

Undertaking # 1

MPI to review interest rate methodology applied to the PUB's order in Centra Gas application.

RESPONSE:

The Public Utilities Board directed Centra Gas to modify its 2013 interest rate forecast to address the issue of upward bias by removing the highest interest rate in each quarter (PUB Order No. 85/13). This would reduce the forecasted average, decreasing their forecasted cost of borrowing and providing a more favourable estimate of impact to Centra Gas' forecasted financial statements.

Applying the same interest rate forecasting methodology to the Corporation i.e. removing the highest interest rate from the average of the 5 banks and Global Insight would somewhat lower the interest rate risk faced by the Corporation. This is because by removing the highest forecast, the forecasted rate is reduced and it lowers the risk of actual rates not reaching the forecast.

However, if this interest rate methodology is applied to more recent interest rate forecasts as requested in Pre-Ask 2(b), where the forecast starts with high actual interest rates to September and then the five banks and Global forecasts averaged for the period and the highest removed, it does not incorporate any consideration for potential interest rate volatility. The interest rate forecast within the GRA, by choosing a lower interest rate growth scenario is effectively providing for some interest rate volatility. If interest rates were to decrease within the rating period from the current higher levels, the Corporation may still be able to achieve it's overall forecast because it used an overall lower interest rate growth forecast.

In the hearing, witnesses for the Corporation have indicated the assumption regarding interest rate risk is the most pivotal decision for the board panel. MPI Exhibit #9 had many scenarios and it demonstrated that, at the end of the day, the only scenario which really impacted rates was a changing interest rate forecast. Changes in interest rates impact both our current investment in bonds and our existing claims liabilities.

If the Corporation used the same methodology as the Board ordered for Centra Gas applied to the most current bank forecasts available (i.e. September 2013), the Corporation's financial forecast would reflect reaching a favourable RSR sooner than that forecasted within the GRA. This scenario was modeled at the Public Utilities Board request as part of PUB (MPI) Pre-Ask 2(b).

Using this forecasting methodology would also increase the Corporation's interest rate risk exposure. As interest rates continue to increase, the probability that they will drop also increases. When interest rates are already low, the probability they will decrease further is less of a risk.

Regardless of the specific methodology used to arrive at the interest rate forecast for the Corporation, if it results in the PUB not approving the requested 1.8% increase in premium rates, it will further increase the Corporation's overall financial risk.

As stated previously, if the Board accepts the current judgement of the Corporation with respect to the interest rate forecast and approves the 1.8% premium rate increase and then interest rates continue to rise higher than the Corporation's forecast, the RSR will be returned to the DCAT driven target more quickly.

If, however, the Board does not approve the 1.8% premium rate increase and interest rates follow historical patterns and fall below the Corporation's forecast, then the Corporation expects both a rate increase and rebuilding surcharge will be required next year.

In the transcript at page 88-89, Ms. McLaren commented on interest rate risk.

"I mean, I -- I was astounded at how relentless they had been at predicting exactly the same thing that had not proven to happen the year before. And, so that's when we started thinking about how in good conscious can we really truly just -- it almost felt to -- to me, you know, and -- and others on our team like we're just going to stick our head in the sand one more time and say, Okay, well let's go with the five (5) banks and Global Insights, and let's try this again 'cause hey we won't need a rate increase and everything will be cool.

"It just didn't make sense and we had to find a way that we believe appropriately balances the risk. And this is all about our determination, your determination at the end of the day. We've told you what we think and it's your determination about risk, how much to assume, what's the downside, what's the upside, and what's in the best interests of rate stability."

The Corporation is not opposed to the concept of dropping the highest bank forecast. The Corporation is very opposed to using the 5 banks and Global Insights as has been done in the past with or without the highest forecast removed. It is particularly inappropriate to use these forecasts as at September because it fails to consider any volatility of interest rates.

The impact of changes in interest rates on existing and future assets and liabilities presents a higher interest rate risk to Manitoba Public Insurance than it does to Centra Gas.

Different circumstances can dictate different decisions for different regulated entities.