, in my presentation, was to indicate that that comes at some cost outside of MPI in terms of -- of ratepayers and what they're expected to -- to pay to achieve this kind of -- this degree of, you know, conservatism.

MR. STEVE SCARFONE: Your narrow I believe, sir, between 185 and 249, by my math is $64 million; that's the operating range?

DR. WAYNE SIMPSON: Sure.

MR. STEVE SCARFONE: And your wide range, sir, between 152 and 268 would be a hundred and sixteen million; is that correct?

DR. WAYNE SIMPSON: Yep.

MR. STEVE SCARFONE: Which you'd agree with me, sir, is significantly lower than the 237, that's been proposed by MPIC?

DR. WAYNE SIMPSON: Exactly.

MR. STEVE SCARFONE: Dr. Simpson, you'd agree that the insurance companies, both private and public, should have sufficient capital reserves.

DR. WAYNE SIMPSON: Yes, recognizing the difference between private and public Crown insurers, yes.

MR. STEVE SCARFONE: And even with that difference though, sir, both companies need to have sufficient reserves in place.

I think that was your answer, correct?

DR. WAYNE SIMPSON: Not -- not the same sorts of reserves because of the questions of the competitive nature of the business and bankruptcy, but they should both have adequate reserves to -- to -- well, in the case of MPI, the focus is really rate shock. I'm not sure that is really the focus of a private insurer.

The focus of a private insurer is -- is avoidance of difficult financial circumstances which is really not rate shock. They have a different set of concerns because they -- they don't control the rates set, in the sense they have to be competitive whereas MPI doesn't have that concern.

So they're -- they're really quite different, I think. So satisfactory in their own domains.

MR. STEVE SCARFONE: Were you aware, sir, that the Act that governs MPIC, the Manitoba Public Insurance Corporation Act, mandates sufficient reserves in place for the Corporation?

DR. WAYNE SIMPSON: Sure, in the context of a Crown monopoly insurer, yes.

MR. STEVE SCARFONE: And, sir, as part of your preparation for this afternoon's testimony, did you review at least some of the materials filed by MPIC in this General Rate Application?

DR. WAYNE SIMPSON: Absolutely.

MR. STEVE SCARFONE: Did you review the overview section of the application, Dr. Simpson?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: You did. And so you're aware, sir, that MPIC has said that its basic insurance operations is financially vulnerable and that -- in the Corporation's view?

DR. WAYNE SIMPSON: They made that statement, yes.

MR. STEVE SCARFONE: And you're also aware, sir, I expect having read the -- the DCAT report that the chief actuary has made a finding that the projected financial condition of Basic is not satisfactory?

DR. WAYNE SIMPSON: Yes, that's what the statement was, yes.

MR. STEVE SCARFONE: And that over the past few years as -- as you've canvassed, forecasted interest rates did not materialize and resulted in $163 -- $163 million in premium deficiencies.

You're aware of that?

DR. WAYNE SIMPSON: Yes, the last few years have been in the negative and before that there were positive years before the great recession, primarily, yeah,

MR. STEVE SCARFONE: When you speak to the great recession, which are you -- are you talking 2008 --

DR. WAYNE SIMPSON: 2008/2009.

MR. STEVE SCARFONE: Yes.

DR. WAYNE SIMPSON: The great moderation, great recession. It wasn't so great as I said in Manitoba but elsewhere in the world, and that certainly affects interest rates, which are much broader than -- than Manitoba or even Canada.

MR. STEVE SCARFONE: But I'm -- I'm speaking even more recently than that, sir. The $163 million, as I understand it, from premium deficiencies was the result of operations in the past two (2) maybe three (3) years. Are you aware of that?

DR. WAYNE SIMPSON: Yes. And I've referred to some of that as coming from the interest rate forecasting, yeah, or the -- the stickiness of interest rates at a relatively low level, yep.

MR. STEVE SCARFONE: And in the overview section of the application it speaks to hail claims during the last two (2) fiscal years that have resulted in claims being $89 million over budget.

Are you aware of that?

DR. WAYNE SIMPSON: Yes. I guess I could add there that the -- I don't see any careful analysis, statistical analysis of the -- the trend to see, in fact, if there is a change in the trend or the variability related to things like hail.

But, subject to that, the last two (2) years have been what they've been, yes.

MR. STEVE SCARFONE: Yes. So you might quarrel with whether that's unexpected or unforeseen, as you -- as you call it?

DR. WAYNE SIMPSON: Well, I -- I just think that there should be constant assessments of the -- of the prospect of climate change.

MR. STEVE SCARFONE: So with the $163 million, that's from the interest rate forecasting and the 80 million -- $89 million as a result of the hail claim, sir --

DR. BYRON WILLIAMS: Mr. -- Mr. Chair, I'm just going to -- we'll -- we will just in terms of the characterization of the 163 million, our witness will certainly be prepared to answer the question and we will accept that MPI has characterized it as being exclusively because of forecasting challenges and in interest rates.

Our client may take issue with how they've characterized it. So, I just want to be not as a statement of fact but the previous questions were how MPI had characterized it. We'll accept that --

MR. STEVE SCARFONE: Yes.

DR. BYRON WILLIAMS: -- that assertion of how you've characterized it.

MR. STEVE SCARFONE: Yes.

DR. BYRON WILLIAMS: But that's not an -- an acceptance of the fact.

MR. STEVE SCARFONE: And I think that

-- thank you, Mr. Williams, for that. I -- I do believe that was -- that was my question, was that MPIC has maintained in its application that a hundred and sixty-three million dollars was deficient as a result of interest rate forecasting.

DR. WAYNE SIMPSON: And that's -- I agreed that that was the statement they made.

MR. STEVE SCARFONE: I thought you did, yes. Thank you.

CONTINUED BY MR. STEVE SCARFONE:

MR. STEVE SCARFONE: So given those two (2) numbers, sir, it wouldn't surprise you, I don't think, to learn that the rate stabilization reserve has been depleted over the past few years?

DR. WAYNE SIMPSON: Yes. And the rate stabilization reserve would be expected to go up and down, which is why there's a range -- should be range.

MR. STEVE SCARFONE: Yes. And indeed, Diana, could you put on the screen for me, please, Exhibit Number 37, MPIC Exhibit Number 37.

One (1) of the undertakings recently filed in this proceeding, Dr. Simpson, was asking the Corporation to identify unexpected and unforeseen events that have drawn down the rate stabilization reserve, over the past number of years.

And if you scroll down, Diana, there's a list of them there beginning in 2008 and 2009 with the -- with the stock market crash, or the recession, as you called it, Dr. Simpson. Below that is $163 million that the Corporation says was the result of interest rate forecasting; the hail as we've mentioned, and if you scroll down further, Diana.

There was an increase in collision frequency in the years there stated and, lastly, an increase in injury claims of $54 million and $36 million.

So, sir, scrolling back up to the top, beginning at 2008/2009, so that's in the past nine (9) years, the Corporation has seen $560 million in losses due to what we say are unexpected and unforeseen events.

Do you have for any reason to dispute those numbers?

DR. WAYNE SIMPSON: No. I'd like to put it in context because it's -- it's kind of a one-sided question. In other words, I think they've responded -- you've responded to a question about the adverse events, but the whole idea of risk and risk analysis is to look at both the favourable and unfavourable events around a best-case scenario.

And, for example, in the case of -- of equities, there are -- there are probably many -- there's a dramatic recovery in -- in equities following 2008/2009. And there are dramatic positive events on the other side.

So again, that's part of the component of the RSR, and why it goes up and down, and why it needs a range, but adding up these adverse events, sure, they're -- they're balanced against favourable events as well. But the stock markets a good example.

In fact, I would use the stock market, the equity decline scenario in the DCAT as a -- as a model scenario, and -- and it's really the -- the kind of thing that I think the interest rate decline scenario should aspire to when conditions are appropriate for it to be like that.

MR. STEVE SCARFONE: Well and on that point, sir, the -- the $560 million loss in nine (9) years, there's no DCAT scenario that speaks to a 1:9 year scenario, is there?

DR. WAYNE SIMPSON: I -- I don't understand the question.

MR. STEVE SCARFONE: Well, most of the scenarios, the adverse scenarios, that the DCAT runs involve 1:40 years, 1:100 years. I haven't seen -

maybe you have - a scenario that would contemplate this kind of loss in nine (9) years.

DR. WAYNE SIMPSON: These -- these are -- the DCAT deals with individual events such as the equity decline scenario.

MR. STEVE SCARFONE: Yes.

DR. WAYNE SIMPSON: And I -- I don't know what you're getting at but there are corresponding, offsetting -- I mean, favourable events associated with every one (1) of these, with the exception of the interest rates; that is to say, the stock market crash is followed by a significant recovery and quite robust returns in recent years.

The -- and the -- he hail, you mentioned the last two (2) years, but there were other years where I suspect hail was better than the forecast. In other words, if you forecast an average set of hail events, there are years when you do better than that.

There's another case where the statistical analysis would -- would be quite -- quite straightforward.

MR. STEVE SCARFONE: On the opening page of your paper, sir, you -- you speak to the definition or the purpose of the RSR, sorry, and it's to protect motorists from rate increases that would otherwise have been necessary due to unexpected variances from forecasted results and due to events and losses arising from non-reoccurring events or factors. And that is, as you've said is -- is the accepted definition that -- that everyone's been working with.

Is there anything in the list that we just went through, Dr. Simpson, I'm going to suggest to you there isn't, that doesn't meet that definition?

DR. WAYNE SIMPSON: No.

MR. STEVE SCARFONE: Those are all unexpected and unforeseen; you would agree with that?

DR. WAYNE SIMPSON: That's -- that's correct. But if you said to me, what are the chances of this -- this occurring over a nine (9) year period, like anything else statistically, they're not -- it's not zero.

MR. STEVE SCARFONE: Correct. And over the past three (3) years, sir, you're aware having read the overview that $176 million has been transferred into Basic's rate stabilization reserve?

You're aware of that?

DR. WAYNE SIMPSON: That's been repeated many times in the Application, yes.

MR. STEVE SCARFONE: And we've heard evidence in this proceeding, sir, that during the past three (3) years Ba -- Basic has been operating at a minimum level of capital.

Were you aware of that?

DR. WAYNE SIMPSON: I can't say that that -- that I -- I am aware of that, no, I would take that -- your statement.

MR. STEVE SCARFONE: Okay. Well, you'd agree with me I think that operating at something other than a minimum level of capital is, generally, recommended for an insurance company?

DR. WAYNE SIMPSON: Yes, depending on what you define as the minimal level.

MR. STEVE SCARFONE: The -- in your paper, sir, the first paragraph, and you spoke to this in your -- in your presentation as well. You indicate that the requested targets of 201 million and four hundred and thirty-eight (438) are higher than -- than those targets request -- threshold, sorry -- than those thresholds requested last year of one eighty-one (181) and four o-four (404).

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: And in fact, much larger than the $159 million approved last year as the lower threshold, correct?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: Were you aware, Dr. Simpson that the Board of Directors for MPIC directed a top up of the RSR in February of this year of $27 million?

DR. WAYNE SIMPSON: I don't recall.

MR. STEVE SCARFONE: And that was the result of Basic operating, again, below its minimum capital target threshold?

DR. WAYNE SIMPSON: I -- I don't recall.

MR. STEVE SCARFONE: Don't recall. You have no reason to dispute that that -- that amount of money was transferred into --

DR. WAYNE SIMPSON: No.

MR. STEVE SCARFONE: -- Basic --

DR. WAYNE SIMPSON: No, no reason to dispute.

MR. STEVE SCARFONE: And you have no reason to dispute, sir, that without the $27 million transfer from the non-Basic line of business that a rebuilding fee may have been required for this year's general rate application?

DR. WAYNE SIMPSON: I think that is

correct, subject to check.

MR. STEVE SCARFONE: And the question that you put in -- to the audience in your paper, sir, at the end of that first paragraph is,

"Have the risks facing the Corporation risen that much in one (1) year." Do you see that?

DR. WAYNE SIMPSON: Yeah.

MR. STEVE SCARFONE: And I think you'd agree, sir, that the Corporation can't responsibly consider its financial state on a year-by-year basis; would you agree with that?

DR. WAYNE SIMPSON: We're talking about risks, so we're talking about the variability of -- of outcomes that they assess could happen from year to year. I think that can be assessed on a year-to-year basis. In other words, those risks are changing, and they should be assessed. And that's the purpose of the DCAT and the RSR.

MR. STEVE SCARFONE: But my question to you, sir, was that -- I didn't ask what risks. I asked about the Corporation's financial state generally, and that they shouldn't be considering that, not responsibly, at least, on a year-to-year basis?

DR. WAYNE SIMPSON: No. I suppose that is correct. I'm not sure what that has to do with the statement I've made.

MR. STEVE SCARFONE: Well, the statement you made, sir, does speak to risks, but you're asking why the Corporation has indicated that it needs an increase of that magnitude in just one (1) year.

DR. WAYNE SIMPSON: In the RSR, which is supposed to deal with unexpected and non-recurring events to avoid rate shock. The general health of the -- financial health of the -- of the Corporation is largely independent of that.

MR. STEVE SCARFONE: Sorry. Should I take that to mean, sir, that the financial state of the Corporation is independent of the amount of capital it has available it?

DR. WAYNE SIMPSON: Of -- of the -- of the size of the RSR, which is supposed to deal with the possibility of adverse events which would be non-recurring.

MR. STEVE SCARFONE: Yes.

DR. WAYNE SIMPSON: So therefore, if they're non-recurring, they wouldn't be occurring from year to year, and so looking out beyond one (1) year is -- is not -- I -- I don't understand what the con -- your connection is that you're trying to make, but I don't accept it.

MR. STEVE SCARFONE: Okay.

(BRIEF PAUSE)

MR. STEVE SCARFONE: Perhaps you'll agree with me on this, then. The -- the rate stabilization reserve, sir, is essentially a capital reserve? Would you agree with that?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: And that every insurance company in Canada, I think we've acknowledged, has a capital reserve, correct?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: And the -- the test, as I understand it, sir, that -- that you'd like to make use of in identifying for the Corporation an upper threshold is the dynamic capital adequacy test, correct?

DR. WAYNE SIMPSON: Consistent with the lower threshold determination.

MR. STEVE SCARFONE: Yes. And the test that the Corporation has -- has advocated for in this application is the minimum capital test, correct --

DR. WAYNE SIMPSON: Right.

MR. STEVE SCARFONE: -- for its upper threshold?

DR. WAYNE SIMPSON: That's right.

MR. STEVE SCARFONE: The MCT, sir, the minimum capital test, that is, simply put, the ratio of capital available equals the capital required.

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: Would you agree with that? And would you agree, sir, that it was a test that was developed by the office of the Superintendent of Financial Institutions?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: And at page 2 of your paper, sir, and you touched upon this in your -- in your presentation, you indicate that what makes MPI distinct is the fact that it's a Crown monopoly insurer, and that the minimum capital test is therefore not appropriate. Is that -- does that sum up fairly your position?

DR. WAYNE SIMPSON: Distinct from private insu -- private property and casual insurers, yes.

MR. STEVE SCARFONE: Yes.
DR. WAYNE SIMPSON: Not distinct from, say, ICBC.
MR. STEVE SCARFONE: Okay. But distinct from an insurer like Ms. Sherry's Wawanesa, correct?
DR. WAYNE SIMPSON: Yeah.
MR. STEVE SCARFONE: And you go on to say that the -- that distinction has some connection to the fact that a prop -- a private insurer has a real possibility of bankruptcy. Do you see that, sir?
DR. WAYNE SIMPSON: Yeah.
MR. STEVE SCARFONE: Is the implication, sir, there that MPIC should not therefore need the protection afforded by the 100 percent MCT criterion?
DR. WAYNE SIMPSON: Yes.
MR. STEVE SCARFONE: Simply by virtue of it being a Crown Corporation?
DR. WAYNE SIMPSON: In comparison with private property and casual insurers who would need more protection because there's a higher risk of -- of bank -- well, there is a risk bankruptcy.
MR. STEVE SCARFONE: And you're aware, sir, that Wawanesa operates -- and maybe you're not,

but Ms. Sherry certainly would be -- operates at over 300 percent MCT?

DR. WAYNE SIMPSON: I -- I didn't know the figure, but I knew it was more than a hundred.

MR. STEVE SCARFONE: And you'd agree that MPIC is not here today asking for 300 percent MCT?

DR. WAYNE SIMPSON: No.

MR. STEVE SCARFONE: And at least to that extent, then, MPIC is not comparing itself to a private insurance company?

DR. WAYNE SIMPSON: Well, it is in the context of its argument for a hundred percent MCT. It made specific reference to the -- the private property and casual insurers, and their -- and their standards.

MR. STEVE SCARFONE: Were you aware, Dr. Simpson, that SGI -- SGI's, that's the Saskatchewan Government Insurance, they have an auto fund that has a target of 100 percent MCT?

DR. WAYNE SIMPSON: I was made aware of that, yes.

MR. STEVE SCARFONE: And SGI, you'll agree, is a provincial Crown Corporation, just like MPIC?

DR. WAYNE SIMPSON: Still is, yes.

MR. STEVE SCARFONE: And it has the same monopoly over automobiles that MPIC has?

DR. WAYNE SIMPSON: Right. And I think ICBC is similar to that in circumstance to that.

MR. STEVE SCARFONE: Similar, except as I understand it, sir, ICBC has a regulatory minimum of 100 percent MCT. Were you aware of that?

DR. WAYNE SIMPSON: I was made aware of that, yes.

MR. STEVE SCARFONE: And that their upper target is at approximately 160 percent MCT?

DR. WAYNE SIMPSON: Yes, I'll -- I'll take your point on that. I am -- I'm not aware of that.

MR. STEVE SCARFONE: Okay. And again, you'd agree with me that ICBC is a provincial Crown Corporation, like MPI?

DR. WAYNE SIMPSON: That's correct.

MR. STEVE SCARFONE: And they too have a mon -- monopoly on the automobiles in that province?

DR. WAYNE SIMPSON: That's correct. And that's precisely the Ernst & Young point -- or one (1) of their points about the appropriateness of the hundred percent MCT criterion.

MR. STEVE SCARFONE: Yeah. And we'll

get to that, sir. And Dr. Simpson, you're aware that MPIC is currently operating at approximately 30 percent MCT?

DR. WAYNE SIMPSON: Right.

MR. STEVE SCARFONE: Are you aware of any private insurer that operates at 30 percent MCT?

DR. WAYNE SIMPSON: No.

MR. STEVE SCARFONE: And that's in large part, I expect, because OSFI wouldn't allow for that. Is that correct?

DR. WAYNE SIMPSON: I -- I take your -- I take your word on that. I would expect not.

MR. STEVE SCARFONE: And you -- I think you've just confirmed that SGI and ICBC operate at least a hundred percent MCT, correct?

DR. WAYNE SIMPSON: Yes.

DR. BYRON WILLIAMS: I'm just going to take issue. I think he confirmed what their targets were --

MR. STEVE SCARFONE: Their targets.

DR. BYRON WILLIAMS: -- and minimums--

MR. STEVE SCARFONE: Yes.

DR. BYRON WILLIAMS: -- and I think the factual premise that ICBC is offering on that, I'm not sure that we would be -- so the -- if you wanted to rephrase that question, sir.

CONTINUED BY MR. STEVE SCARFONE:

MR. STEVE SCARFONE: Sure. We'll rephrase it to this. We just heard that -- and I think you agreed, sir, that SGI and ICBC operate, at least at 100 percent MCT target?

DR. WAYNE SIMPSON: That -- that's a target, yeah. I don't know that they operate at or above that level. I mean, they -- they -- that's a target. They may miss the target.

MR. STEVE SCARFONE: I've just been made aware that -- and again, you're probably not in a position to disagree, in any event, sir, that ICBC has an MCT target of 145 percent.

Are you aware, Dr. Simpson, of any other insurers in the country, private or public, and what they might operate at terms of MCT?

DR. WAYNE SIMPSON: No.

MR. STEVE SCARFONE: So it could be, sir, as we sit here today, that Manitoba Public Insurance is the most undercapitalized insurance company in Canada?

DR. WAYNE SIMPSON: It could be.

MR. STEVE SCARFONE: You have no

reason to dispute that -- that suggestion?

DR. WAYNE SIMPSON: I have no reason to dispute that.

And I don't -- I'd just add that I -- I don't necessarily think that's a -- a bad thing. I -- I think the implication you're trying to draw is that that's a bad thing, and from the sole standpoint of MPI, I would agree with you.

However, from the sti -- that -- what I would call the balance standpoint of taking into consideration the opportunity costs, foregone of having ratepayers without the funds to spend and invest, I -- I wouldn't necessarily characterize that as a bad thing. And I interpret the Ernst & Young statements to support that that position that the -- a balance has to be drawn, and that perhaps the hundred percent MCT and higher levels, if -- if their targets, for example, is -- is excessively conservative when you weigh the two (2) -- two (2) sides. And that's precisely my -- that was my opening point.

MR. STEVE SCARFONE: Well, let me just then turn your attention to the excerpts from the E and Y report that was prepared for the Insurance Corporation of British Columbia. It's on page 2 of -- of your paper.

THE CHAIRPERSON: Can -- can I just ask, do we have the EY report in as an exhibit?

MR. STEVE SCARFONE: I believe it is, yes.

THE CHAIRPERSON: Yeah. Could we -- and -- and --

DR. BYRON WILLIAMS: It was filed in response to an Information Request of the PUB.

THE CHAIRPERSON: Thank you. Okay. That's what I was looking for. Thank you.

CONTINUED BY MR. STEVE SCARFONE:

MR. STEVE SCARFONE: So at -- at the bottom of page 2, sir, of your paper, you make reference to the E and Y report that -- that had to say that government-owned monopoly insurers are not required to adhere to OSFI guidelines.

Do you see that?

DR. WAYNE SIMPSON: Right.

MR. STEVE SCARFONE: And that capital surplus, in their view, can be put to better use by government. That is, not tied up investments. Do you see that?

DR. WAYNE SIMPSON: I -- I can read that, yeah.

MR. STEVE SCARFONE: You would agree with me, sir, that to investments by, their very nature, can be redeemed, sold, rebalanced, otherwise made available to their owner, the cash proceeds, I mean?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: And we've heard evidence in this proceeding, sir, from Mr. Steski. He's at the treasury division for the Government of Manitoba that the investments that MPIC holds are owned by the Crown.

You have no reason to dispute that?

DR. WAYNE SIMPSON: No.

MR. STEVE SCARFONE: And so there would be nothing based on that that would prevent the Province of Manitoba from demanding from MPIC that it redeem its investments and send the cash over to the people at Broadway?

DR. BYRON WILLIAMS: Is My Friend asking for a legal opinion?

MR. STEVE SCARFONE: No. I don't think that's a legal opinion. I think that's just a follow-up question to the witness having confirmed that the Crown owned the investments.

DR. BYRON WILLIAMS: I think he can --

let me put it this way. If the witness feels comfortable answering that question, we won't stop him if -- if he feels able to comment on it.

DR. WAYNE SIMPSON: I feel less comfortable now than I did a moment ago. It perhaps was a bit leading. But I would -- I would add that the other side of that would be that a rebate to tax -- to ratepayers would allow them to make the kind of spending and investment decisions that the -- socially would also be beneficial.

Just going to the government, I'm -- I'm not sure that's the only option, although that is the reference in the -- at the top. But there's a further reference down below to actual -- to ratepayers to keeping money in ratepayers' pockets.

CONTINUED BY MR. STEVE SCARFONE:

MR. STEVE SCARFONE: Well, no. I see that in the first bullet there, sir, at the bottom of page 2, it reads "Capital surplus above target levels" --

DR. WAYNE SIMPSON: Yeah.

MR. STEVE SCARFONE: -- "may be better -- put to better use by the government." My suggestion to you, sir, though, is if there was capital surplus above an upper threshold, that that would result in a rebate to the -- to the customers. Is that not your understanding?

DR. WAYNE SIMPSON: I'm -- and I'm saying, I would hope so.

MR. STEVE SCARFONE: Yes.

DR. WAYNE SIMPSON: Yeah.

(BRIEF PAUSE)

MR. STEVE SCARFONE: The bullet on the next page, at the top of page 3, again, from the E and I rep -- E and Y report reads that:

"Increased capital level -- levels require higher premiums that automobile owners need to pay."

And it can be argued that in light of the above two (2) points, there is no need to have part -- prior pre -- higher premiums. Do you see that, sir?

DR. WAYNE SIMPSON: Yes. That was actually the point I was referring to a moment ago.

MR. STEVE SCARFONE: Yes. But you would agree with me, sir, that has no application if as the Corporation intends to do, is having the investment income retained in the RSR?

DR. WAYNE SIMPSON: Yes. An extremely conservative and high upper threshold for the RSR would ensure that -- that auto owners would not have the money in -- in the form of lower rebates -- lower rates and rebates.

MR. STEVE SCARFONE: And the -- the strategy being proposed by MPIC in this rate application is that there would be no additional monies being paid by ratepayers. Do you agree with that?

DR. WAYNE SIMPSON: At this time, no. Although, that's why that curious 2 percent RSR -- I guess RSR rebuilding fee in the -- in the DCAT is -- is a bit of a curious way to -- to state what I would consider a -- a rate increase at the rate of inflation. I'm not sure where that -- what -- what's behind that. It's -- there's no discussion of it in the DCAT.

MR. STEVE SCARFONE: As part of your review of the materials, did you read that the chief actuary's DCAT report, Dr. Simpson?

DR. WAYNE SIMPSON: The -- the DCAT report in the application?

MR. STEVE SCARFONE: Yes, filed in

this year's application.

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: Yes. Diana, could you pull up the DCAT 66, please.

(BRIEF PAUSE)

DR. WAYNE SIMPSON: Was it -- 66 is -- isn't it? Yeah. Yeah.

(BRIEF PAUSE)

MR. STEVE SCARFONE: Yes. Oh, sorry. I meant Figure 66.

(BRIEF PAUSE)

MR. STEVE SCARFONE: And then if you--

MR. BYRON WILLIAMS: Is this the revised figure that was filed today, sir, or is this the original figure?

MR. STEVE SCARFONE: No, this is the original.

MR. BYRON WILLIAMS: And that's the one that MPI has corrected? Okay. So it's --

MR. STEVE SCARFONE: No.

MR. BYRON WILLIAMS: Okay. Thank you.

MR. STEVE SCARFONE: This -- this is the same.

MR. BYRON WILLIAMS: And I'm sorry for interrupting.

MR. STEVE SCARFONE: Oh, that's all right.

MR. MATTHEW GHIKAS: The -- just for clarity on that, the only thing that was revised was DCAT 64. Figure 64.

CONTINUED BY MR. STEVE SCARFONE:

MR. STEVE SCARFONE: And, Diana, from the opening presentation of Mr. Yien and Mr. Johnston, we would need page 37. If you could pull it up and -- and do them a split screen.

(BRIEF PAUSE)

MR. STEVE SCARFONE: And if it helps, the presentation, I think, was marked as MPI Exhibit Number 11.

(BRIEF PAUSE)

MR. STEVE SCARFONE: 37. Thank you. So, Dr. Simpson, you've earlier confirmed that your recommendation is that the DCAT be used to set the upper RSR target; correct?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: And that the M -- M -- MPI's position is that the threshold should be set using the minimum capital test; correct?

DR. WAYNE SIMPSON: Yeah.

MR. STEVE SCARFONE: On the left, sir, do you recognize the modelling that was done in DCAT 66 that resulted in an RSR target of $442 million upper target using the DCAT analysis?

DR. WAYNE SIMPSON: Okay.

MR. STEVE SCARFONE: Were you aware of that?

DR. WAYNE SIMPSON: M-hm.

MR. STEVE SCARFONE: And you'd agree with me, sir, that the results of that modelling, using the DCAT test, results in a higher upper threshold than what MPIC is recommending in its application?

DR. WAYNE SIMPSON: Yes, that's why my concerns about the interest rate and inflation assumptions in the DCAT simulations.

(BRIEF PAUSE)

MR. STEVE SCARFONE: On the interest rate forecasting part of your presentation, sir, would you agree that the starting point concerning any interest rate forecasting begins with the uncertainty surrounding interest rates and the forecasting of them?

DR. WAYNE SIMPSON: Right.

MR. STEVE SCARFONE: And would you --

DR. WAYNE SIMPSON: But -- but I imagine less uncertainty in recent years than, say, equities in 2008/'09, where you saw the huge drop, which you -- you -- that you've -- we've already discussed.

MR. STEVE SCARFONE: And -- and perhaps less uncertainty than we've seen with interest rates over the past number of years; correct?

DR. WAYNE SIMPSON: Right.

MR. STEVE SCARFONE: And --

DR. WAYNE SIMPSON: Although, I -- I still would maintain that the interest rate decline scenario has driven the combined scenario for a number of years. That's why I found it curious. There was a statement in the transcript of October 6 by Luke

Johnston where he said that he did not expect the interest rate decline scenario to be a major concern in future years. And I just don't know what would take its place. I'm not sure what was going on there. And I was -- it would be interesting to have heard some follow-up to that.

MR. STEVE SCARFONE: But on the issue of interest rate uncertainty, sir, you will agree that there will always be interest rate uncertainty.

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: And, for example, sir, interest rates over the past number years were not forecast to remain at such historic lows for such a prolonged period of time; correct?

DR. WAYNE SIMPSON: No, we were in our unchart -- what I characterize as uncharted territory.

MR. STEVE SCARFONE: Unprecedented; correct?

DR. WAYNE SIMPSON: Right.

MR. STEVE SCARFONE: And in your paper, Dr. Simpson, you're recommending that MPIC abandon its use of the naive forecast and replace it instead with the 50/50 forecast model it used last year; correct?

DR. WAYNE SIMPSON: Right. That's been fairly consistently my position, including at the

April technical conference where I argued that there were good reasons why the cons -- the banks and other people who spend a lot of money in forecasting these things, because it matters a lot to them, have continued to indicate that interest rates would be expected to rise because there are very strong economic foundations behind those kinds of forecasts. And -- and that's what we're seeing happening now.

MR. STEVE SCARFONE: And I'm going to suggest to you, sir, that it also matters to MPIC, because as you've heard, the Corporation takes the position that due to interest rate forecasting there were premium deficiencies of $163 million.

DR. WAYNE SIMPSON: Right. And when the banks get it wrong it costs them a lot more.

MR. STEVE SCARFONE: And so the forecast, sir, the one (1) that's being proposed by MPIC in this rate application, is one (1) in which interest rates remain the same now throughout the forecast; correct?

DR. WAYNE SIMPSON: Right. That's what I'm quarreling with.

MR. STEVE SCARFONE: And I gathered from your paper, sir, on page 6 that you're uncomfortable with the naive model because you believe that interest rates will rise or continue to rise. Is that -- is that fair?

DR. WAYNE SIMPSON: I believe that they would -- can -- would rise. In other words, I believed the standard interest rate forecast all along. And now I -- I'm not going to just believe it. I see it.

MR. STEVE SCARFONE: Yes. And at the top of the page it -- it reads:

"There is also a good reason to believe that interest rates will rise further in the autumn as the SIRF predicted would eventually occur."

That would --

DR. WAYNE SIMPSON: Right.

MR. STEVE SCARFONE: -- that -- that was your statement?

DR. WAYNE SIMPSON: And I originally wrote this before the second increase, the first draft.

MR. STEVE SCARFONE: I'm going to suggest to you, sir, that predicting a rise in interest rates when they were at historic lows for a sustained period of time is -- is no great feat; is it?

DR. WAYNE SIMPSON: No.

MR. STEVE SCARFONE: And so the SIRF -- and now purchasing -- or, sorry, now predicting the continued rise in interest rates is something that isn't necessarily reliable, given their history of predicting their rise for the past several years, when in fact they stayed at sustained periods of low interest?

DR. WAYNE SIMPSON: I think given the forecasts of growth and the fact that they've already risen a couple of times, and the Bank of Canada statements which are in the monetary policy reports, I think it's a pretty good bet that they're not going down in the near future.

MR. STEVE SCARFONE: And you wouldn't --

DR. WAYNE SIMPSON: They're probably going to rise.

MR. STEVE SCARFONE: I don't think though that means, sir, that you can't reasonably include a scenario that has interest rates dropping in your adverse modelling.

DR. WAYNE SIMPSON: There -- there should be an analysis of the degree of risk associated with favourable and unfavourable events around interest rates movements, just like there are, say, with equity movements in the equity decline scenario. And recent historical experience has made that more difficult. And so what we have is what I've characterized as an ad hoc process of characterizing the -- the lower floor on -- on interest rate declines.

The problem with that is that as interest rates rise the scenario still drives interest rates to the floor in predicting the adverse event, which suggests that as interest rates rise interest rate risk will rise. And I would take exception to that.

For example, you wouldn't predict that from the interest -- the equity decline scenario, because the risks around the equity movements would be characterized by historical evidence and it wouldn't change as interest rates begin -- as equities began to rise. So it's different. That's why I characterize it as ad hoc because it's quite different from the equities scenario characterization and the claims characterization, which is also statistically based.

MR. STEVE SCARFONE: But we do know, sir, that the standard interest rate forecast analysis has been off for many, many years now; correct?

DR. WAYNE SIMPSON: Yeah.

MR. STEVE SCARFONE: And if we look at a figure from the investment section, Diana, Figure INV-46.

(BRIEF PAUSE)

MR. STEVE SCARFONE: There's a -- there's a graph here. It's -- it's a somewhat busy one (1), but it shows in black the actual interest rates from February 2008 until the present. You see that, sir?

DR. WAYNE SIMPSON: Well, it goes up to 2021 actually. Doesn't it?

MR. STEVE SCARFONE: Yes. No, I'm --

DR. WAYNE SIMPSON: Which one (1) are you referring to?

MR. STEVE SCARFONE: I'm -- I'm referring to the actual, the -- the black line.

DR. WAYNE SIMPSON: Oh, yes. Okay.

MR. STEVE SCARFONE: So that's represents the drop in interest rates --

DR. WAYNE SIMPSON: February '17. So it's -- it's not updated to the current.

MR. STEVE SCARFONE: No. But that represents the drop in interest rates over the past ten (10) years, roughly; correct?

DR. WAYNE SIMPSON: Right. And if you extended that to October interest rate would be at two point one zero (2.10), which would put it back up -- back up to where it was February of '14, at least.

MR. STEVE SCARFONE: Yes. But if you look back historically, sir, to the first GRA that's depicted there, the one (1) in the blue on the left-hand side, you'll see that the forecast using the standard interest rate forecasting was for the interest rates to go up; correct?

DR. WAYNE SIMPSON: Right.

MR. STEVE SCARFONE: And again in 2010 the Corporation was forecasting interest rates to go up, based on the SIRF.

DR. WAYNE SIMPSON: Yeah.

MR. STEVE SCARFONE: And the actual went down?

DR. WAYNE SIMPSON: That's right.

MR. STEVE SCARFONE: It happened again in 2013, in 2014, and 2015; correct, sir?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: And so you can

understand, sir, why the Corporation might have some hesitation in hanging its hat on what the SIRF has to say about what can happen in the next few months?

DR. WAYNE SIMPSON: Not as much hesitation as (a) ignoring interest rate increases that have occurred and ignoring the bank consensus forecasts that they will continue to rise, no.

MR. STEVE SCARFONE: So you're aware that as part of its rate application this year the Corporation, in conjunction with its -- with its suggestion of a naive interest rate forecasting methodology, has suggested that the Board consider allowing it to do a compliance filing. Were you aware of that?

DR. WAYNE SIMPSON: I've read that, yeah.

MR. BYRON WILLIAMS: I just want to be clear, we're not talking about the DCAT modelling anymore, sir?

MR. STEVE SCARFONE: No.

MR. BYRON WILLIAMS: Okay.

DR. WAYNE SIMPSON: That would -- that -- I think I read that in the rate application.

CONTINUED BY MR. STEVE SCARFONE:

MR. STEVE SCARFONE: Yes.

DR. WAYNE SIMPSON: I believe so.

MR. STEVE SCARFONE: And -- and the -- the idea was, at least, that if they were to update the -- the Board with the actual interest rate at the end of November, they mitigate the risk of any rise or fall in interest rates that might happen before the policy year begins in March 1st; correct?

DR. WAYNE SIMPSON: That's correct. Yes.

MR. STEVE SCARFONE: And you'd agree with me, sir, that that at least somewhat addresses the risk that interest rates may arise in the next month or two (2)?

DR. WAYNE SIMPSON: That's right. I'm more focused on the four (4) here -- four (4) year horizon associated with the DCAT, but that's a -- that's a different issue because the horizon's longer.

MR. STEVE SCARFONE: Yes. And you'd agree with me, sir, that MPI's interest rate forecasting models are based on forecasting the expected yield of the -- the ten (10) year government bond rate?

DR. WAYNE SIMPSON: That's correct. The benchmark rate.

MR. STEVE SCARFONE: Yes. And that there is little if any connection to the overnight rate that -- that drives interest rates for the major banks; correct?

DR. WAYNE SIMPSON: Oh, I don't agree with that at all. The -- the term structure of interest rates is -- is largely driven by the policy rate unless there are intervening factors. But I -- I don't see anything that would not cause interest rates to rise reasonably uniformly with the overnighter policy rate.

MR. STEVE SCARFONE: Well, would you agree with me, sir, that the long-term interest rates are mostly driven by real economic growth and inflation?

DR. WAYNE SIMPSON: They are, but that is what the policy rate is also reacting to.

MR. STEVE SCARFONE: By 'policy rate', you mean the overnight?

DR. WAYNE SIMPSON: Overnight, overnight rate. Yes.

MR. STEVE SCARFONE: At page 6 of your report, sir, in the first -- or second paragraph, you make a number statements there that begin with:

"The question remains, however, as

to the justification of the naive forecast, and the base scenarios interest rates begin to rise."

Do you see that?

DR. WAYNE SIMPSON: M-hm. Yeah.

MR. STEVE SCARFONE: And then later you say:

"Well, hindsight has provided evidence that the SIRF forecast has been off. It may be now useful to look to the SIRF about the expected trajectory of interest rates to be incorporated into the base scenario."

Do you see that?

DR. WAYNE SIMPSON: Right. It's supposed to be the best guess, the best estimate, the best forecast. Right.

MR. STEVE SCARFONE: Right. And you phrase it by asking:

"Is there now useful information in the SIRF?"

Do you see that?

DR. WAYNE SIMPSON: Yes.

MR. STEVE SCARFONE: Yes. And later

you say in that same par -- full paragraph:

"Would even an up-to-date naive forecast now be expected to perform as well as the SIRF?"

Do you see that?

DR. WAYNE SIMPSON: Over the rise and the -- the -- considered in the DCAT. The four (4) year. Yeah.

MR. STEVE SCARFONE: Yes. And then, lastly, at the end of that paragraph it says:

"These are all questions raised at the GRA last year that require even more consideration."

DR. WAYNE SIMPSON: In the light of -- in light of events, yes.

MR. STEVE SCARFONE: Yes. So, sir, I'm going to suggest you that with respect to that paragraph, respectfully, your paper doesn't answer any of those questions does it, sir?

DR. WAYNE SIMPSON: No, I'm -- I'm posing those questions as things that the DCAT should begin addressing. That's right.

MR. STEVE SCARFONE: But it -- more than that, sir, it's -- it's because these questions involve forecasting, which is inherently unpredictable.

DR. WAYNE SIMPSON: Well, if you're saying that it is -- is not a useful endeavour, I don't agree. And I doubt that the banks would agree either.

MR. STEVE SCARFONE: I -- I didn't suggest it wasn't and --

DR. WAYNE SIMPSON: I'm not sure what you mean by 'unpredictable'. I mean, interest rates are inherently unpredictable, like other economic events. Yes.

MR. STEVE SCARFONE: Yes. And in fact in the paper that -- and -- you filed last year in this proceeding on the interest rate forecasting risk factor that the Corporation was proposing, you've included in there that since prediction of the future is inherently risky.

And that's all I'm getting at, sir, is that it is difficult to make these projections into the future about what the interest rates will do.

DR. WAYNE SIMPSON: Right. And that's why we have the interest rate decline scenario, because there are potentially adverse events, yes.

MR. STEVE SCARFONE: Yes. Yes.

DR. WAYNE SIMPSON: My point there

really was that it isn't clear to me why the -- the risk of interest rate decline should increase as interest rates increase. That's -- that's, I think, an anal -- example of how the interest rate decline scenario is -- is simply a mechanical, an ad hoc formulation trying to grapple with the problem where the historical evidence isn't particularly helpful. But that also makes it less valuable than the other scenarios, such as the equity decline and the high loss ratio.

MR. STEVE SCARFONE: Last -- last year, sir you filed that note before the Board on this -- in this proceeding on -- on what is called the interest rate forecast risk factor that was being proposed by MPIC; correct? Do you remember that?

DR. WAYNE SIMPSON: Right.

MR. STEVE SCARFONE: And I appreciate you may not have the note before you. I don't know if your counsel has a copy for you. Just --

DR. WAYNE SIMPSON: They're very good. I've got it.

MR. STEVE SCARFONE: Thank you. Just generally, you were comparing the methodologies used in the DCAT report for an interest rate decline scenario against that used to calculate the -- the interest rate forecasting risk factor that the Corporation was proposing; correct?

DR. WAYNE SIMPSON: Yeah. Yeah.

MR. STEVE SCARFONE: And you were of the view, sir, that the in -- the risk of interest rates falling was already included in the DCAT report, so why count it twice was your -- was your position?

DR. WAYNE SIMPSON: Yeah, and once it was taken as a risk and the other was taken as a -- as a certainty, and I thought that was a contradiction.

MR. STEVE SCARFONE: And in any event, the risk factor used by MPIC was calculated using a 50/50 weighting between the SIRF and the naive; correct?

DR. WAYNE SIMPSON: Yeah, that was a form of compromise to deal with the -- the SIRF forecast not doing as well as the diagram indicated.

MR. STEVE SCARFONE: Right. So MPI used the 50/50?

DR. WAYNE SIMPSON: They went to the 50/50.

MR. STEVE SCARFONE: And the decline scenario in the DCAT report used the standard interest rate forecasting? Used the SIRF.

DR. WAYNE SIMPSON: Used the SIRF.

Right. I thought it used the 50/50. I -- I -- wait a minute. It used the SIRF in con -- in conjunction with the naive forecast, so it used the 50/50. They both used the 50/50.

MR. STEVE SCARFONE: No, the DCAT used the SIRF as, if I understood your report correctly.

DR. WAYNE SIMPSON: Well, subject to check. I -- I would be surprised --

MR. STEVE SCARFONE: Okay.

DR. WAYNE SIMPSON: -- if that were the case.

MR. BYRON WILLIAMS: Will you -- Mr. Scarfone, on that specific fact, you may want to point our -- or my witness to a reference from the DCAT.

MR. STEVE SCARFONE: Yes. Yes, yes, yes.

(BRIEF PAUSE)

MR. BYRON WILLIAMS: And if you need a couple seconds to -- to check on that we don't --

MR. STEVE SCARFONE: I don't think so.

MR. BYRON WILLIAMS: -- we don't mind.

(BRIEF PAUSE)

CONTINUED BY MR. STEVE SCARFONE:

MR. STEVE SCARFONE: I just took that from page 4 of your paper, sir.

DR. WAYNE SIMPSON: Yeah.

MR. STEVE SCARFONE: At the top.

DR. WAYNE SIMPSON: Yeah, that is -- that is what I said. Yeah. Well, it's been a year.

MR. STEVE SCARFONE: I'm sorry?

DR. WAYNE SIMPSON: It's been a year, I said, so.

MR. STEVE SCARFONE: And again at page 4 in your paragraph numbered number 3, you'll see that it reads:

"It is difficult to see how any proposed assessment of the extent of the risk and risk tolerance of the IRFRF would have any reasonable foundation."

Do you see that? It's right at the very end.

DR. WAYNE SIMPSON: Number 3 and page 4?

MR. STEVE SCARFONE: Yes, at the very end:

"It is difficult to see how any

proposed assessment of the extent of the risk and risk tolerance" --

DR. WAYNE SIMPSON: Yeah, this is the same criticism as -- as the interest rate decline scenario.

MR. STEVE SCARFONE: Right. And -- and again, the risk that you speak of here, of course, is the risk of interest rates falling; correct?

DR. WAYNE SIMPSON: That's right.

MR. STEVE SCARFONE: And MPI's use of the 50/50; correct?

DR. WAYNE SIMPSON: That's right.

MR. STEVE SCARFONE: And you were critical of this last year; correct?

DR. WAYNE SIMPSON: I was critical of the -- I was critical of the coincidence of an interest rate decline scenario and an IRFRF which I thought were both dealing with the same problem. One (1) is a risk and the other is a certainty. I don't think I was necessarily critical there of the 50/50 per se.

MR. STEVE SCARFONE: Okay. And that's what I was getting at.

DR. WAYNE SIMPSON: Yeah.

(BRIEF PAUSE)

MR. STEVE SCARFONE: Just give me one (1) second, Mr. Chairman, to review my notes.

(BRIEF PAUSE)

MR. STEVE SCARFONE: Thank you, Dr. Simpson. Those are all my questions.

DR. WAYNE SIMPSON: Okay. Thank you.

THE CHAIRPERSON: Thank you. Mr. Watchman, did you want to go now or did you want to break?

MR. ROBERT WATCHMAN: I don't have a preference. I could go now. It -- I don't expect to be all that long.

THE CHAIRPERSON: Okay. How long do you expect to be?

MR. ROBERT WATCHMAN: Less than half an hour.

THE CHAIRPERSON: You know what? Let's take a break for ten (10) -- for fifteen (15) minutes.

--- Upon recessing at 3:10 p.m.

--- Upon resuming at 3:26 p.m.

THE CHAIRPERSON: All right then. Mr. Watchman

CROSS-EXAMINATION BY MR. ROBERT WATCHMAN:

MR. ROBERT WATCHMAN: Thank you, Mr. Chairman.

Good afternoon, Dr. Simpson.

DR. WAYNE SIMPSON: There we go. Hello.

MR. ROBERT WATCHMAN: And, as indicated, I don't have too many questions for you. And I'm going to avoid repetition. And in that vein, I'm going to go right to the recommendation portion of your report.

DR. WAYNE SIMPSON: Okay.

MR. ROBERT WATCHMAN: Diana, if we could call up Exhibit -- CAC Exhibit Number 5. And I believe it's page 10, the PDF, scroll down. Okay.

And I'm going to go to Recommendation Number 4, which is that the naive forecast in the DCAT should be replaced with a 50-50 forecast.

And that's your recommendation this year?

DR. WAYNE SIMPSON: Yes. I think that balances the -- the factors. It basically suggests that interest rates won't go up as fast as the SIRF. And I'm not quite sure -- you know, I still think, you know, the banks know more about interest rates than I do.

So I thought I said in the report, and maybe I left, that it should be -- at least be replaced with a 50-50 forecast. And I think some consideration -- more consideration of the actual SIRF forecast should be included in the DCAT.

MR. ROBERT WATCHMAN: And -- and just -- yeah, just on that point, we're looking at your report. And I believe in your presentation today, it does read with at least the 50-50 forecast.

DR. WAYNE SIMPSON: That's right. That's what I've said, yes.

MR. ROBERT WATCHMAN: So -- so maybe I've modified it in that fashion in my mind as we've gone along, yes.

DR. WAYNE SIMPSON: Thank you.

MR. ROBERT WATCHMAN: Now, we've heard that in last year's application, the 2017 GRA, it was Dr. Cleary's recommendation to use a 50/50 forecast. And Dr. Cleary was MPI's expert witness.

Do you recall that?

DR. WAYNE SIMPSON: I do recall that, yes.

MR. ROBERT WATCHMAN: And you recall --

DR. WAYNE SIMPSON: And I think we've clarified that the 50-50 forecast was used in the DCAT -- the revised DCAT in October. So that was a source of confusion earlier.

The original -- original DCAT used the SIRF, and then the revised DCAT used the 50-50, which would be consistent with the IRFRF application.

MR. ROBERT WATCHMAN: And there was some reference to your criticism of Dr. Cleary's recommendation. But I understand that your criticism last year was directed to the supporting analysis that had been undertaken by Dr. Cleary.

Is that -- do you recall that?

DR. WAYNE SIMPSON: I do recall that. You may have to refresh my memory on exactly what -- you -- what you're getting at. But, yes.

MR. ROBERT WATCHMAN: Well, I just want to clarify the -- 'cause you made the comment today that the you don't feel that there's anything wrong with the 50/50 forecast per se.

And the point was made that you were critical of Dr. Cleary's recommendation last year. And my understanding was is that your criticism last year was more directed to the rigour of the statistical analysis that -- leading up to Dr. Cleary's report.

DR. WAYNE SIMPSON: Right. Right. And, essentially, the notion that there's a substantial amount of anal -- analytical rigour attached to the -- to the SIRF. And -- and that they devote a significant amount of resources to forecasting and getting that right, because it matters to the -- to their business line if -- if they get it wrong, and that those people would be introducing, you know, the kind of rigour that you would expect from that kind of an exercise.

MR. ROBERT WATCHMAN: Okay. I want to turn now -- just -- and this is more for clarification. Diana, if we could call up PUB-CAC-1-2. And Part A there where the interrogatory was whether you and Ms. Sherry considered the 50/50 interest rate forecast to be a best estimate forecast for capital target purposes.

And if you scroll down to the answer -- you sum it up in the last line there. It says:

"Thus they return -- at least they
return to the 50/50 forecast -- used
previously would seem appropriate."

And I just want to understand, is there any distinction between what we've referred to as 'best estimate forecast' and your response that, Well, it would at least be appropriate?

DR. WAYNE SIMPSON: Well, I think I get -- I think I should say that -- that timing is important in all this because events are happening -- you know, quite significant events are happening, in terms of interest rates. And, in particular, over the summer, the movements by the Bank of Canada and the -- the news' reports on the growth of the Canadian economy have change people's opinions about -- at least changed my opinions about the where interest rates are going.

And I'm more inclined now towards the SIRF than I was before, and less inclined certainly towards the naive forecast. So as -- as those weights shift, when I say, "at least the 50/50," I don't discount the possibility that -- that we should pay more serious attention to the SIRF as well, given where interest rates have gone over the last four (4) months.

MR. ROBERT WATCHMAN: So in you -- in your view, is -- is there such a thing as a best estimate approach to forecasting interest rates?

DR. WAYNE SIMPSON: Yes. Any forecast should have in it -- at least statistically, it should have an expected value and that expected value should be their best -- the best estimate with a -- with a variation around it which constitutes the forecasting risk.

MR. ROBERT WATCHMAN: Now, is it fair to conclude that the reason, or at least in part, the reason why interest rate forecasting is so difficult is because it's so that context sensitive? By that I mean it's highly influenced by the changing economic and market forces.

DR. WAYNE SIMPSON: It is, but I think it's more the recent episode that has -- has confounded interest rate forecasting. Because of the economic fundamentals that I outlined at the technical conference would -- would suggest interest rates have to rise, but the timing is not so easy to predict and -- and this is where the problems have arisen and where the SIRF has gotten it wrong, to some degree, over the last few years.

MR. ROBERT WATCHMAN: Okay then. Is

it -- is it fair to say that with these recent increases -- and as I understand that your evidence that it's reasonable to expect that this will continue at least in the near future? Is that something that you can say with a higher level of confidence this year than was the case a year ago?

DR. WAYNE SIMPSON: Absolutely.

MR. ROBERT WATCHMAN: If I can -- If we -- Diana, if we can go back to Exhibit 5, CAC Exhibit 5, back to the recommendations. And I want to look at Recommendations 7 and 8, sort of straddling the page I think there.

And in 7, your recommendation is that the results for the interest rate decline and combined scenario -- scenarios in the DCAT continue to be discounted because of the ad hoc nature of the interest rate decline scenario. And then in Recommendation 8, that MPI consider revising the interest rate decline scenario in future DCAT reports to reflect rising interest rates.

And is it fair to say that part of your criticism with respect to the interest rate decline modeling is the use of this interest rate floor?

DR. WAYNE SIMPSON: Yes, that's -- that's not only the fundamental driver of the entire scenario, but also a -- what I characterize as an ad hoc element.

MR. ROBERT WATCHMAN: And, Diana, if we could turn to PUB-CAC-1-3.

And you see there in Question A, you were asked the practical alternative to imposing an interest rate floor. And if we scroll down to the answer, again you -- you indicate that you consider that to be an ad hoc response. And the response goes on to say that the traditional statistical methods of interest rate forecasting that yield best predictions should be used.

DR. WAYNE SIMPSON: Right.

MR. ROBERT WATCHMAN: And --

DR. WAYNE SIMPSON: And I think this was actually before the interest rates began to rise, or about the same time, and so this was sort of in anticipation that that would eventually occur and allow MPI just to go back to more traditional meth -- methods, yeah.

MR. ROBERT WATCHMAN: And are you satisfied that these more traditional methods -- or an alternative approach would avoid assuming exceptionally low rates, or even negative interest rates?

DR. WAYNE SIMPSON: Yes, and -- and -- and while I'm critical of the floor assumption, I think it -- it is -- it was reasonable in the context of the recovery from the recession and the low interest rate period to assume that there was some floor below which interest rates would not go because the cash alternative sort of sets a zero lower bound.

And -- and -- so the preponderance of -- of economic opinion, and I think financial opinion, was that interest rates had a floor. I was critical of how that was characterized in the scenario because it was based I think on a -- the lowest monthly interest rate as opposed -- when you're talking about annual episodes for the DCAT.

But I think some sort of floor was necessary to capture, essentially, the fact that there is a lower bound interest rates. And -- and -- and we've seen that. They -- they crypt along the -- this lower bound for a while and now they're beginning to rise.

MR. ROBERT WATCHMAN: So if I understand that correctly, it's your opinion that there's less of a need for a floor now, with increased rates?

DR. WAYNE SIMPSON: I think so, and

particularly as we go, say, forward to next year the -- the DCAT should take -- it should take a careful look at how it characterizes this scenario, and whether the floor is appropriate given interest rate events that will likely involve some further increases.

MR. ROBERT WATCHMAN: Okay, if I could -- if we could go back to Exhibit 5, Diana, and just down to recommendation Number 9. And you're recommending the inclusion of the -- the risk of corporate bond default in the combined scenario be reviewed; correct?

DR. WAYNE SIMPSON: Yes.

MR. ROBERT WATCHMAN: And as -- as a starting point, though, would you agree that a move to change the asset mix to include relatively more corporate bonds in the Corporation's investment portfolio that that would be expected to elevate the Corporation's exposure to market interest rate risks?

DR. WAYNE SIMPSON: That's right. It would certainly -- and that's reflected in the -- in the premium paid to these corporate bonds, and I -- and I would guess that also reflects default risk. Although, I've never thought of it that way. I've always thought of it as -- as interest rate -- as the bond rates being more volatile, and therefore, there being a premium to volatility.

MR. ROBERT WATCHMAN: Now, the Corporation has provided some support for its modelling of the corporate bond default risk in the investment section and elsewhere in the Application, and I assume that you had some opportunity to review that documentation?

DR. WAYNE SIMPSON: Yes, I can't remember much about it right at this moment to be truthful.

MR. ROBERT WATCHMAN: Okay. Well, my final question to you was going to be as to whether there are -- you could provide the panel with any more specifics as to what it is you're recommending be reviewed in greater detail with respect to the default risk?

DR. WAYNE SIMPSON: Well, I -- I would simply say that some -- some expert opinion, and I'm not an expert in this area, some expert opinion be -- be sought by MPI and perhaps stakeholders, and perhaps PUB just to see whether, in fact, this is a reasonable way to add.

I mean, we're adding a fourth risk, I don't know how immaterial it is to the outcome and I don't want to overemphasize it because I don't -- don't know how big the risk -- you know, how big an impact it would have on the assessment of risk in the combined scenario.

But I -- I -- I would like some expert opinion on -- on whether this is a sensible way to characterize the risk in a -- in a DCAT.

MR. ROBERT WATCHMAN: Thank you, Mr. Chairman, those are all of my questions.

THE CHAIRPERSON: Okay, I'd ask the panel if you have any questions?

Dr. Simpson, I've got a few. Diana, can you pull up the transcript from last year's GRA application? Go to 2083 -- 2083. Okay, keep going. Okay. Just go -- yeah, okay, let's stop there.

So, Dr. Simpson, I'm wondering if you remember this last year Ms. McCandless asked what you would use for changes in interest rates and your comment was,

> "I don't forecast interest rates on a regular basis in teaching students about labour economics or in doing research on income maintenance programs."

But then you asked if -- if -- what you

would do about forecasting interest rates - if you could just go down, Diana - and -- and this -- and you said,

"You'd look back at the forecasting record. You'd give some significant weight to what has gone on in the last five (5) or six (6) years but I'd probably look back further than that at interest rates."

What I'm hearing from you today is that there seems to be a significant change from last year to this year; that we're not going back five (5) or six (6) years we're going back to recent interest rate increases this year and making the sort of the prediction based on that.

Am I hearing that accurately?

DR. WAYNE SIMPSON: That -- that -- yeah, I think depending on how much interest rates rise, we'll get closer to the kind of territory that we've had in the past, before, in particular the period before the -- what I've characterized as a great recession where inflation was -- was low and stable, so interest rates would also -- nominal interest rates would also have been low and stable.

THE CHAIRPERSON: Okay. So, prior to

this year if you went back five (5) or six (6) years, essentially, you're looking at flat interest rates; is that correct?

DR. WAYNE SIMPSON: Well, five (5) or six (6) years from that year. I guess I was guessing back with -- I'm thinking more before the great recession.

THE CHAIRPERSON: Okay.

DR. WAYNE SIMPSON: So 2006/'7/'8, that period.

THE CHAIRPERSON: Well, the period after the -- the recession --

DR. WAYNE SIMPSON: Yeah.

THE CHAIRPERSON: -- to last year, the interest rates were pretty flat for that period.

DR. WAYNE SIMPSON: That's right, yeah.

THE CHAIRPERSON: Okay.

DR. WAYNE SIMPSON: They've been flat the last few -- I guess they track -- tracked down and then flattened out, yeah.

THE CHAIRPERSON: Okay. Last year, as I understood it, MPI proposed 50/50 as the interest rate forecast to be used.

DR. WAYNE SIMPSON: Right. And

initially the initial DCAT used the SIRF and then this -- the revised DCAT in October used the 50/50.

THE CHAIRPERSON: Right. Then at the time of last year's hearing my understanding was that you thought that SIRF was a better -- a better target than 50/50.

DR. WAYNE SIMPSON: Yes, because in the DCAT you're looking forward four (4) years and I thought interest rates would begin to rise and that probably the banks had a better handle on it than we did.

THE CHAIRPERSON: Okay. Now I remember the discussion from last year.

DR. WAYNE SIMPSON: I'm repeating --

THE CHAIRPERSON: I was going to say, do you think that maybe you're giving the banks too much credit.

DR. WAYNE SIMPSON: Well, I'm not so much giving the banks so much credit as saying that they know more about this than anybody in this room.

THE CHAIRPERSON: Yes. I guess the question I have --

DR. WAYNE SIMPSON: Know more about it anyway.

THE CHAIRPERSON: Well, they certainly

know more about it than me but I guess the question is: Given how flat interest rates were last year and you thought SIRF was the standard for last year, I'm wondering why you think 50/50, at least, is the standard for this year when interest rates are going up. I would have thought you would have gone immediately to SIRF?

DR. WAYNE SIMPSON: Well, I said at lease 50/50 because we'd kind of reached agreement last year that the 50/50 was a compromise. I said -- I said, and probably some of this had to do with -- with when it happened, but, I said that we were trying to out guess the banks, and I had some trouble with that. And I still have some trouble with that.

So my comment at least 50/50 sort of reflects the fact that we shouldn't be going in the wrong direction at exactly the wrong time.

THE CHAIRPERSON: Now, I guess, there's a certain aspect of -- of interest rate projection that's an art versus science. I'm going to give you a hypothetical and you can certainly decide not to answer it.

What happens if the United States terminates NAFTA? Do you think interest rates will go up or down?

DR. WAYNE SIMPSON: It will cause a lot of volatility to markets, and that's a long process, because once the executive branch announces that they are -- are through with NAFTA, it has to go through Congress and it's -- it's a lot more unpredictable than -- than anything else and creates a lot of volatility.

If NAFTA is actually repealed then the question is what happens next. The Canada/US Free Trade Act, I guess, is not -- not the default. So, there'd -- there'd have to be new negotiations. I suspect that there be a new Canada US Free Trade deal and if that -- if all this un -- uncertainty results in a recession in Canada then -- then that would probably slow interest rate increases. I doubt it would drive them back as they have before, but it would slow things down.

THE CHAIRPERSON: Dr. Simpson, you made an interesting comment that I hadn't heard before. And I -- I just want to make sure I got this correct. I think you said you -- that we need constant assessment of the cost of climate change.

Now, was I right in writing that down or --

DR. WAYNE SIMPSON: In the context of

hail damage, yeah.

THE CHAIRPERSON: Okay. So, your comment about the climate change was simply in relation to the hail damage that -- that MPI is -- experiences?

DR. WAYNE SIMPSON: Well, I think here it would be primarily the -- the loss ratio in the sense -- in the sense that climate change, that would be the most immediate impact you could think of. I think in the longer term it -- it will also affect -- it could also affect equities.

THE CHAIRPERSON: Okay.

DR. WAYNE SIMPSON: But that -- that's guesswork, really, at this point, because we don't really know how much change there will be and we don't know what its impact wi -- is going to be with any certainty, especially in a province like Manitoba where we have some degree of protection.

THE CHAIRPERSON: Dr. Simpson, you -- you also made a reference to the cost to the ratepayers by having too high an upper threshold.

DR. WAYNE SIMPSON: Right.

THE CHAIRPERSON: How do you quantify that? I mean, I -- I understand the concept of it, but it -- how do we quantify what the actual cost is to ratepayers if the -- if the threshold is MCT 100 versus the -- the mid target that you were talking about?

DR. WAYNE SIMPSON: Well, you could actually quantified it in the sense that you could do what's referred to as an input-output analysis where you look at -- a couple of scenarios, one where the -- the -- the rate -- the rate is higher, and the money is -- is invested by MPI or by the government on behalf of MPI, the RSR money.

And the other scenario would be one where the rates are lower and, therefore, consumers have more money in their pockets and are able to spend that money and, to some extent, save and invest that money as they see fit, and the implications of that for the Manitoba economy. I mean, the immediate assessment would be that since a significant portion of that would be spent, it would be more stimulative than -- than MPI investing the money in the -- in the RSR.

In other words, the investment returns would be returns that would scattered in investments across Canada and the world, and the rates would be spent largely in Manitoba.

THE CHAIRPERSON: Okay. And I take

that if you were going to do that kind of study you would have to create a list of assumptions on which you're -- you're basing your examination?

DR. WAYNE SIMPSON: Right and -- and you'd use the Statistic Canada input-output tables to assess impact. They -- they periodically produce tables that -- for the provinces, and indicate how -- how money is spent and what -- in what fashion.

THE CHAIRPERSON: Thank you, Dr. Simpson. Ms. Dilay, any redirect? Sorry, Mr. Williams.

DR. BYRON WILLIAMS: Yes and I have -- I have just a few questions in re-direct.

THE CHAIRPERSON: Okay, certainly.

RE-DIRECT EXAMINATION BY DR. BYRON WILLIAMS:

DR. BYRON WILLIAMS: And perhaps if we can turn to MPI Exhibit 37, Doctor, and to the very first paragraph.

Dr. Simpson you were directed to this response by MPI in cross-examination, you recall that?

DR. WAYNE SIMPSON: Yes. My short-term memory is still there.

DR. BYRON WILLIAMS: I'm reassured to hear that. I want to direct your attention to the first paragraph and -- where you see the suggestion by MPI that the correct way to assess the risk of a significant draw-down is using the results of the dynamic capital adequacy test report.

Do you see that, sir?

DR. WAYNE SIMPSON: Right.

DR. BYRON WILLIAMS: And assuming that you were in agreement on the methodology is -- is that something that you would agree with, sir, in -- in terms of the conclusion?

DR. WAYNE SIMPSON: Right.

DR. BYRON WILLIAMS: Was that a "yes"?

DR. WAYNE SIMPSON: Yes.

DR. BYRON WILLIAMS: If we can go to the DCAT report, figure 66, that was referred to in cross-examination by My Friend for MPI. And just below Figure 66, Dr. Simpson, go down one (1) more line, Diana, you'll see at line 4 that the -- this is a combined scenario before management action, sir?

DR. WAYNE SIMPSON: Right.

DR. BYRON WILLIAMS: And do you have any comments about further -- from the perspective of the DCAT report about whether one should be seeing the RSR before or after management action?

DR. WAYNE SIMPSON: Yeah, we've had

discussions about this before. It seems unreasonable to believe that -- that in a three-year horizon, for example, there'll be no management action to adverse events.

And -- and -- so it -- it seems meaningless as the longer you go out to assume that -- that nothing will happen.

DR. BYRON WILLIAMS: Okay, thank you. If we could go, Diana, to the 2016 DCAT report of Manitoba Public Insurance dated October 7th, page 25. That's fine there.

Dr. Simpson, you recall some discussion about whether the scenario for the 2016 DCAT was the -- the SIRF or the 50/50?

DR. WAYNE SIMPSON: Right.

DR. BYRON WILLIAMS: And I'll direct your attention to lines 2 to 4, sir.

DR. WAYNE SIMPSON: Right which indicates that it was the 50/50.

DR. BYRON WILLIAMS: Okay, thank you. And finally, just as follow-up to one (1) of the questions asked by the Chair, Dr. Simpson, you recall reference by the Chair to a question about constant assessment of the impacts of climate change?

DR. WAYNE SIMPSON: Right.

DR. BYRON WILLIAMS: And can you indicate whether or not that constant assessment would involve a review of the data for structural breaks in the data, or how one might undertake that?

DR. WAYNE SIMPSON: Right, either a -- a change in trend; if it's a case of hail you'd look at to see whether, in fact, there's changes in the trend over time that you can detect, as well as possibly changes in volatility.

And one (1) way of looking at changes in trend would be the idea of an actual structural break, if you could identify it somewhere in the data.

DR. BYRON WILLIAMS: Thank you. I have no further questions.

THE CHAIRPERSON: Thank you. We will adjourn until five o'clock. Mr. Williams, I understand, Dr. Sherry, is here at five o'clock?

DR. BYRON WILLIAMS: Ms. Sherry will be here for five o'clock, and Dr. Simpson, I think has kindly agreed to be her back row.

THE CHAIRPERSON: Okay.

DR. BYRON WILLIAMS: So he'll be sticking around as well.

THE CHAIRPERSON: Good, thank you, we'll adjourn until five o'clock

--- Upon recessing at 3:55 p.m.
--- Upon resuming at 4:59 p.m.

THE CHAIRPERSON: Good afternoon. Mr. Ghikas, did -- did you want to --

MR. MATTHEW GHIKAS: That's something I'm going to use during cross-examination so --

THE CHAIRPERSON: Okay, that's fine.

MR. MATTHEW GHIKAS: -- yeah, I just want to make sure everybody had it in advance.

THE CHAIRPERSON: Thank you. Sure, okay. Now, Ms. Dilay...?

MS. KATRINE DILAY: Thank you, Mr. Chair.

MS. KATRINE DILAY: Good afternoon, Ms. Sherry, and thank you for joining us and we'd also like to thank the Board and counsel and parties for accommodating the schedule this evening.

So we'd like to maybe call upon Mr. Christle to swear or affirm Ms. Sherry in as a witness.

CAC PANEL 2

ANDREA SHERRY, Sworn.

EXAMINATION-IN-CHIEF BY MS. KATRINE DILAY:

MS. KATRINE DILAY: Thank you, Mr. Christle. Before starting we have distributed electronically and a paper version of Ms. Sherry's PowerPoint presentation, which we would file as Exhibit CAC-23.

--- EXHIBIT CAC-23: PowerPoint presentation by Ms. Sherry.

CONTINUED BY MS. KATRINE DILAY:

MS. KATRINE DILAY: And so, Ms. Sherry, it's our understanding that you have already been prequalified with the Board, and that your curriculum vitae has been filed as well. But before you begin your presentation, I'd just like to ask a few questions to highlight your qualifications, as they relate to your testimony today, as well as the written evidence that you have provided in this proceeding.

So in terms of your education, Ms. Sherry, you received a Bachelors of Commerce with a major in actuarial mathematics in 1990, is that right?

MS. ANDREA SHERRY: That's true.

MS. KATRINE DILAY: And you became a Fellow of the Casualty Actuarial Society, and of the Canadian Institute of Actuaries in the year 200?

MS. ANDREA SHERRY: That's right.

MS. KATRINE DILAY: You became a chartered risk manager and a Fellow chartered insurance professional in 2005?

MS. ANDREA SHERRY: Correct.

MS. KATRINE DILAY: And you received your certified management accountant designation in 2008, and you are now chartered professional accountant, certified management accountant; is that right?

MS. ANDREA SHERRY: That's true.

MS. KATRINE DILAY: In terms of your experience, you have served as an associate actuary at Manitoba Public Insurance between 1991 and 1998, correct?

MS. ANDREA SHERRY: Correct, yeah.

MS. KATRINE DILAY: And your role there involved the calculation of policy liabilities, the forecast of premiums and claims amounts?

MS. ANDREA SHERRY: True.

MS. KATRINE DILAY: And you were also

involved in the preparation of Extension rates reports, rate-making methodology reports, and claim's forecasting reports; is that right?

MS. ANDREA SHERRY: Yes, that's true.

MS. KATRINE DILAY: You also assisted in the preparation of the application to the Public Utilities Board as well during this time period?

MS. ANDREA SHERRY: I did.

MS. KATRINE DILAY: In terms of your other experience, you served as an actuary with Federated Insurance Company between 1999 and 2004, correct?

MS. ANDREA SHERRY: Correct.

MS. KATRINE DILAY: And you were their first in-house actuary responsible for actuarial systems?

MS. ANDREA SHERRY: Yes.

MS. KATRINE DILAY: You were responsible for all rate changes, including the calculation of indications and rate filings with regulators in all the provinces in which the company wrote insurance; is that right?

MS. ANDREA SHERRY: Yes, it is.

MS. KATRINE DILAY: And you also monitored -- you also monitored the IBNR, the incurred but not reported adequacy on a monthly basis?

MS. ANDREA SHERRY: I did, yeah.

MS. KATRINE DILAY: You also served as both assistant vice-president and corporate actuary for Saskatchewan Government Insurance between 2004 and 2008; is that right?

MS. ANDREA SHERRY: That's right, yeah.

MS. KATRINE DILAY: And in that role you operated as the valuation actuary both for the Auto Fund and SGI Canada Insurance Services?

MS. ANDREA SHERRY: True.

MS. KATRINE DILAY: You prepared regular rate indications and rate filings for the province of Alberta?

MS. ANDREA SHERRY: I did, yeah.

MS. KATRINE DILAY: Moving on to your -- the next experience, from 2008 to I believe '10 you served as vice-president solvency and vice-president corporate actuary for Aviva Canada?

MS. ANDREA SHERRY: I did, yeah.

MS. KATRINE DILAY: As part of your duties you managed the solvency II and economic capital teams; is that right?

MS. ANDREA SHERRY: That's right.

MS. KATRINE DILAY: You worked within enterprise risk management to ensure continued viability of the company from a regulatory and economic capital basis; is that right?

MS. ANDREA SHERRY: Yes.

MS. KATRINE DILAY: And turning now to your cur -- current position, you are vice-president insurance solution at the Wawanesa Mutual Insurance Company?

MS. ANDREA SHERRY: That's right.

MS. KATRINE DILAY: And in that role you're responsible for the company's actuarial pricing, product development and maintenance, as well as head office personal lines underwriting for all of Canada?

MS. ANDREA SHERRY: That's right.

MS. KATRINE DILAY: As well as the US?

MS. ANDREA SHERRY: Yep.

MS. KATRINE DILAY: And you are responsible for underwriting structure and function across the organization; is that right?

MS. ANDREA SHERRY: That's correct, yeah.

MS. KATRINE DILAY: Now, in terms of your work before the Public Utilities Board, you have consulted with CAC Manitoba on MPI rate applications for the last six (6) years, including reviews of claims liabilities, rate setting methodology, and RSR -related issues; is that right?

MS. ANDREA SHERRY: That's true, yeah.

MS. KATRINE DILAY: And you were qualified as an expert and provided testimony to the PUB last year and the year before on issues related to the RSR, as well as accepted actuarial practice?

MS. ANDREA SHERRY: M-hm, yes.

MS. KATRINE DILAY: And Ms. Sherry, you have been cre -- prequalified in this proceeding as having expertise in actuarial matters, specifically, as they relate to valuation, including the calculation of policy liabilities, forecast premiums, and claims amounts based upon trends, as well as solvency and economic capital, including oversight of capital stress testing and economic capital calculations and, also, actuarial pricing and product development.

And so, Ms. Sherry, in terms of your evidence, you are responsible for the written evidence filed in this proceeding as Exhibit CAC-4 which was entitled Actuarially Indicated Rates for MPI Investment Return on RSR, correct?

MS. ANDREA SHERRY: Correct, yep.

MS. KATRINE DILAY: And you were jointly responsible for the report filed in this proceeding as Exhibit CAC-5 entitled Does the RSR need To Be So Large; correct?

MS. ANDREA SHERRY: Yes.

MS. KATRINE DILAY: And you were responsible for Information Request responses con -- contained within Exhibit PUB-11, correct?

MS. ANDREA SHERRY: Correct.

MS. KATRINE DILAY: And can you confirm that this written material was prepared under your direction and control, and is accurate to the best of your knowledge and belief?

MS. ANDREA SHERRY: I can.

MS. KATRINE DILAY: So those are my questions for Ms. Sherry before her presentation so I would now turn it over to Ms. Sherry.

PRESENTATION BY MS. ANDREA SHERRY:

MS. ANDREA SHERRY: First of all, thank you to the Board for having me today and thank you to everyone who is present for accommodating my schedule. I do really appreciate it. I understand that's it's 5:00 p.m. now, so it's getting late so thank you for being here.

We can go to the second slide, Diana. Just in terms of a quick overview, I think it's been obvious from what I've written in various times throughout this hearing that it is my belief that MPI should use the investment income on the total equity in the calculation of their rate indication and I gave some reasons for that in my report, and I'll go through a few of them here.

So this is Section 2620.01 of the Standard of Practice of the Canadian Institute of Actuaries and I know that you have all seen this throughout the hearing because I've read it in the transcripts.

But, in particular, I wanted to point out on this slide that the best estimate present value of cashflows relating to the revenue at the indicated rate includes a present value of a provision for profit. As you can see in the second last line there. So that's really what I'm getting at is that there should be a provision for profit in the cashflows relating to revenues.

And further to that because the standards read like that, it is normal best practice to include the investment income on the surplus packing the book that you're pricing for. In a private organization, obviously, there is fear of pricing for many different products in many different regions but you always have a certain amount of capital that is backing that book and you do take into account the investment income on the capital backing the book that you are pricing for in the rate indication that you calculate.

So my point is that the RSR is the capital backing the Basic book and, therefore, the investment income on it should be taken into account when you calculate the rate indication.

I wanted to make the point with this slide and I apologize for the large black font, I didn't mean it to come across as quite as strongly as that but I didn't want to miss the point that I'm not suggesting in any way that we reduce the RSR, and include some sort of monies in the rate indication. What I'm suggesting is the investment income on the RSR, as it's calculated, should be included in the rate indication.

Really, the investment income on the RSR is a revenue to Basic. It shouldn't be added to the RSR to -- as any sort of buffer.

It's also come up quite a bit in the

transcripts I've read quite a bit that the fact that a lot of the capital in the RSR now has been transferred from Extension or SRE, I don't think that's relevant to this discussion. Extension, SRE wouldn't exist without Basic. The profits from these lines of business should benefit the customers of MPI. I feel that the further removed the investment income on the RSR is from the people who invested the funds, that make that investment income, does create an intergenerational equity issue.

So I think it should be included in the rate indication to keep the rate indication lower so that it benefits the people closest to that money.

Which leads, basically, to my recommendation. And this is a very -- the typical calculation of a profit provision in a rate indication. In the case of MPI, the return on equity would be zero. So that formula, basically, boils with a zero in the ROE, or return on equity spot. The formula boils down to a negative I over -- IR over PSR which IR is the before tax investment return rate on the assets supporting total equity. PSR is the premium to surplus ratio. So that would be consistent with the zero profit to our breakeven objective of the Corporation with the return on equity at zero.

And that concludes my presentation.

MS. KATRINE DILAY: Thank you, Ms. Sherry. Ms. Sherry will now be available for questions from cross-examination and from the Board.

THE CHAIRPERSON: Thank you. Mr. Ghikas...?

MR. MATTHEW GHIKAS: Thank you, Mr. Chairman.

CROSS-EXAMINATION BY MR. MATTHEW GHIKAS:

MR. MATTHEW GHIKAS: Good afternoon, Ms. Sherry. As you know from last year my name is Matt Ghikas, I'm counsel for MPI. I want to start by dealing first with Exhibit CAC-5, which is the evidence that you co-authored with Dr. Simpson, okay.

MS. ANDREA SHERRY: Okay.

MR. MATTHEW GHIKAS: If we can -- thank you, Diana, and the pages aren't numbered but what -- it's the second page of text towards the bottom, the last full paragraph. The moreover paragraph. There we go. Up on the screen in front of you.

Do you have that there?

MS. ANDREA SHERRY: I do, yeah.

MR. MATTHEW GHIKAS: Okay. Now this

is a passage that Dr. Simpson included verbatim in his PowerPoint presentation earlier. And what -- first of all, you're familiar with the E&Y report?

MS. ANDREA SHERRY: I am -- well, I wouldn't say -- I haven't memorized it, I'm familiar with it.

MR. MATTHEW GHIKAS: Okay. And certainly enough to have included this in your co-authored evidence, correct?

MS. ANDREA SHERRY: Yep.

MR. MATTHEW GHIKAS: All right. Can we -- if we just go down a little bit on to the next page there, keep going a little bit, please. All right.

And what I am interested in is about six (6) -- five (5) lines down from the top of the page, do you see there's an ellipsis there? Three (3) little dots?

MS. ANDREA SHERRY: Yeah.

MR. MATTHEW GHIKAS: Okay. Who made the decision to omit a portion of that passage; you or Dr. Simpson or both of you?

MS. ANDREA SHERRY: We would've agreed.

MR. MATTHEW GHIKAS: Okay.

MS. ANDREA SHERRY: Which page? Can you direct me to which page on the ICBC report -- oh, it's right there, sorry.

MR. MATTHEW GHIKAS: Yes. I'm -- this is actually the -- yeah, page 85 and you're -- you're ahead of me here. So what I would -- what I would like to do then, Diana, is to do -- actually go to PUB Exhibit 11, which is the ICBC report and maybe we can go right to page 85, please. And I'd just like to find the same passage, if we can. Right. Yeah, so if you can scroll up just a little bit to the previous page. It's the there -- there we go, right.

And you'll see the reference to "as a government owned monopoly insurer"?

MS. ANDREA SHERRY: Yes, yep.

MR. MATTHEW GHIKAS: Okay, so your quote started there and it went down to the very end of that page, and then you inserted an ellipses after "to have higher premiums." Do you see that?

MS. ANDREA SHERRY: Yep.

MR. MATTHEW GHIKAS: And so -- then you skipped over a little bit. You skipped over the next sentence at the top of the next page and over the table and over one (1) more sentence after the table, and then you included, "Consideration should be -- should also be given to whether the OSFI MCT ratio is the appropriate framework for setting capital for the Basic product."

Correct?

MS. ANDREA SHERRY: Correct, yeah.

MR. MATTHEW GHIKAS: Okay. Now, the -- in the course of -- I looked at your report, Ms. -- Ms. Sherry, and over the course of nine (9) pages there were at least two (2) other quotations that were significantly longer than the one that you included here.

And I'm wondering, you know, whether you just put that ellipses in there to save space or why did you do that?

MS. ANDREA SHERRY: I think we left out parts that we didn't think would be relevant to the discussion.

MR. MATTHEW GHIKAS: All right. Well, let's -- let's go to the sentence right above the table then.

So you'd agree with me that ICBC's basic MCT target ratio is 145 percent?

MS. ANDREA SHERRY: I see that, yes.

MR. MATTHEW GHIKAS: Okay and that's -- that's true, isn't it?

MS. ANDREA SHERRY: I think that's -- sorry, their target ratio?

MR. MATTHEW GHIKAS: Yeah.

MS. ANDREA SHERRY: At the time of this paper, yes.

MR. MATTHEW GHIKAS: Right. And -- now the sentence, if we go down and -- and sorry, you'll -- you also or you're aware that they have a regulatory minimum of 100 percent MCT?

MS. ANDREA SHERRY: I am.

MR. MATTHEW GHIKAS: Okay. And that they have a capital level of 160 MCT over which they may consider a rebate; correct?

MS. ANDREA SHERRY: I did not know that.

MR. MATTHEW GHIKAS: Okay. You'll agree with me that ICBC's regulatory minimum at 100 percent MCT is equivalent to what the upper level of the RSR that MPI is seeking here?

MS. ANDREA SHERRY: I am.

MR. MATTHEW GHIKAS: Okay. Now if we can go after the paragraph -- sorry, after the table to the next sentence, you'll see it says:

"In light of the above discussion
ICBC in conjunction with the
government should consider a lower
target capital provision for the
Basic product more in line with
other jurisdictions."

Do you know what other jurisdictions they're referring to there, Ms -- Ms. Sherry?

MS. ANDREA SHERRY: I don't know but I could put forward a guess.

MR. MATTHEW GHIKAS: Okay. So why don't -- why don't we look then. Diana, if you wouldn't mind scrolling up to the paragraph immediately prior to the one that Dr. Simpson and Ms. Sherry quoted. All right.

MS. ANDREA SHERRY: There we go.

MR. MATTHEW GHIKAS: And see where it says:

"other automo -- auto monopoly
government schemes in Canada have a
target MCT of 100 percent. Manitoba
and Saskatchewan, while similar
schemes in Australia for Auto and
Worker's Compensation have targets
that are no higher than an MCT of

100 percent. ICBC's capital target
is high relative to those schemes."

Do you see that?

MS. ANDREA SHERRY: I do see that, yes.

MR. MATTHEW GHIKAS: And was it your consideration, Ms. Sherry, that it wouldn't be of interest to the PUB to know that the recommendation that was being made was that ICBC's target ratio be reduced to 100 percent MCT to be on par with Manitoba?

MS. ANDREA SHERRY: We felt that the comment, the last comment that we quote in our paper was the most relevant to the discussion.

MR. MATTHEW GHIKAS: Okay, so maybe you could go back. Diana, could you go back to the evidence for me. And scroll up slightly from the quotation, the E&Y quotation.

And if we -- the previous paragraph, just slightly higher, right under the heading, okay. And you'd agree with me that the first sentence of that section, Ms. Sherry, is:

"MPI continues to argue for the use
of 100 percent MCT criterion to set
the upper threshold for the RSR."

MS. ANDREA SHERRY: Agreed.

MR. MATTHEW GHIKAS: Right. And you'd agree with me that portions of that sentence -- or that passage from the E&Y report deals directly with whether or not it's appropriate to have an MCT ratio equal to 100 percent MCT?

MS. ANDREA SHERRY: No, it -- the quote from the E&Y report suggests that the OSFI MCT might not be -- or consideration should be given to whether it's the appropriate framework for setting capital for a monopoly auto insurer.

MR. MATTHEW GHIKAS: I recognize that's the portion you quoted, Ms. Sherry. I'm asking about the portion you didn't quote. And you'd agree with me that the portion you chose not to quote is right on the subject of that first sentence in the section there?

MS. ANDREA SHERRY: I'm sorry but I'm not seeing the connection between the two (2) necessarily.

MR. MATTHEW GHIKAS: Okay. Why don't we do it this way. So, Ms. Sherry, in the section in which you quoted the passage from the E&Y report, you'd agree with me that you are also making an argument that 100 percent MCT is too high for MPI?

MS. ANDREA SHERRY: We are making that

argument. We're also quoting the part that says that consideration should be given whether the MCT is the right framework for setting capital.

MR. MATTHEW GHIKAS: And if we can go to the paragraph immediately following where you quote Ernst & Young. The first sentence there:

> "MPI continues to advocate for the hundred percent MCT to set the upper threshold in the absence of an approved methodology."

So there you are talking, again, about 100 percent MCT; correct?

MS. ANDREA SHERRY: M-hm, yep.

MR. MATTHEW GHIKAS: Now, Ms. Sherry, I'm going to turn to the topic of capital reserves, generally, and we should go fairly smoothly here so long as you answer the questions the same way as you did last year. And I suspect that won't be an issue, because I don't think this is controversial.

All right. You'd agree with me, Ms. Sherry, that every insurance company in Canada, public or private, has a capital reserve?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And that OSFI, the Office of the Superintendent of Financial

Institutions sets capital levels for private insurers in Canada?

MS. ANDREA SHERRY: It does for federally regulated insurers.

MR. MATTHEW GHIKAS: Right. And it's developed a test called the Minimum Capital Test to assess capital adequacy; correct?

MS. ANDREA SHERRY: That's right.

MR. MATTHEW GHIKAS: And it's applied to those federally regulated insurers; correct?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: And simply stated, Ms. Sherry, the MCT test is the ratio of capital available to capital required, expressed as a percentage?

MS. ANDREA SHERRY: Yes, that's true.

MR. MATTHEW GHIKAS: And 100 percent MCT is where the capital available equals the capital required, correct?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: And OSFI's guidelines stipulate how those amounts are to be calculated, correct?

MS. ANDREA SHERRY: That's correct.

MR. MATTHEW GHIKAS: Okay. Now, I

sent -- let me -- let me ask you this. If you go to -- back to your evidence that you prepared with Dr. Simpson. And now I'm on -- under the heading, again, right under -- same page, right under the heading One Use of MCT to Set The Upper Threshold for the RSR. So slightly higher, Diana. Okay. Right there.

You'll see right there there's a reference to MPI continues to argue for the use of 100 percent MCT criterion to set the upper threshold for the RSR, and then you go and say -- let's see -- you make the point that:

> "MPI as a Crown monopoly insurer is in quite a distant position, excuse me, from the private property and casualty insurers who operate in a competitive market with real possibility of bankruptcy."

So that's one (1) of the arguments that you make that the MCT criterion should not be used; correct?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: Okay. Now, I sent an email to your counsel yesterday indicating that I'd be referring to the OSFI guidelines and you -- you got that notice, did you?

MS. ANDREA SHERRY: I did, yeah, I got a copy here.

MR. MATTHEW GHIKAS: Okay and I circulated or I had somebody circulates some excerpts from that guideline earlier and everybody should have those on their desk. And this excerpt was, in fact, an exhibit last year, MPI Exhibit 81 from last year. And I believe it will be MPI Exhibit Number 53 in this proceeding.

But do you recognize this document, the excerpt says, "excerpts from the guideline Minimum Capital Test Guideline?

MS. ANDREA SHERRY: I do recognize it, yeah.

MR. MATTHEW GHIKAS: So what I'd like to do is, first of all, if you can go over to page 4 of the -- of the guidelines within that excerpt in section 1.1 overview. Right.

And you'll soon under the heading 1.1.1 it indicates:

> "Under the MCT regulatory capital requirements for various risks are set directly at a predetermined target confidence level. OSFI has elected 99 percent of the expected

shortfall conditional tail
expectation, or CTE 99 percent over
a one year time horizon as the
target confidence level."

Do you see that?

MS. ANDREA SHERRY: I do.

MR. MATTHEW GHIKAS: So what this is saying is that the probability that it is assessing is a 1:100 scenario?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: Right. And -- and the probability that they're measuring is the probability simply of the capital reaching zero, correct?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: Okay. Now, if we go over to the following page -- first of all, you'll agree with me that what the MCT test does is it looks at the particular balance sheet of an insurer; right?

MS. ANDREA SHERRY: M-hm.

MR. MATTHEW GHIKAS: Sorry, you'll have answer "yes" or "no".

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And each individual insurer's own balance sheet is going to be different, right?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: And so what this test does is it looks at that individual insurer's characteristics, and comes up and assesses the itemized risks in the context of an individual insurer; correct?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: Okay. And so an indiv -- an individual insurer's risk profile and the risk to its balance sheet are assessed under this test, correct?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: Now, keeping it really simple, at a high level, that means that if there are two (2) different insurers, and they're both operating at 100 percent MCT, the amount of capital that they're actually retaining in dollars could be quite different, depending on the risks to their balance sheet and the size of the business?

MS. ANDREA SHERRY: The type of business they write, et cetera, yes.

MR. MATTHEW GHIKAS: Right. Okay. So, if we can look on page 5, you'll see there is an overview of the minimum capital requirements, and how they're calculated. And I just wanted to run through some of them with you, Ms. Sherry.

You'll see it says "minimum capital requirements are calculated as follows: Some of..." and then there's a list. Do you see that?

MS. ANDREA SHERRY: I do, yeah.

MR. MATTHEW GHIKAS: Okay. So let's go through some of the items. First of all, 1(a) capital required for unpaid claims and premium liabilities. Do you see that?

MS. ANDREA SHERRY: M-hm. Yes, I do.

MR. MATTHEW GHIKAS: Okay. You'd agree with me that Basic Autopac has unpaid claims and premium liabilities?

MS. ANDREA SHERRY: I would agree.

MR. MATTHEW GHIKAS: And you'd agree with me that Basic Autopac has risks associated with the potential for catastrophes?

MS. ANDREA SHERRY: I would have to look into that one, to be honest with you because I'm not sure if that's thr -- anything related to earthquake.

MR. MATTHEW GHIKAS: Okay. But depending on the catastrophe and depending on what they're writing, they can conceivably have that;

correct?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: Right. And to the extent that they have less than another insurer, that's going to be picked up in the -- in the balance sheet, correct?

MS. ANDREA SHERRY: Yep.

MR. MATTHEW GHIKAS: Okay. And the next one "margin required for reinsurance seated to unregistered reinsurers." MPI doesn't include anything for that.

MS. ANDREA SHERRY: M-hm.

MR. MATTHEW GHIKAS: But -- so we'll -- we'll leave that one.

But you'll agree with me that MPI has exposure to interest rate risk?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And that, for example, would be reflected in the fact that there is -- there is -- had to be $163 million transferred from optional to the Basic side of the business to deal with interest rate variances?

MS. ANDREA SHERRY: I would agree that MPI has interest rate risk, yes.

MR. MATTHEW GHIKAS: Right. And you'd

agree with me that MPI has foreign-exchange risk on investments that are US denominated or US infrastructure investments?

MS. ANDREA SHERRY: Yep.

MR. MATTHEW GHIKAS: And you'd agree with me that MPI, to the extent that it is holding equity in its portfolio, has equity risk?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And you would agree with me that if there is real estate in MPI's portfolio - which I understand there is - MPI would also face real estate risk?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And you'd agree with me -- let's skip over the next one.

You'd agree with me that there is the potential for counter-party default risk for MPI?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: Okay. And the next two they are no values for MPI, so I'll skip over those.

And there is the potential for operational risk, just like any other insurer; correct?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: Okay. Now, I take it that the fact that MPI is not subject to competition, the only place for that to fit is under 2(e) capital required for other market risk exposures?

MS. ANDREA SHERRY: Yes, I believe you're correct in the MCT.

MR. MATTHEW GHIKAS: Okay. And so for Basic then what MPI would simply do is put a zero value in for that, on their P&C-1 form. Right?

MS. ANDREA SHERRY: Is that a question?

MR. MATTHEW GHIKAS: It is.

MS. ANDREA SHERRY: I don't know what MPI would do.

MR. MATTHEW GHIKAS: Okay. So if -- if there is no market risk exposure from competition, you would expect that simply -- the insurer would simply fill -- fill out that line item reflecting the fact that they have no competitive risk; correct?

MS. ANDREA SHERRY: Okay.

MR. MATTHEW GHIKAS: Now, I just want to clarify your position, Ms. Sherry, on whether you oppose the use of the MCT as a test for MPI, or whether you simply believe that 100 percent MCT is too high?

MS. ANDREA SHERRY: My belief is that the MC -- a choice of a target, a higher level of the RSR using 100 percent MCT is arbitrary. The MCT wasn't created for an RSR target per se, it was created so that OSFI would know when a company was in to the potential of going insolvent.

So the tests around it including tests of a BC earthquake, et cetera, things that MPI does not face. As well, MPI does not face the risk of insolvency and the risk to the whole economy of Canada if we -- they go down on. That's what OSFI is trying to protect the consumers against. It wasn't built for a monopoly public insurer.

MR. MATTHEW GHIKAS: Okay. So let me -- let me ask you this again. I'm not sure if I understood whether you are objecting to the use of the test itself, or whether you're objecting to the use of 100 percent.

MS. ANDREA SHERRY: I'm objecting to the use of the MCT as -- in setting the RSR range.

MR. MATTHEW GHIKAS: Okay.

MS. ANDREA SHERRY: You can calculate the MCT and see where you're at, but it's -- I -- I don't think it should be used to set the RSR range.

MR. MATTHEW GHIKAS: Okay. Can we go,

Diana, if you can pull up last year's transcript, please. And to page 2,059. And you can -- if you go down to line 15, please.

Okay. Now, last year, Ms. Sherry, you -- I cross-examined you last year, right?

MS. ANDREA SHERRY: I recall.

MR. MATTHEW GHIKAS: And if -- starting at line 15 of this transcript, I asked you:

"And I've seen your transcripts, Ms. Sherry, where you had indicated that you didn't believe MCT was the appropriate -- was appropriate for use for MPI. Is that correct?"

Answer:

"I wouldn't say that it's not appropriate to use for MPI. The MCT is really just an output of a set of financial statements. My opinion is that it shouldn't serve as the -- a hundred percent MCT shouldn't serve as the upper target for the RSR."

Now, do you recall being asked those questions?

MS. ANDREA SHERRY: Vaguely.

MR. MATTHEW GHIKAS: Okay. And do you

recall giving those answers?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And were they true?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: Thank you. Now, you said that the MCT test was prepared to deal with the issue of solvency. You'd agree with me, Ms. Sherry, that basic Autopac has a risk of reaching zero capital?

MS. ANDREA SHERRY: I would agree with that.

MR. MATTHEW GHIKAS: Thank you. And you'd agree with me that -- that SGI Auto Fund uses the minimum capital test?

MS. ANDREA SHERRY: I have been told they do, and seen documents that show they do.

MR. MATTHEW GHIKAS: Okay. And you'd agree with me that currently ICBC does, as well, right?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: Okay. All right. Are you aware, Ms. Sherry, that MPI's current capital level is 29 percent MCT?

MS. ANDREA SHERRY: I believe I read

that throughout the hearing process, yes.

MR. MATTHEW GHIKAS: Okay. And you -- you seem to have a lot of experience in Canada. Are you aware of any P&C insurer anywhere in Canada, Crown or private, where the applicable regulator has determined that such a capital level is sufficient?

MS. ANDREA SHERRY: I am not aware of that, no.

MR. MATTHEW GHIKAS: Okay. And are you aware of any P&C insurer anywhere in Canada, Crown or private, that has -- that is more thinly capitalized than basic Autopac?

MS. ANDREA SHERRY: I can't answer that question with certainty because I don't know the risk profile of all of the companies in Canada.

MR. MATTHEW GHIKAS: Okay. Well, it wouldn't be a private one, would it, or else it would be under the -- under OSFI's control right now, correct?

MS. ANDREA SHERRY: True. If it was feg -- federally regulated, yeah.

MR. MATTHEW GHIKAS: Right. And -- and the FSCO in Ontario also uses the MCT test?

MS. ANDREA SHERRY: FSCO? No. FSCO is a rating regulator.

MR. MATTHEW GHIKAS: Okay.

MS. ANDREA SHERRY: As far as I know they do not use the MCT.

MR. MATTHEW GHIKAS: Okay. So, to your knowledge, is there anyone more thinly capitalized than Autopac?

MS. ANDREA SHERRY: As I said, I -- to my knowledge no because I don't know the risk profile of every company in Canada.

MR. MATTHEW GHIKAS: Okay. And in terms of the lower RSR level coming out of the collaborative process, that's based on a 1:40 DCAT scenario, Ms. Sherry?

MS. ANDREA SHERRY: That is what is being proposed, yes.

MR. MATTHEW GHIKAS: And you're aware that that currently translates to $201 million for basic Autopac?

MS. ANDREA SHERRY: I'm just checking the number. You are correct, yes.

MR. MATTHEW GHIKAS: Okay. And that that translates to 37 percent MCT?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: Okay. Are you aware of any other P&C insurer anywhere in Canada, public or private, where the applicable regulator has determined that an acceptable minimum level of capital is the amount generated by a 1:40 DCAT scenario?

MS. ANDREA SHERRY: No, I am not aware.

MR. MATTHEW GHIKAS: Okay. Are you aware of any P&C insurer anywhere in Canada, public or private, where the applicable regulator has determined that 37 percent MCT is an acceptable minimum level of capital?

MS. ANDREA SHERRY: No, I am not aware.

MR. MATTHEW GHIKAS: And last year -- if you'll just confirm for me, Ms. Sherry, last year you were advocating that the PUB put in place a band around the lower RSR with the bottom level based on a 1:10 DCAT risk tolerance?

MS. ANDREA SHERRY: We had an upper and a lower band, I believe. So there was a 1:10 and a 1:20 that we thought should be considered right.

MR. MATTHEW GHIKAS: Right. And a 1:10 scenario, that would be a 10 percent probability of hitting zero capital after management action, correct?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: And I think we established last year that you as a professional actuary would never endorse or sign off on that type of probability level for DCAT?

MS. ANDREA SHERRY: Not for running scenarios, no.

MR. MATTHEW GHIKAS: Right. You wouldn't sign off on that, would you?

MS. ANDREA SHERRY: No.

MR. MATTHEW GHIKAS: Right. And that level of capital is so low, in fact, Ms. Sherry, that actuarial standards of practice would not even permit an actuary to sign off on a DCAT with that probability, would it?

MS. ANDREA SHERRY: If you were a federally regulated company, they would not.

MR. MATTHEW GHIKAS: Right. If you were subject to the standards of practice, right?

MS. ANDREA SHERRY: No. If you were a federally regulated company.

MR. MATTHEW GHIKAS: I see. So the standards of practice only apply to actuaries at federally regulated companies?

MS. ANDREA SHERRY: I'm sorry. Can you show me the standards of practice that say that you have to -- I know there's the OSFI guidelines, but I'm not familiar with the standard of practice that requires you to run the DCAT at a certain level of probability.

MR. MATTHEW GHIKAS: Okay.

MS. ANDREA SHERRY: Am I missing that?

MR. MATTHEW GHIKAS: Isn't -- are you familiar with the educational note regarding plausible adverse events?

MS. ANDREA SHERRY: Yeah. It's an educational note; it's not a standard of practice.

MR. MATTHEW GHIKAS: I see. And -- and the -- the educational note is suggesting that a 95 percentile or 1:20 is the minimum, correct?

MS. ANDREA SHERRY: That would be correct, yeah.

MR. MATTHEW GHIKAS: And so it's educational note because that's considered a best practice, Ms. Sherry?

MS. ANDREA SHERRY: It's an educational note. I can't say that it -- I think it -- best practices would vary among -- amongst the circumstances for which the work is being used.

MR. MATTHEW GHIKAS: Okay. Wawanesa sells automobile insurance?

MS. ANDREA SHERRY: Sure do. Yeah.

MR. MATTHEW GHIKAS: And in 2016, your MCT, based on your annual report, was 317 percent MCT?

MS. ANDREA SHERRY: Yes, it was.

MR. MATTHEW GHIKAS: Okay. Now, all I -- OSFI's supervisory target is 150 percent, correct?

MS. ANDREA SHERRY: That's correct, yeah.

MR. MATTHEW GHIKAS: And OSFI has an early intervention process if the capital levels fall below a hundred and fifty (150)?

MS. ANDREA SHERRY: Yeah.

MR. MATTHEW GHIKAS: And so in order to avoid falling below 150 percent, private insurers retain sufficient capital above that level to absorb volatility, correct?

MS. ANDREA SHERRY: We actually agree with OSFI on a target, and if we go below the target OSFI shows interest.

MR. MATTHEW GHIKAS: Okay. In your joint report, if we can just flip back there very briefly, Diana, please. The last page, I believe, in the joint recommendations, numbers 4 and 5.

Right. So numbers 4 and 5. The joint recommendations that you made with Dr. Simpson are that the strict use of the naive forecast in the DCAT be replaced with the 50/50 forecast used previously.

And 5: That MPI undertake to assess the 50/50 forecast, in light of rising interest rates.

Do you see that?

MS. ANDREA SHERRY: I do, yeah.

MR. MATTHEW GHIKAS: Okay. So this year, Ms. Sherry, you'll agree with me that the SIRF is not a best estimate forecast?

MS. ANDREA SHERRY: I'm going to go to my back row. That's okay?

(BRIEF PAUSE)

MS. ANDREA SHERRY: Sorry about that. So I guess the question begs another question. Is -- you asked if the SIRF was not a best estimate forecast, and I think that would depend on whose opinion you're asking, but --

MR. MATTHEW GHIKAS: I'm asking yours.

MS. ANDREA SHERRY: I think that it's -- it's probably better than the naive forecast, but we think that, based on the uncertainty that the 50/50, as was done for last year's, would make more sense.

MR. MATTHEW GHIKAS: Okay. So the SIRF is not a best estimate?

MS. ANDREA SHERRY: I think it's probably --

DR. BYRON WILLIAMS: Mr. Ghikas, just to be clear, you're asking in the context of the DCAT methodology, sir?

MR. MATTHEW GHIKAS: I'm asking whether it's --

DR. BYRON WILLIAMS: Well, this --

MR. MATTHEW GHIKAS: -- Mr. Williams, whether it's a -- whether it's a best estimate or not.

DR. BYRON WILLIAMS: And this is in the context of their evidence, which is the DCAT methodology, sir?

MR. MATTHEW GHIKAS: That's fine.

DR. BYRON WILLIAMS: And the recommendation?

MR. MATTHEW GHIKAS: That's fine.

(BRIEF PAUSE)

MS. ANDREA SHERRY: So we believe that the SIRF is a better forecast than the naive forecast. So we feel that at least moving part way to the SIRF, using the 50/50 makes more sense than simply using the naive.

I'm not sure that answers your question.

MR. MATTHEW GHIKAS: Well --

MS. ANDREA SHERRY: I don't think that we can say that we can do better than the banks at forecasting. It might...

MR. MATTHEW GHIKAS: Okay. So you don't think you can do better than the banks, but you're not going to use their forecast. Have I got that correct?

MS. ANDREA SHERRY: Well, what we're suggesting is that we move between the naive and the SIRF forecast.

MR. MATTHEW GHIKAS: And that's because the SIRF itself is not a good forecast, correct?

MS. ANDREA SHERRY: I don't want to say that it's not a bad -- or not a good forecast. I certainly don't want to pretend I could do better. But I think that we could move towards the SIRF.

MR. MATTHEW GHIKAS: Okay. Your -- your recommendation is to use 50/50, correct?

MS. ANDREA SHERRY: That's correct.

MR. MATTHEW GHIKAS: Okay. And do you recall giving evidence last year, Ms. Sherry, and I can take you there, but where you indicated it would be poor practice -- and those were your words -- poor practice to purposefully, purposely use an estimate or a forecast that is not what you believe to be the best estimate?

MS. ANDREA SHERRY: I agree with that statement, and I didn't say that the best estimate was my best forecast. I'm saying that it's -- it's a estimate, an estimate, and the -- the banks' estimate. And because I don't have anything -- the best estimate is really a combination of what information you have out there, and that what we have is the naive and the SIRF forecast.

MR. MATTHEW GHIKAS: Did you pick 50/50, or did Dr. Simpson, Ms. Sherry?

MS. ANDREA SHERRY: We decided -- we talked about that together.

MR. MATTHEW GHIKAS: Okay. And so you must have turned your mind as to whether or not you were exercising poor practice by putting forward a 50/50?

MS. ANDREA SHERRY: Of course.

MR. MATTHEW GHIKAS: All right. I

want to spend a moment changing gears, here, to just walk through some basics with you, and hopefully we can agree on -- on these con -- concepts.

MS. ANDREA SHERRY: Okay.

MR. MATTHEW GHIKAS: So as we addressed earlier, Ms. Sherry, that MCT is the ratio of capital available to capital required, expressed as a percentage, correct?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: And the capital available, the numerator, is essentially the total equity available to pay claims liabilities, correct?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: And the capital required, which is the denominator, is the amount determined under the criteria specified in the MCT guidelines as being necessary to address risks to the balance sheet, effectively?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And so a hundred percent, as we said before, is when capital available is equal to capital required, right?

MS. ANDREA SHERRY: Yes. Correct.

MR. MATTHEW GHIKAS: Okay. So if we can -- maybe the best way to -- to deal with this is if we can turn to PUB-MPI-2-38. And this is the SGI capital plan document, capital management policy. And did you get a copy of -- of this? I --

MS. ANDREA SHERRY: I did, yeah.

MR. MATTHEW GHIKAS: -- advised your --

MS. ANDREA SHERRY: Yeah.

MR. MATTHEW GHIKAS: -- counsel -- counsel last night.

MS. ANDREA SHERRY: Yeah.

MR. MATTHEW GHIKAS: Okay. And you had a chance to take a look at that?

MS. ANDREA SHERRY: No, I haven't, actually.

MR. MATTHEW GHIKAS: Okay. Well, what -- we don't have to get into the specifics of it. What -- what I actually thought is there was a useful description of the concepts that I was trying to work through here.

Right. It's on page 4, under the heading 3, capital management policy. And you'll see there's a little 2, capital maintenance provision, there. So this -- I actually thought this was a very useful discussion.

And so what SGI says is that as the business volume grows through inflationary pressures and vehicle population, an additional amount of capital is required in order to maintain the MCT at the current level. Specifically, the denominator in the MCT calculation, the capital required, is increased by factors such as higher claims costs and growth in investments.

So pausing there for second, so far that -- you'd agree with that description of what would happen?

MS. ANDREA SHERRY: Yes, as a company grows.

MR. MATTHEW GHIKAS: Right, as the company grows, the denominator grows, right?

MS. ANDREA SHERRY: Yeah.

MR. MATTHEW GHIKAS: And so as your fleet gets bigger, your exposure to -- gets bigger, and so the denominator is growing, the capital required grows?

MS. ANDREA SHERRY: M-hm.

MR. MATTHEW GHIKAS: Yes?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: All right. And so then they say, correspondingly, the numerator, capital available, must grow by the same percentage as the denominator in order to maintain the same MCT ratio. And that's correct, isn't it?

MS. ANDREA SHERRY: Correct, yeah.

MR. MATTHEW GHIKAS: Right. So -- and then it goes on to say -- put another way, even if the SAF were able to break even on rates every year, MCT would erode over time as the growth and capital required outpace the growth and capital available. And that would be true, just simply by math?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And -- so when SGI is saying, Breaking even, what they are saying, effectively, is based on a zero profit provision, correct?

MS. ANDREA SHERRY: That's correct, yeah.

MR. MATTHEW GHIKAS: Okay. And so the dynamic that SGI is describing here that the MCT falls due to growth in the business, that's true for any insurer, correct?

MS. ANDREA SHERRY: Sorry, say that again, please?

MR. MATTHEW GHIKAS: The dynamic that they're describing here that the MCT will fall due to growth in the business, other things being equal, that -- that's a -- that would be true for any business?

MS. ANDREA SHERRY: Well, it depends on your capital available and what's happening with that as well.

MR. MATTHEW GHIKAS: Right. If you're increasing that --

MS. ANDREA SHERRY: It -- it depends. Yeah.

MR. MATTHEW GHIKAS: Right. But other things being equal, the effect would be -- if other things being equal, if the numerator is staying constant, and the denominator is getting bigger, then you are --

MS. ANDREA SHERRY: If you did nothing else --

MR. MATTHEW GHIKAS: -- your MCT is going down?

MS. ANDREA SHERRY: -- if you did nothing else, yes.

MR. MATTHEW GHIKAS: You'd agree with me that MPI's Basic business is growing?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And it's subject to inflationary pressures?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And the vehicle

population is growing?

MS. ANDREA SHERRY: Yes, and they have the -- they have drift factors, et cetera, in their rate-making that accounts for that.

MR. MATTHEW GHIKAS: Sorry, they have what?

MS. ANDREA SHERRY: In your rate-making, you have drift factors so that you -- if the type of vehicles you're writing, et cetera, et cetera, change over time, that's included in rates.

MR. MATTHEW GHIKAS: Okay. But what MPI doesn't have is a -- a capital provision, a capital maintenance provision, right?

MS. ANDREA SHERRY: Right.

MR. MATTHEW GHIKAS: Okay. And just -- just so that we -- we look there as to -- that's described by SGI as saying, To address this, a capital maintenance provision will be added to the base rate designed to offset the decline in MCT arising from the overall growth in SAF's business.

So -- so a capital maintenance provision, Ms. Sherry, just so we're on the same page, effectively, that increases the numerator to match the increase in the denominator so, you still end up with the same MCT, right?

MS. ANDREA SHERRY: That's correct --

MR. MATTHEW GHIKAS: Okay.

MS. ANDREA SHERRY: -- it would appear.

MR. MATTHEW GHIKAS: Now, for a private insurer, Ms. Sherry, if they wanted to maintain an MCT ratio in the face of business growth, they would price the product to incorporate a profit provision that's sufficient to cover -- to increase its capital available and still generate an acceptable return, correct?

MS. ANDREA SHERRY: Quite frankly, the MCT is not considered at all in pricing or rating --

MR. MATTHEW GHIKAS: Right.

MS. ANDREA SHERRY: -- in a private company.

MR. MATTHEW GHIKAS: Right, but you'd have to consider it to make sure that you don't fall offside with your regulator?

MS. ANDREA SHERRY: We don't look at it at all. Proper rate-making doesn't consider the MCT in rates.

MR. MATTHEW GHIKAS: Right. Not your individual product pricing, but your overall capitalization you need to pay attention to, right?

MS. ANDREA SHERRY: Of course it's monitored, yes.

MR. MATTHEW GHIKAS: Right. And so you -- in order to ensure -- if you -- if your capital has fallen, for example, you want to have coming out of -- a sufficient provision in your rates to ensure that your MCT ratio will not fall below unacceptable levels?

MS. ANDREA SHERRY: There is not a direct line between our capital level and pricing. There's too many other things that a private company has to take into account, like the loss of business, our competitors, new entrants. There's so many factors that go into a private company's pricing, and the MCT is not considered as one (1) of them.

MR. MATTHEW GHIKAS: Okay. So SGI pays attention to it, obviously, based on this document, right?

MS. ANDREA SHERRY: M-hm.

MR. MATTHEW GHIKAS: Yes?

MS. ANDREA SHERRY: Yes, obviously.

MR. MATTHEW GHIKAS: Okay. And you'd agree with me that one (1) of the things that they have is a capital maintenance provision?

MS. ANDREA SHERRY: I would agree with

you, yes.

MR. MATTHEW GHIKAS: All right. And they also -- you'll see on that page, there, they have a capital build and release provision?

MS. ANDREA SHERRY: I see that, yes.

MR. MATTHEW GHIKAS: Okay. And you'd agree with me that the purpose of a capital build provision, according to SGI, is to not just maintain the MCT, but to build it back to their target one-fifth (1/5) each year?

MS. ANDREA SHERRY: This is interesting, because SGI doesn't apply for rate changes every year.

MR. MATTHEW GHIKAS: You'd agree with me that that's their capital policy?

MS. ANDREA SHERRY: Yes, but they don't apply for rate changes every year and don't have rate changes every year, so I don't know if this policy is applied every year.

MR. MATTHEW GHIKAS: Okay. Fair enough. You'd agree with me that they have a capital policy that allows for them to maintain their MCT level with a capital maintenance provision and a capital build provision to build it?

MS. ANDREA SHERRY: It looks that way,

yes.

MR. MATTHEW GHIKAS: All right. Now, one (1) of the things that -- if we turn to your -- your report, the one that you wrote individually, CAC Exhibit 4.

(BRIEF PAUSE)

MR. MATTHEW GHIKAS: Now, you -- you indicated on page 2, just above -- just above the quote of the actuarial standards, right above heading 1, actuarial best practice. Although -- so you identify there that MPI's proposal has a significant flaw in its calculation, being that the calculation includes a 0 percent profit provision?

MS. ANDREA SHERRY: I do, yes.

MR. MATTHEW GHIKAS: Okay. And so that -- and which you say has the effect of allowing the expected return on the investment assets supporting total equity to be available to grow the RSR, and you say, The investment income on the RSR should be accounted for in the rate indication calculation, which is consistent with actuarial practice generally, and is applied to other Crown insurers such as SGI and ICBC.

I just want to be absolutely clear about this, Ms. Sherry. MPI's proposal is also consistent with accepted actuarial practice, isn't it?

MS. ANDREA SHERRY: I actually struggled with that, because if you look at the standards of practice, it says, Includes a present value of a provision for profit. So I did struggle with that a little bit, and I can't say for sure that it's against the standards of practice, but if I was the actuary, I would probably contact someone on -- at the Canadian Institute of Actuaries to ensure that I wasn't against standards.

MR. MATTHEW GHIKAS: Ms. Sherry, you've said that they've included a zero percent profit provision, right? Well, let's -- let's look at the standards.

MS. ANDREA SHERRY: No -- so in that case, if you're trying to get a -- I said, It includes a zero percent profit provision, but it's actually the formula at the back, here, and that might have been a misstatement.

MR. MATTHEW GHIKAS: I'm sorry?

MS. ANDREA SHERRY: Well, the fact is that they don't include a zero percent profit provision, because if the rate indication did, it would follow the formula of negative 'I' over -- 'R' over PSR.

MR. MATTHEW GHIKAS: Your -- your profit provision, by proposing what you've proposed to do with the total equity, to credit the total -- sorry, the investment income on total equity, using that formula, that results in a negative profit provision, doesn't it?

MS. ANDREA SHERRY: It results in a negative underwriting profit provision, but a zero return on equity --

MR. MATTHEW GHIKAS: Right.

MS. ANDREA SHERRY: To be clear.

MR. MATTHEW GHIKAS: So you're focusing on the dollar amount, but the profit provision on an actuarial basis is negative?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: Okay.

MS. ANDREA SHERRY: The underwriting profit provision.

MR. MATTHEW GHIKAS: Right.

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: Now, one (1) of the things that -- that you say is, if you look just slightly down below the actuarial best practice quote there, the paragraph afterwards, it says, The investment income on the assets supporting total equity is a cash flow to the Corporation and should be included in the cash flows used to determine the rate indication.

You'd agree with me, Ms. Sherry, that something being, "A cash flow to the Corporation" is not the test under the section you've quoted?

MS. ANDREA SHERRY: Sorry, I -- I --

MR. MATTHEW GHIKAS: Well --

MS. ANDREA SHERRY: -- don't understand the question.

MR. MATTHEW GHIKAS: You've said it belongs there because it's quote unquote, a cash flow to the Corporation, and I'm just -- I'm zeroing in on the fact that that passage you've quoted says it's the best estimate present value of cash flows relating to the revenue at the indicated rate. That's the test, right?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: Right. And the rev --

MS. ANDREA SHERRY: And the revenues flowing in, m-hm.

MR. MATTHEW GHIKAS: The revenues

flowing in from the policies written in the policy year for which you are setting rates, correct?

MS. ANDREA SHERRY: And which -- you include the capital backing the book of business. The investment income from that capital is a revenue for that book of business.

MR. MATTHEW GHIKAS: As a profit provision, right?

MS. ANDREA SHERRY: It could be, yeah.

MR. MATTHEW GHIKAS: Well, what do you mean, "It could be," Ms. Sherry? You've -- you've indicated that it belongs there as a negative profit provision.

MS. ANDREA SHERRY: Okay. Fair enough.

MR. MATTHEW GHIKAS: Okay. So the profit provision, you'd agree with me, is something that management can set?

MS. ANDREA SHERRY: Yes, in a private company. We -- there is judgement involved in that, although regulators are involved as well.

MR. MATTHEW GHIKAS: Right. And...

(BRIEF PAUSE)

MR. MATTHEW GHIKAS: You'd agree with me that having a negative profit provision on top of not having a capital maintenance provision would result in the MCT level declining for basic Autopac, all other things equal?

MS. ANDREA SHERRY: Yes, I would agree with that.

MR. MATTHEW GHIKAS: Now the -- I found -- switching gears, here -- that on page 3 of your report, the paragraph right above intergenerational equity, you say, The Corporation concedes the investment income earned on the RSR as revenue, but argues that this revenue is not related to policies issued in the 2018/'19 policy year. This is only partially true.

So stopping there, from a financial perspective, Ms. Sherry, that is absolutely true, isn't it?

MS. ANDREA SHERRY: Well, its investment -- its investment income that has been collected from prior policyholders -- or on the RSR that has been collected from prior policyholders. So my point there is that since MPI is a monopoly, the current policyholders were most likely policyholders -- or most likely will be next year, and were the year before, and last, et cetera. You have a fai -- fairly stable book of policyholders.

MR. MATTHEW GHIKAS: Right. But if we are in this application, setting rates for the upcoming policy year, MPI hasn't even started to collect any revenues associated with policies written in that year, has it?

MS. ANDREA SHERRY: Well, except a large percentage of the policyholders that will be with you in 2018/'19 were with you in the past.

MR. MATTHEW GHIKAS: Right.

MS. ANDREA SHERRY: So it's pol -- the same -- obviously there's change, but a -- probably a large percentage of the book --

MR. MATTHEW GHIKAS: Okay.

MS. ANDREA SHERRY: -- is the same people.

MR. MATTHEW GHIKAS: So I hear what you're saying about the same people, but the sentence that you've quoted, or that you've stated there, or you've said that MPI argues that:

"This revenue is not related to policies issued in 2018/2019 policy year. This is only partially true."

And that's just plain and simple wrong,

right?

MS. ANDREA SHERRY: I don't think so. I think it is only partially true. I think you've got the same policyholders. So the RSR is built up over the same policyholders that have been there for years. And so that -- that revenue is related to them, and to the people that will have policies in 2018/'19.

MR. MATTHEW GHIKAS: It's not related to the premiums collected on the policies to be written in 2018/2019, is it?

MS. ANDREA SHERRY: Well, I'm arguing that it is, that it should be factored into that.

MR. MATTHEW GHIKAS: Okay. Okay. Has MPI collected any premiums associated with policies written in 2018/2019 yet?

MS. ANDREA SHERRY: No.

MR. MATTHEW GHIKAS: Thank you. All right. Can we go to your slide deck, please, Diana.

(BRIEF PAUSE)

MR. MATTHEW GHIKAS: And there's a slide that says, Transfers from Basic, which I think it was probably it -- it's a typo of, Transfers from -- from Extension, I think, to Basic --

MS. ANDREA SHERRY: Very correct, sorry about that.

MR. MATTHEW GHIKAS: It's okay. It's -- we're all --

MS. ANDREA SHERRY: It should be, Transfers to Basic.

MR. MATTHEW GHIKAS: Yes. Now, on this point, essentially, your point is -- well, let's -- let's backup. You indicated that in your -- in your evidence, you said, under the topic of intergenerational equity:

"The money held in the RSR today has been built up over the years by policyholders that are either still going to be ensured by MPI in the 2018/2019 rating year or not, because of relocation, death or other reasons."

And then MPI indicated in its rebuttal evidence that, in fact, $176 million of the $181 million in the RSR was actually from extension; right?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And so your riposte to that, I guess, is -- is this slide here?

MS. ANDREA SHERRY: Well, that was in

response to that. I knew it would be an issue.

MR. MATTHEW GHIKAS: And so the essence of yours is that -- your -- your position on this is that Extension should be cross-subsidizing Basic Autopac?

MS. ANDREA SHERRY: I believe that Extension wouldn't exist without Basic Autopac. So, yes.

MR. MATTHEW GHIKAS: Okay. One (1) of the things I understood you to be saying earlier, is that the RSR is cash that's backing Basic. And so the income on it should be backing Basic.

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: Okay. Would it not, then, be true that the income from optional line of business would be -- would -- should be backing the optional line of business?

MS. ANDREA SHERRY: MPI doesn't need to be in the optional lines of business. Basic is their basic policy. That's where they have the monopoly.

MR. MATTHEW GHIKAS: And is that -- is that your actual --

MS. ANDREA SHERRY: It's actually their primary concern.

MR. MATTHEW GHIKAS: -- is that your actuarial opinion, Ms. Sherry? Yeah. Okay. All right. Now, I want to turn to your slide that says "standards." The second slide that says "standards," the one (1) that talks about normal best practice. I think it's the next one (1), Diana. Right.

So you -- you have on this slide saying you're invoking normal best practices to include investment income on the surplus backing the book that you were pricing for, as it is a revenue cash flow to that book; right?

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: Okay. Is it normal best practice to have a 27 percent MCT?

MS. ANDREA SHERRY: Not in a private insurance company regulated ASFI, no.

MR. MATTHEW GHIKAS: Okay. And is it -- is it normal best practice to have a DCAT at 1:40?

MS. ANDREA SHERRY: No, not in private organizations regulated by ASFI.

MR. MATTHEW GHIKAS: And is it your -- is it common best practice to run a private business where your lines of business are running a negative profit?

MS. ANDREA SHERRY: Actually --

MR. MATTHEW GHIKAS: Collectively?

MS. ANDREA SHERRY: Not collect -- well, not collectively, but we definitely run some lines in -- in a profit.

MR. MATTHEW GHIKAS: Right. As a market -- as a market share issue.

MS. ANDREA SHERRY: No, because we can't. Yeah. There's a lot of issues, but I don't think it's really relevant to this discussion.

MR. MATTHEW GHIKAS: Right. Collectively your shareholders would be -- I know you don't have shareholders --

MS. ANDREA SHERRY: We --

MR. MATTHEW GHIKAS: -- but in a private business, the shareholders would be unhappy with you if you weren't building in a positive profit provision.

MS. ANDREA SHERRY: Correct.

MR. MATTHEW GHIKAS: Now, let's -- let's talk about your -- if we can go back, Diana -- Sorry to jump around on you here -- back to the evidence of Ms. Sherry. And I'm on page 2. And right above the heading "actuarial best practice," the paragraph above. There we go. I just wanted to focus in on the investment. The sentence that says:

"The investment income on the RSR should be accounted for in the rate indication calculation, which is consistent with actuarial practice generally, and is applied to other Crown insurers such as SGI and ICBC."

And you'd agree with me -- I think we canvassed before that both SGI and ICBC have capital targets considerably above MPI's?

MS. ANDREA SHERRY: That's correct. Yeah.

MR. MATTHEW GHIKAS: Okay. And you'd agree with me again that SGI has a capital plan that contemplates a maintenance and build provision?

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And you'd agree with me that ICBC has that -- that those types of provisions as well?

MS. ANDREA SHERRY: I didn't know they have a capital maintenance provision as well, sorry? ICBC?

MR. MATTHEW GHIKAS: Yes.

MS. ANDREA SHERRY: Oh, okay.

MR. MATTHEW GHIKAS: Okay.

MS. ANDREA SHERRY: I will take your word for that.

MR. MATTHEW GHIKAS: Okay.

MR. BYRON WILLIAMS: We're going to take that one (1) subject to check, Mr. Ghikas.

MR. MATTHEW GHIKAS: That's fine.

CONTINUED BY MR. MATTHEW GHIKAS:

MR. MATTHEW GHIKAS: All right. Now, you had -- over on to page 4, under the heading 4. You've quoted from MPI's response to PUB-2-10 there. Do you see that?

MS. ANDREA SHERRY: Yes, I do. Yeah.

MR. MATTHEW GHIKAS: And maybe we can turn to Exhibit 15, PUB-2-10, Diana, please.

(BRIEF PAUSE)

MR. MATTHEW GHIKAS: Okay. If you can scroll down a bit. Right. So there we have the passage that you've -- that you've quoted. Can you scroll down a little bit further? Okay.

And you see there you're -- right at the beginning of the second page there you stop the quotation just before the word "however?"

MS. ANDREA SHERRY: Yes.

MR. MATTHEW GHIKAS: And I'm just wondering if, you know, given the value that you place on adhering to public industry -- public insurance industry norms, why you wouldn't have continued with that paragraph when you quoted it in your evidence?

MS. ANDREA SHERRY: Well, the question was whether investment income on the RSR should be included in the rate indication. And I was pointing out that they do that.

MR. MATTHEW GHIKAS: And -- and not pointing out that they also have another mechanism to replenish their capital?

MS. ANDREA SHERRY: That would -- that would take it off the subject matter. It wasn't essentially hiding it. It's right there in the Information Request.

MR. MATTHEW GHIKAS: Thank you.

MS. ANDREA SHERRY: And I didn't know that ICBC did.

MR. MATTHEW GHIKAS: Thank you, Ms. Sherry. Thank you, Mr. Chairman. Those are my questions.

THE CHAIRPERSON: Thank you, Mr. Ghikas. Mr. Watchman...?

MR. ROBERT WATCHMAN: Thank you, Mr. Chairman. I -- I don't anticipate being very long.

THE CHAIRPERSON: That's fine. We'll continue.

CROSS-EXAMINATION BY MR. ROBERT WATCHMAN:

MR. ROBERT WATCHMAN: Okay. Good evening, Ms. Sherry.

MS. ANDREA SHERRY: Hello.

MR. ROBERT WATCHMAN: Now, if we could go back, Diana, to exhibit CAC Number 4, Ms. Sherry's report. And on page 2. And just scroll down a little bit there at the midpoint. Is it fair to say that the thrust of your paper is captured in that sentence just above the heading "actuarial best practice" where you say that effectively the investment income on the RSR in the rate indication -- or should be included in the rate indication?

MS. ANDREA SHERRY: Yes, that's definitely the argument to the paper.

MR. ROBERT WATCHMAN: Yes. And again, just -- just so we're clear for the record, you've referred to -- in the RSR, and sometimes total equity. And I think in previous Board orders, what the Board has spoken of, is basic total equity for target capital purposes. Do you recall that?

MS. ANDREA SHERRY: Yes.

MR. ROBERT WATCHMAN: Yeah. And so we're just -- just again --

MS. ANDREA SHERRY: Okay. Yeah.

MR. ROBERT WATCHMAN: -- to make the record clear, we're talking about the same thing. When you use RSR you're talking about the same thing?

MS. ANDREA SHERRY: Yes.

MR. ROBERT WATCHMAN: Now, and then your arguments are -- you -- you provide four (4) arguments, beginning with the actuarial best practice. And if we could just scroll down to the standard and because there was some discussion between you and Mr. Ghikas about this.

And I just -- just so we're clear, can you tell us why you believe it's appropriate to include the expective -- expected return on investment in the rate indication based upon that practice?

MS. ANDREA SHERRY: When you do a rate indication you always look at the capital backing the book of business it's been priced for. And you take into consideration the return on investment on that capital. So to me it should be done here as well, for that reason as well as other reasons.

MR. ROBERT WATCHMAN: So if I'm understanding correctly that investment income would come in by virtue of the first part of the standard, the present value of cash flows relating to the revenue at the indicated rate. Is that where it comes in?

MS. ANDREA SHERRY: You could do it in a few different ways, but another way is you could use the discount rates to discount -- you could take the discount rate on the entire portfolio and discount the cash flows that way. That's one (1) way to include the investment income on the RSR. What I'm suggesting is the formula that we've talked about here.

MR. ROBERT WATCHMAN: Okay. And so when we talk about AAP, this is the standard that we're talking about. And specifically, this is with respect to deriving indicated rates for insurance contract of property and casualty insurance.

Is that right?

MS. ANDREA SHERRY: Yeah.

MR. ROBERT WATCHMAN: And this is binding on all actuaries practicing in Canada?

MS. ANDREA SHERRY: It is, yes.

MR. ROBERT WATCHMAN: Now, if we could turn to the bottom of page 4, please, Diana. Right to the bottom there. And then,-- now, you've already -- you've given evidence with respect to the determination of that breakeven formula --

MS. ANDREA SHERRY: M-hm.

MR. ROBERT WATCHMAN: -- the IR over the PSR.

MS. ANDREA SHERRY: Yes.

MR. ROBERT WATCHMAN: And the IR is again, so we're clear, is the expected income return on assets supporting basic total equity?

MS. ANDREA SHERRY: That's correct. Yeah.

MR. ROBERT WATCHMAN: And this formula is the formula that had been the subject of discussion previously during the collaborative process?

MS. ANDREA SHERRY: That's right. Yes.

MR. ROBERT WATCHMAN: And If we could turn to the top of the next page, please. Now, here you talk about the -- the (INDISCERNIBLE) -- indicated rates based upon two (2) different approaches?

MS. ANDREA SHERRY: Yes. That's straight from PUB-2-11.

MR. ROBERT WATCHMAN: Okay. Thank you.

MS. ANDREA SHERRY: If that's your question.

MR. ROBERT WATCHMAN: Can you just explain for the panel the -- the two (2) different approaches and -- and what the significance is as between them?

MS. ANDREA SHERRY: Can we go to PUB-2-11?

MR. ROBERT WATCHMAN: Certainly.

MS. ANDREA SHERRY: Actually, I might have it here. Let me see. So, actually, if you go back to the first page there it explains it. So, sorry, down a little bit. There we go.

So it's saying there that the premium to surplus ratio is based on the forecasted 2018/'19 Basic written premium divided by the basic total equity midway between the proposed upper and lower basic total equity target levels. So is that clear or helpful?

MR. ROBERT WATCHMAN: Okay. Sorry. If we go back to page 5, just so we understand. So --

MS. ANDREA SHERRY: So that's for the midway --

MR. ROBERT WATCHMAN: The midway.

MS. ANDREA SHERRY: That's between the

upper and lower total equity target levels.

MR. ROBERT WATCHMAN: Right. And it provides that the indicated rate would be 1.1 percent in that case?

MS. ANDREA SHERRY: Yes.

MR. ROBERT WATCHMAN: And then it goes on to say if the PSR is based on the forecasted 2018/'19 total equity of 205 million instead of the midway target of three-ten (310) --

MS. ANDREA SHERRY: Right.

MR. ROBERT WATCHMAN: -- the rate increase would be 1.6 percent.

MS. ANDREA SHERRY: Yes.

MR. ROBERT WATCHMAN: So I was just -- so there's two (2) different scenarios there and I was just trying to understand the difference between the two (2).

MS. ANDREA SHERRY: So the one (1) is the midway between the lower and upper target for total equity, and the other is what the projected total equity for 2018/'19 in the base scenario.

MR. ROBERT WATCHMAN: And in your paper or are you suggesting that one (1) of these two (2) scenarios is preferred?

MS. ANDREA SHERRY: I actually did not

indicate a preference in my paper.

(BRIEF PAUSE)

MR. ROBERT WATCHMAN: Oh.

MS. ANDREA SHERRY: Because the targets, or the lower and upper targets for the RSR is being still discussed I would suggest that the forecasted 2018/'19 total equity would probably be a more stable figure to use. But I did not express that opinion in the paper.

MR. ROBERT WATCHMAN: Now, Diana, if we could turn to MPI Exhibit 27. And, Ms. Sherry, this is relates to an undertaking that was given. And it had to do with the determination of investment income on the assets supporting total equity. I don't know if you've had an opportunity to see this previously.

MS. ANDREA SHERRY: No, I haven't.

MR. ROBERT WATCHMAN: Well, then just in --

MS. ANDREA SHERRY: I've had the opportunity, but it's my own fault I haven't.

MR. ROBERT WATCHMAN: Okay.

MS. ANDREA SHERRY: Yeah.

MR. ROBERT WATCHMAN: Well, what the question -- or what the undertaking was directed to is whether or not it was appropriate to charge investment fees and expansion -- pension expense, rather, to the investment income. And the question is, is whether you have an opinion as to whether those items should have been charged to the investment income on assets supporting total equity.

MS. ANDREA SHERRY: Sorry, I just need a moment to actually read this over carefully.

(BRIEF PAUSE)

MS. ANDREA SHERRY: I actually don't want to express an opinion on that right now. I'd have to give it more thought.

MR. ROBERT WATCHMAN: Okay. Thank you.

MR. BYRON WILLIAMS: Just for the Board, if the Board deems it appropriate for Ms. Sherry to reflect upon that, we would be prepared to do an undertaking.

MS. ANDREA SHERRY: For sure. I just --

MR. BYRON WILLIAMS: But -- so we

don't -- and we could probably have that available for tomorrow, but we leave that to the Board's discretion.

(BRIEF PAUSE)

MR. ROBERT WATCHMAN: Okay. So then can we have the as an undertaking, please?

MS. ANDREA SHERRY: M-hm.

MR. ROBERT WATCHMAN: And --

MR. BYRON WILLIAMS: And -- and the undertaking, as I understand it, is to reflect on the question of whether investment pay -- fees paid in pension expense are appropriately charged to the investment income on assets supporting total equity?

MR. ROBERT WATCHMAN: Yes.

MR. BYRON WILLIAMS: Thank you.

MR. ROBERT WATCHMAN: And -- and if I might, as a -- as a follow-up to that, and whether or not the inclusion or non-inclusion of those amounts has any bearing on the estimate of the cash flow discount rate for rates setting purposes.

MR. BYRON WILLIAMS: We'll confirm that undertaking.

MS. ANDREA SHERRY: Okay.

--- UNDERTAKING NO. 34: CAC to reflect on the question of whether investment fees paid in pension expense are appropriately charged to the investment income on assets supporting total equity, and whether or not the inclusion or non-inclusion of those amounts has any bearing on the estimate of the cash flow discount rate for rates setting purposes

CONTINUED BY MR. ROBERT WATCHMAN:

MR. ROBERT WATCHMAN: Diana, if we could go to PUB-MPI-2-38, and attachment A. Oh, right there. Perfect. To that page. This is -- as you recall Mr. Ghikas had asked you some questions about the capital maintenance provision in the first paragraph and the portion about -- or the purpose of the capital maintenance provision to keep the numerator in percentage with the denominator. And I just wanted to go to the paragraph following that, which provides:

"To address this, a capital maintenance provision will be added to the base rate designed to offset the decline in MCT arising from the overall growth in SAF's business."

My question to you is whether or not you believe that a similar provision could be built into the rate-making in Manitoba.

MS. ANDREA SHERRY: I believe it could be. I don't believe it should be.

MR. ROBERT WATCHMAN: Can you elaborate on that?

MS. ANDREA SHERRY: Well, for the same reason. I think that when the PUB determines what the target RSR range should be set based on, and whether it's a range of the DCAT or the 1:40 and the 100 percent MCT, whatever that range is, then I think as long as the company operates within that range then we don't need to throw on top of that any sort of maintenance provision.

It's -- if you -- you will manage within that range, and if you fall below the lower level of the range, then you have an RSR rebuilding whatever it is, 2 percent, to get you back into it. I don't think that we need to arbitrarily guess what we think we're going to need in this fashion.

MR. ROBERT WATCHMAN: So you're in favour of having the range rather than a single capital target? Is that -- is that right?

MS. ANDREA SHERRY: Very much so, yes.

MR. ROBERT WATCHMAN: Thank you very much, Ms. Sherry. Mr. Chairman, those are all my questions.

THE CHAIRPERSON: Okay. Does the panel have any questions? Any redirect?

RE-EXAMINATION BY DR. BYRON WILLIAMS:

MR. BYRON WILLIAMS: Ms. Sherry, I have three (3) general areas of redirect. You'll re -- recall a considerable discussion with My Learned Friend representing MPI about the MCT targets in -- related to SGI, as well as ICBC. You recall that conversation?

MS. ANDREA SHERRY: Yes, I do.

MR. BYRON WILLIAMS: And if Diana can pull up PUB-1-73B, if we need it. But, Ms. Sherry, to your knowledge, would it be fair to suggest that the MCT target in Saskatchewan ICBC have been set by indepen -- have been set by the government rather than independent regulators?

MS. ANDREA SHERRY: I'm sorry. Are you asking if it was set by the provincial government in those provinces?

MR. BYRON WILLIAMS: Yes.

MS. ANDREA SHERRY: I don't know that with certainty.

MR. BYRON WILLIAMS: Ms. Sherry, in terms of the -- in terms of the -- perhaps you recall a discussion that you had with My Learned Friend on behalf of MPI in terms of whether the SIRF, the 50/50, or the naive forecasts were a best estimate for the purposes of the DCAT?

MS. ANDREA SHERRY: I do. Yes.

MR. BYRON WILLIAMS: Okay. Can we pull up PUB/CAC-1-2 for a minute? And the response. Ms. Sherry, just in terms of that discussion that you had with My Learned Friend, is there anything you just want to add to that, based upon this response?

MS. ANDREA SHERRY: Well, I think that's -- and perhaps I didn't make myself clear, but what we're saying is that the naive forecast is -- and that's what Wayne's presentation -- or Dr. Simpson's presentation was earlier, that we feel that the naive forecast is the most unrealistic forecast. And the

SIRF might not be -- well, it's another forecast that should be used as well. So we feel like the 50/50 would be the best. At least moving to a 50/50 would make more sense than using the naive.

MR. BYRON WILLIAMS: Okay. Thank you. You recall a conversation, both with learned counsel for MPI as well as with Board counsel, in terms of the growth of -- of reserves via a capital maintenance fee?

MS. ANDREA SHERRY: M-hm.

MR. BYRON WILLIAMS: You recall that discussion?

MS. ANDREA SHERRY: Yeah.

MR. BYRON WILLIAMS: Would it be fair to say that unbiased forecast -- an unbiased forecasting process takes into account inflationary impacts on both revenues and costs?

MS. ANDREA SHERRY: Yes.

MR. BYRON WILLIAMS: And assuming a well-run business with unbiased forecasting, would we expect positive variances as well as negative variances from forecasts?

MS. ANDREA SHERRY: Of course.

MR. BYRON WILLIAMS: And over time, the level of both positive variances and negative variances should refer -- reflect inflationary pressures assuming unbiased forecasting?

MS. ANDREA SHERRY: Yes.

MR. BYRON WILLIAMS: I have no further questions.

THE CHAIRPERSON: Thank you. We're going to adjourn now until Wednesday morning. And when the applicant will be putting in its submission. Thank you, Ms. Sherry. Thank you all. Have a good evening.

--- Upon adjourning at 6:34 p.m.

Certified Correct,

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Cheryl Lavigne, Ms.