MANITOBA PUBLIC UTILITIES BOARD

Re: MANITOBA PUBLIC INSURANCE
2010 GENERAL RATE APPLICATION

Before Board Panel:

Graham Lane - Board Chairman
Eric Jorgensen - Board Member
Len Evans - Board Member

HELD AT:

Public Utilities Board
400, 330 Portage Avenue
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APPEARANCES

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UNDERTAKINGS

--- Upon commencing at 9:03 a.m.

THE CHAIRPERSON: Okay. Good morning, everyone. Hopefully we can dispense with the bells today, but we'll see.

Mr. Saranchuk and Mr. Palmer, I believe you were engaged in discussion when we broke off.

MPI PANEL RESUMED:

MARILYN MCLAREN, Resumed

DONALD PALMER, Resumed

OTTMAR KRAMER, Resumed

CONTINUED CROSS-EXAMINATION BY MR. WALTER SARANCHUK:

MR. WALTER SARANCHUK: Yes, we were, sir. Just picking up where we left off, Mr. Palmer. We were dealing with the potential for estimation error as one (1) of the attributes for the three (3) approaches to determination of the RSR target level.

Do you recall that, sir?

MR. DONALD PALMER: I do, yes.

MR. WALTER SARANCHUK: And of course this is addressed in Interrogatory Number 28 in the Second Round of the Public Utilities Board, and we were reviewing that as part of the enclosure in Tab 29 in the book of documents. And this is actually the second last page of that enclosure.

And if you wouldn't mind, sir, could you please as you were for the earlier attributes, review the comparisons that are set forth in the Corporation's response and then I'll have some questions regarding it.

MR. DONALD PALMER: And -- and again starting with the potential for estimation error. The risk analysis has the greatest potential for estimation error because we're only looking at the risks in the recent past, in the last fourteen (14) years. So to the extent that there are adverse events that haven't happened over that period of time, we would miss them and hence have that large estimation error.

MCT would be an improvement over that but again depending on the percentage of required capital that you choose, there could be errors introduced at that point. And DCAT, for this particular measure, is what we would consider the best, because we take a look at all the relative -- relevant risks and would therefore have that as the lowest potential for estimation errors.

Transparency --

MR. WALTER SARANCHUK: Just before you go on to that next one, sir, there's mention with reference to the MCT about the selection of an appropriate percentage level, and I was going to ask you in what respect does the selection of a target MCT ratio a source of estimation error?

MR. DONALD PALMER: In -- in terms of -- of error from the standpoint of choosing what the possible variation could be from year to year activities.

MR. WALTER SARANCHUK: Now, isn't it a fact that the DCAT, according at least to MPI anyway, that DCAT has the least potential for estimation of errors since it measures all identified risks faced by MPI?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: Now, isn't the risk of making a poor choice for adverse scenario plausibility level much like the risk cited for MCT?

MR. DONALD PALMER: No, I would consider those quite different. With the -- choosing the -- the adverse scenarios as I had mentioned yesterday, we do -- we did construct a team to ensure that we had all of the relevant risks covered. So from that perspective that would be quite different than choosing a capital percentage.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: So but really isn't it the tolerance for the adverse scenario plausibility level that is relevant, insofar as this issue, and not the estimation for error?

MR. DONALD PALMER: To a -- to a point I would agree with that. And again, the plausibility of those adverse scenarios is -- is something that we have taken very seriously within that committee approach that we talked about. So there is -- and we talked about subjectivity yesterday -- there is some subjectivity to the probability of any of those plausible scenarios occurring, but through both historical data and through some more anecdotal data we have determined those -- all those scenarios to be plausible.

MR. WALTER SARANCHUK: What about the risk of error arising from modelling complex economic and financial systems with simplified processes? Isn't that really a simplification of reality?

MR. DONALD PALMER: I wouldn't call it a simplification at all. Certainly, we're trying to model possible future scenarios, absolutely. I don't think that that necessarily is a simplification.

MR. WALTER SARANCHUK: And of course I'm talking about if DCAT were used.

MR. DONALD PALMER: If DCAT were used.

But in terms of the -- the selection of the plausible scenarios and all -- all the modelling in terms of all the interrelationship of all the variables going into the financial model, I -- I would call that far from simple.

MR. WALTER SARANCHUK: And in terms of the answer that you just gave, could you expand on why you take the position that you just have.

MR. DONALD PALMER: With the future modelling -- and we talk about looking at the adver -- or the effect of adverse events and -- and very much a prospective exercise, but embedded in that certainly is the knowledge of what has happened in the past, in terms of the interrelationship of all the variables, the possible ripple effects of all of the adverse scenarios, the possible management action of all the -- of all the scenarios.

So in terms of putting that altogether we think that we have constructed absolutely the best possible model into evaluation of the risks that are faced by the Corporation.

MR. WALTER SARANCHUK: All right. Thank you, sir.

MR. DONALD PALMER: Just adding to that, really we think that the DCAT is really the only method of the three (3) that really delves into all the complex interrelationships amongst all the variables that the Corporation is facing.

MR. WALTER SARANCHUK: Doesn't the selection of a plausibility level for the DCAT adverse scenario equate to deciding on one's tolerance for risk?

MR. DONALD PALMER: Yes, I certainly would agree with that?

MR. WALTER SARANCHUK: So how is this different from the selection of an MCT target ratio?

(BRIEF PAUSE)

MR. DONALD PALMER: For -- there's a number of -- of things going on here. Firstly, we talk about MCT and DCAT as being mutually exclusive; they're not really. MCT is a measure at a point in time, as opposed to DCAT which is a more dynamic process to -- to model the effect of certain actions. And -- and you could, and we have stated we will, measure what the MCT ratio will be at future time after certain events occur.

We look at the -- the effect of certain adverse scenarios and the plausibility of those certain scenarios. That to me is a far different exercise than picking a point in -- as an MCT ratio. Without really measuring -- it's somewhat arbitrary. That's, as we studied and -- and as the Board pointed out to us in the last couple of rulings, we didn't really have a good reason why 50 to 100 percent was the right number. We didn't measure that to see if that was truly enough to protect us from the risks that the Corporation is facing.

So, from that standpoint, I -- I look at the plausibility of the ratios and the picking of somewhat arbitrary MCT target as being completely different.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: Wasn't the selection of the 50 percent to 100 percent target MCT ration range a reflection of MPI's tolerance for risk?

(BRIEF PAUSE)

MS. MARILYN MCLAREN: Sure, we wouldn't argue with that at all. But I think the point that we're making with this Application and with this recommendation to adopt the DCAT process, is a recognition that while that somehow the Corporation put a stake in the ground and said, Here's our tolerance for risk, 50 to 100 percent of MCT. What Mr. Palmer's saying is it was not based on a robust consideration of all the different complex adverse events that the Corporation could face, and in some cases the interplay between a couple of adverse scenarios.

So the underlying basis of a recommendation to adopt a DCAT driven target of $185 million is far more robust, detailed, substantive, than the analysis and stake in the ground of a tolerance for risk under a 50 to 100 percent of MCT. Far different and far more robust and meaningful, in terms of the actual risks that the Corporation faces with the basic compulsory plan.

MR. WALTER SARANCHUK: Is that essentially because of the factor of judgment that is utilized?

MR. DONALD PALMER: Both of those would -- would entail judgment, absolutely. In terms of looking at that -- that judgment and the risks that are faced by the Corporation, we look at the DCAT as really being the better measure of facing -- going back to why we even have an RSR in the first place, and that's to protect the Corporation, or protect Manitoba motorists from rate increases caused by those adverse scenarios.

So again, tying back to the purpose that we're even -- we've got for the RSR, the DCAT, in our estimation, is a far better measure.

MR. WALTER SARANCHUK: Thank you, sir.

MS. MARILYN MCLAREN: Mr. Saranchuk, just one (1) further point on that. I think, you know, our understanding of this landscape of MCT and DCAT and so on, is that insurers calculate -- calculate an MCT and use a DCAT process. More and more insurers are investing a lot of effort into the scope and the quality of their DCAT process, more so than a few years ago, and it drives their business plans and assessment of risk and -- and risk tolerance as you pointed out.

Maybe to a certain extent we have somehow -- simply could be perceived that we somehow, you know, eliminated a step in the process by going to a DCAT rather than an MCT, but they're both very, very tightly aligned. And I think too, as -- as Mr. Palmer said, we would calculate an MCT and we would understand what that ratio meant to us, but based on the substantive work done in the DCAT process. The DCAT process is -- is what now -- you know, we had our external actuary do it for years and they would say, you know, The financial condition of the Basic plan is unsatisfactory, and so on.

And we believe we have a process now, with this Board's support, that would drive a satisfactory financial condition for the Basic plan through the DCAT process. And if at some point that translates to some sort of MCT ratio score or target, you know, we certainly wouldn't have any concerns with that, but what we are strongly recommending to this Board is that the DCAT process be relied on to truly understand the -- the risks, the complexities of the risks faced by the Basic compulsory program.

MR. WALTER SARANCHUK: Is the answer perhaps a hybrid between a DCAT-like process and the MCT?

MS. MARILYN MCLAREN: DCAT-light? Did you say DCAT-light?

MR. WALTER SARANCHUK: L-I-K-E.

MS. MARILYN MCLAREN: That's better. No, we don't want DCAT-light.

Perhaps, perhaps, but I think the meaningful thing for this Corporation, and -- and we believe for this Board, is a very transparent robust process of identifying and -- and weighting the risks faced by the plan through a DCAT process. And if at some point, you know, that -- that drives a target, based on a, you know, tightly aligned but different methodology to the MCT, we wouldn't be opposed to that.

But the heart of our position is that the DCAT is the best opportunity we have to really truly understand and -- and analyze and calculate the risks that the Corporation faces, and is flexible and adaptable to change and add and drop risks if -- if that's required into the future.

MR. DONALD PALMER: Just adding to that, in terms of the use of the -- the DCAT, and one (1) of the outputs is a -- a measure of the financial condition of a Corporation, and in the private industry the -- one (1) of the measurements of a satisfactory financial condition is that under the base scenario you'll always meet the minimum MCT test set by the regulator.

So there again the MCT is a static measure at a point in time, as opposed to the DCAT being a longer term modelling exercise.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: Mr. Palmer or Ms. McLaren, is, not arguably the largest risk to MPI's RSR, that it's a major benefit design change retroactively applied as an event not measured by DCAT?

MR. DONALD PALMER: No, I -- I would not agree with that. And in the measurement of the DCAT we have reported on -- on many -- we have seven (7) adverse scenarios that are reported within the DCAT. That's certainly not the only adverse scenarios that we considered. So we had a very long laundry list of -- of adverse scenarios that included benefit increases, included misestimation of policy liabilities.

And so in terms of -- of modelling those or assessing a probability of those, it was difficult for us to measure that they would be plausible. Because certainly any of those coverage changes -- and -- and it's not ours to make -- it's certainly the government legislative decision to make those -- but certainly I would think that all of those would be made within the context of the finance -- the current financial position of the Corporation. If we were mired in a huge accumulated deficit, I have -- I find it difficult to believe that the Government would increase benefits based -- based on that.

So in terms of -- of an ongoing risk, no, I -- I wouldn't characterize that as being the biggest risk that the Corporation faces, with us having over $2 billion of assets and -- and the market volatility that we could be faced with, the interrelationship of equity markets interest rates because we are discounting our liabilities, and interest rates have a -- a huge effect on us. I think the economic circumstances that the Corporation is faced with is -- is for sure the -- the biggest risk that we're faced -- faced with.

MR. WALTER SARANCHUK: Well, just for example --

MS. MARILYN MCLAREN: Sorry, Mr. Saranchuk, if I could. I support completely Mr. Palmer's comments about what he would see as the biggest economic risk for the Corporation. But maybe I'm a little bit more cynical with respect to the comments about whether there is a risk of governments making changes that will hurt the financial strength of -- that's absolutely a risk, of course it is. We can dream up any number of things that could be done in the Legislature that have a significant negative impact on the Basic program, sure we could.

MR. WALTER SARANCHUK: The $90 million for the PIPP enhancement for one?

MS. MARILYN MCLAREN: Absolutely not, no. I think there's evidence on the record, actually. Throughout the Corporation's existence there is evidence on the record to support Mr. Palm -- Palmer's perspective that governments would make prudent financial decisions, that $90 million did not hurt the financial strength of the Corporation. So I think that's the important point, in terms of what has happened historically.

Might different governments in the future do different things that would hurt the financial condition? Absolutely they can. That -- that's, you know, they -- they define this program in legislation. They -- they can do that. But at what point?

It was sort of the same perspective we took when I think it was the CAC asked about why -- you know, why didn't we consider an adverse scenario of an unexpected increase in the PIPP liabilities? You know -- I mean, to what extent? You know, do you say, Uh oh, well, what would happen if it was a $300 million adjustment? Or what if the legislation changed and it -- and it hurt the financial pro -- stability to the tune of six hundred (600)? What do you do? What kind of a number do you pick?

It's highly subjective with no basis in historical fact, and that's really why we did not consider that an adverse scenario that should be concluded -- included. Clearly we know it could happen. We -- it has not happened historically, and to speculate on the value, the dollar value of something that might happen in the future, was so subjective as to be not -- not to be helpful.

MR. WALTER SARANCHUK: Doesn't it indeed have a long-tail effect of some $7 million per year?

MS. MARILYN MCLAREN: Absolutely. Which translates to about a 1 percent equivalent revenue requirement on the Basic plan, for sure.

MR. WALTER SARANCHUK: And that 1 percent was not built into rates, was it?

MR. DONALD PALMER: It is now, as part of the -- this Application. There are other savings that we've built in, in -- into our forecasts, theft savings. We've got some savings that we expect to realize with the PIPP project.

So there's always, as we do our forecasting exercise going forward, there's always pluses and minuses, yes, that looked upon in isolation means about an extra 1 percent. But that taken with all the other factors and cost savings initiatives that we're embarking upon the -- the net effect is -- are zero percent rate application.

MR. WALTER SARANCHUK: Thank you, sir. Perhaps we can now move onto the fourth attribute dealing with transparency.

(BRIEF PAUSE)

MR. DONALD PALMER: Maybe I'll be shorter with this one. They all are transparent. But in terms of explaining why we need a certain level, we feel the DCAT is the most transparent. In -- in all of our calculations for the Basic Autopac rates and NRSR, the Corporation is and always will be completely transparent in any of these methods.

MR. WALTER SARANCHUK: How is the detailed DCAT modelling assumptions -- or how are they transparent?

MR. DONALD PALMER: We -- we have documented them within our report, all of the -- the adverse scenarios: Why we picked them, the ripple effects that are -- that are in there. If we have missed anything and -- and this was our -- our first shot at the complete documentation of DCAT. There have been many questions that have been asked about DCAT in our Information Request process. We have answered all of those questions.

So in terms of the completeness and transparency, I think it's -- it's an open book.

MR. WALTER SARANCHUK: But the work put forward into the DCAT cannot be reproduced, can it?

MR. DONALD PALMER: Could you rephrase the question?

MR. WALTER SARANCHUK: Yes. I'm asking you whether or not the work put forward by the Corporation in the DCAT can be reproduced? In other words, another actuary can't pick up the DCAT report and reproduce the results without more explanation?

MR. DONALD PALMER: In terms of the financial model that's underlying the DCAT, that in itself is difficult to completely reproduce because there are a number of assumptions underlying that. Just reading the DCAT report would be difficult for sure to -- to come up with all the interrelationships, but the -- the effects are all explained fully.

With the -- the model being presented -- and -- and essentially it's the same financial model that we have -- had presented in these hearings for a number of years. It's just now the added benefit of being able to do more detailed scenario analysis. So in terms of reading the report and -- and being completely reproduced by another actuary, if that other actuary had as the starting point our financial model that we have built and developed, then certainly he could -- he or she could come up with the same results.

MR. WALTER SARANCHUK: And what about the complexity of assessing the DCAT adverse scenario plausibility level?

(BRIEF PAUSE)

MR. DONALD PALMER: We have -- had

justification for the plausibility level of each adverse scenario. As with any actuarial report, any policy liabilities report, the key is fully disclosing the assumptions that underlying -- underlie that report. To say that two (2) actuaries would necessarily have the same judgment in -- in picking assumptions, would not necessarily be -- be able to be completely recreated, I don't think. Once those assumptions are established, then you should be able to recreate the -- the results that are produced and -- and I think we've done that.

MR. WALTER SARANCHUK: Thank you, sir. Let's move on to the dependence on historical results.

MR. DONALD PALMER: In terms of the risk analysis, that's a complete basis of -- of that -- that analysis, is looking at -- at what has actually happened without adjusting past history in any way to reflect circum -- current circumstances. MCT is an as-at measure. Of course history has gotten you to you -- to the point that you're at, but it -- it is an as-at measure at a certain point in time.

In terms of the DCAT, the history -- historical data has always been the basis of our forecasts, no question. But that historical data is adjusted to -- to meet current circumstances to reflect current economic conditions, forecasted inflation rates for instance.

We very much, and again as -- as a base -- a base case our -- our base business case for auto -- Basic Autopac, we have used historical data to -- to project into the future.

So from that standpoint, absolutely the DCAT looks at history. It looks at history in terms of measuring what the interrelationships of all the variables are, what the possible ripple affects would be. So from that standpoint, historical data is used but the key is that it's adjusted to meet not only the current circumstances, but also the expected future circumstances of the Corporation.

MR. WALTER SARANCHUK: Is it a fact, sir, that the DCAT and MCT allow for measured risks, whether experienced or not?

MR. DONALD PALMER: Absolutely.

MR. WALTER SARANCHUK: Let's move on to a degree of conservatism, sir. And this has nothing to do with the political climate.

MR. DONALD PALMER: I note that it is Small 'C' Conservatism.

The level of conservatism is really dependent on the assumptions that -- that you pick. For the risk analysis really it looks at recent historical experience. You could be more or less conservative in -- in the confidence interval that you decided to -- to pick. We -- we don't think it's conservative enough, because it doesn't adjust to current benefit levels or to current inflation rates.

Again, when you look at our history of fourteen (14) -- fourteen (14) years ago, and when we look at the actual financial results that have comparison of forecast versus actual, back in 1994 we had a -- a total investment portfolio probably somewhere between half a billion and a billion dollars. To -- to look at the var -- at -- plus we had a completely investment asset mix. Back then we were a hundred percent invested in -- in fixed income securities.

So to -- to compare the results back then with the results now, it's -- it's -- I don't know if there's a -- the opposite of conservative. I don't know if it's liberal or if it's just unconservative. But there's really a real -- a real risk of underestimating the possible risk when you look back and -- and apply any sort of credibility to those results back in 1994 without adjusting them.

In the MCT the calculation is -- is based on the application of -- of risk factors to various balance sheet items. The real overall conservatism would be dependent on the target -- target percentage of capital required, so you can sort of pick your -- your conservatism that you would want to apply.

The DCAT, we don't believe is an overly conservative estimate. We believe it to be a best estimate of the effect of adverse scenarios that are in that 95th to 99th percentile of risk. So protection from a -- a one (1) in twenty (2) event we believe is reasonable. Protection from a one (one) in a hundred event we believe is reasonable.

MR. WALTER SARANCHUK: So in a nutshell, in terms of conservatism, for the risk analysis that can arise, conservatism can if the extreme events are of the history used in the analysis.

Is that correct?

MR. DONALD PALMER: For -- for the -- sorry, for the risk analysis? It -- it could be, yes.

MR. WALTER SARANCHUK: And for MCT the conservatism arises or at least depends on the target ratios used?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: And for DCAT it depends on the adverse scenario plausibility levels?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: Moving on to

stability over time, sir.

MR. DONALD PALMER: Don't have to say too much about the risk analysis -- value-at-risk analysis being stable when the results more than doubled because of one (1) year's activity. So that's certainly not stable over time.

I guess that was our biggest objection to this risk analysis, that we didn't believe it to be robust. Looking at the last fifteen (15) years have been very good for the Corporation, from a financial perspective. We've had some ups and downs, absolutely, but overall it's -- it's been a -- a very good financial run for the Corporation. That's no guarantee that that good financial run would continue, as it did not last year.

So that risk analysis value-at-risk certainly does not -- did not pass the test of robustness, and the -- the results really changed over -- because of a one (1) year -- one (1) year in history.

The minimum capital test, the components of the capital test we would expect to remain fairly stable and -- and gradually increase over time, again as your investment portfolio increases as your liability estimates increase.

The key risks faced by the Corporation

will continue to be the risks in the future. There may be some changes evolving over time. Those changes we would believe to be gradual. The standards of practice could change over time. There are -- again, the standards of practice is a living evolving document so that could change.

But we -- so we would -- but we would believe, overall, that there -- the DCAT would be fairly stable just because the risks don't change dramatically from year to year.

MR. WALTER SARANCHUK: So essentially can you confirm that both approaches, that's MCT and DCAT, would be stable to the extent the risks measured by each do not change and the approach to measuring those risks do not change?

MR. DONALD PALMER: I would agree with that.

MR. WALTER SARANCHUK: Thank you, sir. Moving onto the last attribute, that is the relevance to current circumstances.

MR. DONALD PALMER: For the risk analysis value-at-risk, we really believe that there is a bias towards under estimation because it doesn't adjust to current circumstances. And, in addition, those historical results may not be a good reflection of what's currently happening today or in the future. The MCT will reflect current circumstances to the extent that these circumstances have impacted relevant balance sheet items. I'm quoting directly from Number 29 on that one. I don't know that there's too much more to say.

The DCAT and the reason that we certainly prefer -- maybe the -- the key point of our preference for the DCAT, is that it is the most relevant to current circumstances, to the current business plan, the recognition of all the current risks that we're -- we're currently looking at that we've looked at in the current past and -- and that we will continue to look at as part of our business plan.

MR. WALTER SARANCHUK: Would you say that it's then more forward looking?

MR. DONALD PALMER: Absolutely.

MR. WALTER SARANCHUK: Now, perhaps specifically we can deal with the documentation filed relative to the risk analysis and value-at-risk approach, in determining the RSR target level.

And this is dealt with in AI.18.3 as amended, and this is at page 5. The documentation that I'm referring is at the back of Tab 29, five (5) pages from the back. And this of course is with reference to the information provided in response to the Public

Utilities Board Information Request Number 64 in the First Round.

The title at the top of page 5 of AI.18.3 is "Combined Operational and Investment Risk".

Do you have that, sir?

MR. DONALD PALMER: I have it.

MR. WALTER SARANCHUK: Thank you. Can you confirm that Tables 4 and 5 show the RA/VaR results combining operational investment risk at two (2) confidence levels, with and without operating expenses, assuming either perfect correlation or zero correlation and showing current and 2007 GRA results?

MR. DONALD PALMER: Yes, I will confirm that. These tables outline -- and we talk about a range -- often a range is some confidence interval -- the risk analysis doesn't really base it upon that. We have eight (8) estimates of the requirement of eight (8) single point estimates, and then the range is chosen from the minimum of the -- those eight (8) estimates and the maximum of those eight (8) estimates.

MR. WALTER SARANCHUK: And can you confirm that there have been no methodological changes since the last Board approved -- the risk VaR analysis?

MR. DONALD PALMER: We did it exactly the same as we had done in 2007, yes.

MR. WALTER SARANCHUK: And just looking at the Table 4 on page 5, can you confirm that the 2007 GRA implied RSR target range was about $52 to $79 million? This would actually be Tables 4 and 5.

(BRIEF PAUSE)

MR. DONALD PALMER: Fifty-two (52) to seventy-nine (79), is that what you said?

MR. WALTER SARANCHUK: Yes, sir.

MR. DONALD PALMER: That's correct.

MR. WALTER SARANCHUK: And can you confirm that the 2010 GRA implied RSR target range is about 91 to 232 million before indexing to 2010/'11?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: And can you confirm that 2010 GRA implied RSR target range is about 97 to 246 million after indexing to 2010/'11?

MR. DONALD PALMER: Indexing by the growth in gross written premium, yes.

MR. WALTER SARANCHUK: Now, it appears that the operational risk component has grown by about 15 million since 2007.

What are the main sources of the growth, sir?

MR. DONALD PALMER: It's mainly due to the variability in loss costs over the last few year -- years.

MR. WALTER SARANCHUK: So would this include the actuarial adjustments that have been applied to the year-end financial positions?

MR. DONALD PALMER: Yes. We -- and that was confirmed in PUB-1-64 Part C.

MR. WALTER SARANCHUK: Yes, thank you, sir. Now, it appears that the investment risk component, that's the investment risk component, has grown by some $65 to $137 million.

And what are the main sources of that growth, sir?

MR. DONALD PALMER: That would be the huge volatility that we saw in investment markets last year.

MR. WALTER SARANCHUK: Thank you. Now, if we move over to the next page, this is four (4) pages from the back of Tab 29, there is the response by the Corporation to Interrogatory Number 27 of the Public Utilities Board on the Second Round. And turning over to page 2 and page 3 of that response, could you please explain the information presented in the response to Part A, which is on page 2. This is Part A of the question, the information shown on page 2.

(BRIEF PAUSE)

MR. DONALD PALMER: This was a measure of the -- the value-at-risk, taken at various discrete points in time. Had we done the cal -- calculation starting at year-end of '05/'06 and then repeating that calculation on a semi-annual basis up till the end of -- of February '09 and then taking it five (5) months further into July 31st of 2009, because that was the most recent data we had available --

MR. WALTER SARANCHUK: With a 25 percent equity weight?

MR. DONALD PALMER: That's correct. And then measuring the investment risk at both a 95 percent confidence limit and a 97 1/2 percent confidence limit, this would be the amount of value that we would expect to lose over a two and a half (2 1/2) year period.

For most of that time the value-at-risk was zero until the end of February, after the volatility of the investments that we saw last year, when that grew to $64.6 million at the 95 percent confidence limit, and $153 million at the 97 1/2 percent confidence limit, for the end of July those numbers have decreased because we have seen some stability in -- in equity markets to zero at the 95 percent confidence limit, and $115.3 million at 97 1/2 percent confidence.

MR. WALTER SARANCHUK: And of course the Corporation does not have 25 percent equity?

MR. DONALD PALMER: We do not.

MR. WALTER SARANCHUK: Now...

(BRIEF PAUSE)

MR. DONALD PALMER: And -- and just to confirm, that 25 percent was utilized because that was the basis of the question.

MR. WALTER SARANCHUK: Now, comparing the information in response to Part B of that Interrogatory, sir, first of all what does Part B reflect and how does it differ from what is shown in Part A? This is on page 3 versus page 2.

MR. DONALD PALMER: Yes, I have it. The measurement is using -- using our actually equity weight at each of those points in time, rather than the 25 percent target in -- that has been in our investment policy statement.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: Now, can you comment on the significance of the difference between the 'A' and 'B' investment risk results?

(BRIEF PAUSE)

MR. DONALD PALMER: Because we are currently our equity target there is less volatility shown in -- with using our actual equity weight, as opposed to the 25 percent equity weight. For -- at the 95 percent confident limit, the value-at-risk is zero for all the points in time we measured. For the 97 1/2 percent confidence limit, we had $52.2 million at February 28th, of 2009, as opposed to 153 million for the 25 percent equity weight. At the end of July we were $51.7 for the actual, as opposed to a hundred and fifteen point three (115.3) for the 25 percent.

MR. WALTER SARANCHUK: So Part B reflects the reality of the situation from the Corporation's standpoint?

MR. DONALD PALMER: Today, yes.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: Can you comment,

sir, on the decline shown in the investment risk at the 97.5 percent confidence limit column in the table on page 2, compared to the decline in that column as shown on page 3. That would be from February '09 to July '09.

(BRIEF PAUSE)

MR. DONALD PALMER: There would be an effect of the -- a different equity weight, from one (1) -- from one (1) point in time to another, as -- as that has changed from February 28th to the end of July. So that's the -- that's the biggest factor in this, rather than -- if we had the same -- exactly the same equity weights at that point in time, you'd see a similar decrease as you have seen in Part A of that question.

MR. WALTER SARANCHUK: So essentially equity is obviously a major source of risk?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: Now, which of these bases is consistent with the Board-approved Risk Analysis/Value-at-Risk approach?

MR. DONALD PALMER: The 25 percent.

MR. WALTER SARANCHUK: But the risks being faced by the Corporation at present are those in 'B' as opposed to 'A'.

Is that correct?

MR. DONALD PALMER: Right now with our current equity risk, yes. We do have that target in our investment policy statement, so we would be moving towards that 25 percent.

MR. WALTER SARANCHUK: Any idea as to when you're going to get to the 25 percent?

(BRIEF PAUSE)

MR. DONALD PALMER: We don't have a target date specifically, depending on the markets, and certainly this final weights of all our investments are the decisions of -- final decision of the Department of Finance.

So we don't have a -- I can't tell you that by some given point in time that we will have reached that equity target.

MR. WALTER SARANCHUK: And can you confirm that the 'A' part of the response underlies the information shown at Tables 4 and 5 on page 5 of AI.18.3 that we reviewed earlier?

MR. DONALD PALMER: Yes.

(BRIEF PAUSE)

MR. DONALD PALMER: And just let me add that those equity rates really are dependent on the level of the market. Since we have dropped in value of those equities that percentage changed rather dramatically.

MR. WALTER SARANCHUK: So assuming the normal investment market behaviour prevails going forward, how many months will it take for the measure of the investment risk at the 97.5 percent confidence limit to return to zero?

MR. DONALD PALMER: Today I'm -- I'm not sure what normal is. If we were given some specific assumptions as to what normal is we could undertake to do that calculation. It would take some time.

MR. WALTER SARANCHUK: In terms of long-term averages?

(BRIEF PAUSE)

MR. DONALD PALMER: It's not something that I can do today or probably even this week. We would take an undertaking to at least investigate that question, and probably early next -- next week either have an answer for you or an explanation why we can't have an answer for you.

--- UNDERTAKING NO. 2: MPI to indicate how many months will it take for the measure of the investment risk at the 97.5 percent confidence limit to return to zero

CONTINUED BY MR. WALTER SARANCHUK:

MR. WALTER SARANCHUK: If you can't give us an estimate of the time would you agree that the trend is that eventually it will return to zero, assuming normal behaviour?

MR. DONALD PALMER: Over some long period of time it likely would return to zero. Markets do what markets do and -- and we will see another drop at some period of time. If I knew if it was six (6) months or six (6) years, I probably wouldn't be sitting in -- in this seat.

So to speculate that that would go to zero with -- if there was no current or no real fluctuation, unusual activity in the marketplace over some period of time, I would agree that it would go to zero, yes. But to -- to guarantee when or if that would even take place, I can't do that.

MR. WALTER SARANCHUK: Does the

volatility over time in the VaR calculation that's indicated raise concerns about its appropriateness for setting RSR targets?

MR. DONALD PALMER: That volatility and uncertainty, yes, I would agree with that.

MR. WALTER SARANCHUK: With reference to the information shown at Tab 15 in the book of documents, sir, very briefly, this is the Corporation's response to the Information Request PUB/MPI Number 7 in the First Round, on page 3, just looking at the outlook period.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: And just looking at the outlook period shown on page 3 for the corporate investment portfolio -- this will be dealt with in depth later -- but in terms of the equities, could you just review the percentages shown there and comment as to the amounts shown with reference to returned, or at least to attaining a 25 percent equities level.

(BRIEF PAUSE)

MR. DONALD PALMER: For public equities the target in the investment policy statement is 20 percent, not 25. We have included a 5 percent weighting in private equities. We -- unsure when we're going to -- to start that so we didn't included that weighting in this particular table.

Again, this is an assumption of what we think is a likely scenario over the next period of time. Of course, the equity weight is dependent on the level of the markets as well, so if we add both the -- the equity line, the venture capital line, which is also equities, and the EAFE equities, we're...

(BRIEF PAUSE)

MR. DONALD PALMER: For the final year it's just under 18 percent, we've calculated.

MR. WALTER SARANCHUK: So in terms of the value-at-risk analysis, what did it measure? Canadian or US equities?

MR. DONALD PALMER: All equities. We used the actual equity weights that we have in the portfolio.

MR. WALTER SARANCHUK: That was public and private?

MR. DONALD PALMER: Yes, we have a very, very small allocation in private equity currently.

MR. WALTER SARANCHUK: Thank you, sir. Now, moving on to the MCT approach. This is dealt with at Tab 12, at least dealt with in part at Tab 12, with the filing by the Corporation of AI.18.4.

Now, what context was origin -- sorry?

MR. DONALD PALMER: Sorry, I -- I'm sorry, Mr. Saranchuk, what was the reference?

MR. WALTER SARANCHUK: Tab 12 in the book of documents, the last page of AI.18. This is AI.18.4.

MR. DONALD PALMER: I have it.

MR. WALTER SARANCHUK: Let me ask you sir, what context was originally provided in support of the Corporation's proposal to adopt the target RSR range based on an MCT ratio of 50 percent to 100 percent? What was the context?

For example, was there any analytical support provided for it?

MR. DONALD PALMER: I would say it was more anecdotal support than -- than analytical support. We had the calculation of what those levels would be. The fact that just the nature of the test, the measurement of the required capital versus the available capital, that capital required to ensure what we had exactly sufficient capital that would have been the requirement for the 100 percent.

In terms of the 50 percent range, that would have been largely arbitrary at -- at the time. It was really the hundred percent that we were focussed in on. That was also the level that was adopted by both ICBC and -- and SGI. That certainly was a factor in the consideration, but detailed analytical support why it should be 100 percent and not 110 percent or not 90, that was -- was never done.

MS. MARILYN MCLAREN: And just further to that, Mr. Saranchuk, the purpose, the context of proposing the range, was really with -- to propose rules for rebating and surcharging triggers. That's what the range was really about.

And that's why it's an important point for us to reiterate in these proceedings with recommending a different target that does not have a range, is that we are really strongly recommending moving from a rules-based approach to when do we start surcharging and when do we start rebating, to something that is more contextual and -- and values-based with respect to an understanding of the overall economic condition and the prospects going forward, as opposed to a rules-based approach.

Without the intention to propose rules for rebating and surcharging, there would not have been the same proposal of a range. And Mr. Palmer referenced SGI and ICBC. They largely work with -- with a number as well, an MCT score, as opposed to a range.

Certainly, you know -- and I think the Board has pointed this out, quite -- unusual to have, you know, such a broad range as the fifty (50) to a hundred (100) drove (sic).

MR. WALTER SARANCHUK: Just looking at this table, does accumulated other comprehensive income, or the acronym AOCI, affect the calculation of the actual basic MCT at a certain date?

MR. DONALD PALMER: Yes, it does.

MR. WALTER SARANCHUK: Now, with reference to this document, sir, can you please review the calculation of the MCT ratio, as at February 28, 2009, in particular, noting the impact of the AOCI level.

MR. DONALD PALMER: Our measure of our MCT score at the end of 2009, because of that large AOCI in line 4, that AOCI of negative $92.3 million, and also a loss on the available-for-sale debt securities of $9.3 million total to a -- get us an MCT score of 7.26 percent.

MR. WALTER SARANCHUK: As compared to 70.59 percent the prior year?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: Just for the record, at a high level what is AOCI?

MR. DONALD PALMER: Accumulated Other Comprehensive Income is the unrealized capital gain or capital loss in your available-for-sale assets.

MR. WALTER SARANCHUK: And is the Corporation inclined to agree that AOCI should be taken into account in calculating RSR target levels or not?

MR. DONALD PALMER: In calculation of the RSR targets, it's certainly part of the overall financial strength of the Corporation.

(BRIEF PAUSE)

MR. DONALD PALMER: So -- so, yes, in terms of the RSR and all the risks that are -- the Corporation faces, that should be considered as one of the risks to the Corporation. That's really part of the financial strength.

MR. WALTER SARANCHUK: Does that also apply to other comprehensive income or OCI, as for rate setting purposes?

MR. DONALD PALMER: For...

(BRIEF PAUSE)

MR. DONALD PALMER: Accumulated other comprehensive income versus other comprehensive income, it's two (2) different measures.

MR. WALTER SARANCHUK: You've given us a high level explanation of the accumulated, how about the other?

(BRIEF PAUSE)

MR. DONALD PALMER: The other comprehensive income is the change -- the change of that value in -- in a given year. So as you see it at this particular chart on lines 4 and 6, that other comprehensive income that was realized in the '08/'09 year was overall negative. So as a -- so I'm not sure what the question is.

I'm -- I'm not quite sure I understand the context of the question, because the two (2) concepts of AOCI and OCI aren't directly comparable.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: Can you confirm, sir, that both SGI and ICBC utilize MCT ratios to define the RSR target levels for basic insurance operations?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: Can you give us any idea of their respective targets?

(BRIEF PAUSE)

MR. DONALD PALMER: One's a hundred percent and one's 125 percent. I'm not sure which one's which.

We can double check and get back to you on that.

MR. WALTER SARANCHUK: Thank you. And if it is a range, could you please indicate that?

MR. DONALD PALMER: We'll find that out.

--- UNDERTAKING NO. 3: MPI to indicate the RSR target levels, or range, for basic insurance operations, that both SGI and ICBC utilize

CONTINUED BY MR. WALTER SARANCHUK:

MR. WALTER SARANCHUK: Thank you, sir. Quickly moving onto the DCAT approach. This is shown at

AI.18.2 in Volume III, Part 3. And this is not a section that was revised, so we have to turn unfortunately to Volume III, Part 3.

And I'm looking into -- nineteen (19) pages into that document you come up with the 2009 report on Dynamic Capital Adequacy Testing, as at February 28, 2009. This follows page 18 of the original eighteen point one (18.1) in AI.18.

MR. DONALD PALMER: I have it.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: This is also dealt with, sir, at Interrogatory Number 68, filed by the Corporation in response to that question in the First Round, that's a PUB Interrogatory. And that is at Tab 30.

And just with reference to the information on Tab 30 on page 3, 4, and 5, again, at a very high level can you compare the assumptions utilized in the 2008 DCAT and the 2009 DCAT, as I say, at a high level, because the information is there to be read.

(BRIEF PAUSE)

MR. DONALD PALMER: You're talking specifically about the assumptions underlying the adverse scenarios?

MR. WALTER SARANCHUK: Yes, sir.

MR. DONALD PALMER: In the inflation scenario, the 2008 DCAT which was completed by Jim Christie of Ernst & Young, the inflation rates for 2008/'09 through '10/'11 were 8 percent, 9 percent, 10 percent, 7 and 3, as opposed to the current DCAT which we had an increase in inflation of -- an increase in the first year of 5.1 percent and then staying constant for the outlook period. The rate increases that would follow that for the 2008 report, was zero percent, 8 percent, 20 percent, 7 and 3. In the current DCAT, because the inflation didn't go up as dramatically, the rate increases assumed are zero percent, 3 percent, 6 percent and 3 percent. The yield curve in -- in both cases change by the assumed inflation increases.

We've added a couple of assumptions in the current DCAT that the expected rate of return is assumed to track directly with inflation, and the claims forecast has been adjusted to track that inflation as well.

For the government and political action, the last DCAT included a 6.4 percent increase in unpaid claims and a 6.4 percent increase in claims. As a result of that, for '08/'09 and all subsequent years we did not explicitly test that assumption or report on that assumption in the current DCAT.

MR. WALTER SARANCHUK: And could you just explain that position.

MR. DONALD PALMER: Again, from a perspective of -- of being unexpected and random, we didn't know how to measure the -- the plausibility of that scenario or the associated probability of that.

MR. WALTER SARANCHUK: Okay, sir, moving on to claim frequency and severity, the loss ratio.

MR. DONALD PALMER: The former DCAT used 115 percent loss ratio for 80 -- '08/'09. For the current, we assumed an increase in claims costs of $79 million higher than forecast.

MR. WALTER SARANCHUK: And the rationale there?

MR. DONALD PALMER: We had a -- a simulation of claims in the confidence interval that we would expect from a high level of claims.

MR. WALTER SARANCHUK: Moving on, sir, investment.

MR. DONALD PALMER: For the deterioration of asset values, DCAT 2008 assumed a drop in market value of debt securities based on an increase of a hundred and fifty (150) basis points in the out yield curve and a decline of equities consistent with a 25 percent decline in the TSE 300 index.

We had two (2) deterioration of asset value scenarios in our adverse scenario list in the current DCAT. One was that equity assets would decline by 40 percent in 2010/'11 and remain at that level for the forecast period. The second scenario included both a equity decline of 20 percent for 2010/'11, and the interest rates would remain low at the '09/'10 levels.

For the catastrophic event claim frequency and severity, the last DCAT assumed $125 million hailstorm in 2008/'09, of which 119 million would be based on Basic Autopac and that MPI's reinsurer with the largest partition -- participation would default in 50 percent of the payments.

We ran two (2) hail scenarios in the current DCAT. One (1) with a hailstorm of $355 million in 2010/'11, and with the ripple effects of how that would impact future re-insurance premiums and claims expenses. The second scenario we ran was that -- was a much smaller hailstorm, a $55 million combined with a decline in equity value.

And the last scenario, based on interest rate decreases, the -- the 2008 DCAT included a -- a shift of three hundred (300) basis points in the yield curve in 2008/'09 and a return to normal after that. And for the current scenarios, the assumption was that interest rates for 2010/'11, '11/'12, would remain at the same levels that we've currently got in '09/'10, that's basically the low interest rate environment we're currently faced with.

MR. WALTER SARANCHUK: All right. Then just before proceeding on to the different adverse scenarios, which I assume will be done after the break, let me just ask you a couple questions reference to the commentary by the Corporation on page 13 of AI.18.2. This is again in Volume III, Part 3.

Just again, very briefly, could you comment and -- or just summarize the definition of a satisfactory future financial condition as shown in this report?

MR. DONALD PALMER: Excuse me, Mr. Saranchuk, what was the reference again?

MR. WALTER SARANCHUK: AI.18.2, page 13.

(BRIEF PAUSE)

MR. DONALD PALMER: And I'll just read in the first paragraph under section 3.2.

"The insurer's financial condition is
satisfactory if throughout the forecast
period it is able to meet all its
future obligations under the base
scenario and all plausible adverse
scenarios, and under the base scenario
it meets the minimum regulatory capital
requirement, and insurer is able to
meet all its future obligations, as
long as its assets are greater than its
liabilities."

MR. WALTER SARANCHUK: So is that the definition from the Canadian Institute of Actuaries, the standard of practice?

MR. DONALD PALMER: Yes, it is.

MR. WALTER SARANCHUK: Now, how does the CIA standard of practice define, quote "meet all future obligations," end of quote?

(BRIEF PAUSE)

MR. WALTER SARANCHUK: And while you're looking up that information, for Basic what makes up the difference between assets and liabilities? Is it the RSR and the AOCI?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: And how does the report's test of meeting all future obligations differ from the CIA's test?

(BRIEF PAUSE)

MR. WALTER SARANCHUK: Is it when the RSR goes negative, then the AOCI is excluded?

(BRIEF PAUSE)

MR. DONALD PALMER: In the standard of practice, specifically, it doesn't define, at least the clause that I'm currently looking at, what meeting all future obligations is, so the assumption that we made was that assets exceed or -- assets exceed liabilities.

MR. WALTER SARANCHUK: How does the report's test of meeting all future obligations differ from CIA's test?

MR. DONALD PALMER: I don't think it does at -- at this point in time. I'll double-check that at the break.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: Are you testing that assets -- or I'm sorry, that the assets fall below liabilities or are you testing that the level falls below the RSR?

MR. DONALD PALMER: We are testing that the RSR goes to a negative position.

MR. WALTER SARANCHUK: Now, is that the same as testing as to whether assets are less than liabilities?

(BRIEF PAUSE)

MR. DONALD PALMER: If I may ask the Board's indulgence, I'd like to think about that over the break.

MR. WALTER SARANCHUK: Okay, then, perhaps this is an opportune time to have a break, Mr. Chairman.

THE CHAIRPERSON: Sounds like it is.

MS. MARILYN MCLAREN: Mr. Chairman, if we can I had a quick look at the ICBC and SGI web sites. From their '08 annual reports, the Insurance Corporation of British Columbia target for the retained earnings for their Basic compulsory program is a -- is a minimum of a hundred percent. There's not a range specified but they are required to have a minimum of a hundred percent MCT as their RSR target. And SGI, the Auto Fund, the compulsory program does have a range. It is expected to have between a hundred and 125 percent of MCT.

MR. WALTER SARANCHUK: Thank you.

--- Upon recessing at 10:35 a.m.

--- Upon resuming at 10:58 a.m.

THE CHAIRPERSON: Okay. Welcome back.

CONTINUED BY MR. WALTER SARANCHUK:

MR. WALTER SARANCHUK: Mr. Palmer, you've got the floor.

MR. DONALD PALMER: The question was: What does it mean, regarding if assets are greater than liabilities for a sort of a -- within the context of the educational note that would be at market value. For our measurement of retained earnings it would be realized assets over liabilities. So there is a slight difference between what we measure as a retained earnings being realized as opposed to equity which would include the unrealized gains and losses.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: So with reference to the information in Tab 12 with the AOCI shown in the order of $92 million -- actually a hundred and one (101) when you total of the two (2) figures -- is that what you are including in your description as a slight difference?

MR. DONALD PALMER: If -- if I used the term "slight difference," I misspoke.

MR. WALTER SARANCHUK: How would you describe it?

MR. DONALD PALMER: It's a big difference. Our -- our RSR is on a realized basis, not -- not including the AOCI. So -- and -- and put clarity on that -- on that point, as at the end of February of 2009, we had a large RSR balance but a very large negative AOCI, so our equity in the Corporation was much slower than the RSR level that we reported.

MR. WALTER SARANCHUK: So why is it that you're making this distinction between -- with AOCI and without?

MR. DONALD PALMER: The RSR has been defined within the Corporation before AOCI.

MR. WALTER SARANCHUK: What range of adverse scenario plausibility levels are used for a DCAT carried out in accordance with the CIA standard of practice?

MR. DONALD PALMER: 95 to 99 percent.

MR. WALTER SARANCHUK: And why is this level of plausibility appropriate for the purposes of setting a target level of RSR?

MR. DONALD PALMER: We certainly want to protect ourselves from those unexpected events. We think, in terms of the 95 percent that's protecting ourselves from a one (1) in twenty (20) event, as opposed -- and a ninety-nine (99) is a one (1) in a hundred year event, that certainly we would look at measuring that definition of unexpected.

We're here for the long term and we really want to have the Corporation strong in -- in a one (1) in twenty (20) event or a one (1) in a hundred year event.

So that's why we -- we picked those particular confidence intervals as being appropriate for the DCAT.

MR. WALTER SARANCHUK: Are you -- oh, sorry.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: You said as being appropriate for DCAT, you meant for setting the RSR level?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: Are you aware that ICBC uses a DCAT-like approach which incorporates the adverse scenarios with an estimated one (1) in ten (10) year event, that's the 90th percentile?

MR. DONALD PALMER: I'm aware of that.

MR. WALTER SARANCHUK: Can you comment on that, as in comparison to your approach.

MR. DONALD PALMER: I don't know what their purpose of the RSR is, the stated purpose within the context of ICBC.

MR. WALTER SARANCHUK: Do you have any dialogue with them from time to time, or did you have any, relative to the MPI approach?

MR. DONALD PALMER: I have dialogued from time to time with ICBC. I did not have dialogue specifically on their DCAT and their one (1) in ten (10) -- ten (10) year selection.

And just going back to the -- our purpose of the RSR and the unexpected events arising from non-recurring events or factors, is that a one (1) in ten (10) year event, does that define a one (1) in twenty (20) or a one (1) in a hundred year event? Unexpected and non-recurring, I would suggest for the context of our

RSR is probably more than one (1) in ten (10).

So the one (1) in twenty (20) and -- or one (1) in a hundred is certainly more reasonable within the context of the purpose of the RSR.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: I take it then you agree that it would be difficult to reach a consensus?

MR. DONALD PALMER: There could be many opinions in terms of what that plausibility should be, I would agree with that. In terms of the difficulty in consensus, I guess that depends on the -- the parties trying to reach the consensus within the management group and with the Board of Directors of the Corporation, that one (1) in twenty (20) or one (1) in a hundred event range that we talked about as being a plausible adverse scenario, is -- is what was selected and what was agreed upon.

And so there may be different opinions on that. We think it's reasonable under the context of the stated purposes of the RSR.

MR. WALTER SARANCHUK: Given a situation involving an adverse scenario itself, doesn't the judgment involved in the assumptions to be utilized to the extent that adverse scenario will come to fruition? Isn't that in itself a situation which makes it difficult for the consensus to be reached?

MR. DONALD PALMER: Again, whether -- the difficulty of consensus depends on the judgment of the parties that -- that are involved. To come to a -- a point as -- as to the definition of those adverse scenarios, whether they're one (1) in a hundred, whether it's one (1) in ten (10), one (1) in twenty (20), whatever we should be testing, it's certain -- certainly can be the source of much debate, I will absolutely grant you that.

And we have put forward our adverse scenarios that were determined by the management of the Corporation. The people in the room that I'd talked about in that DCAT committee who are most familiar with the operations of the Corporation, with the risks of the Corporation, that deal with those operations and the risks every day, certainly, that's the people that I would rely on -- upon to best determine the adverse scenarios and -- the plausible adverse scenarios that the Corporation is facing.

MR. WALTER SARANCHUK: Thank you, sir. Now, perhaps we can proceed to deal in some depth with the adverse scenarios. And just as a preliminary matter to be addressed prior to that, I would ask you to turn to Section AI.18, Point 2, in the Volume III, Part 3, and this is page 3, where there's reference to the base scenario, which I believe is the benchmark basically for the whole process of the comparison of the adverse scenarios.

And just at a high level, looking at page 3, if you have that, sir, with the reference to the base scenario, and then turning over to page 4, could you explain the concept and the calculation for this so-called bottom line, if you will? How did you get to the base scenario?

MR. DONALD PALMER: Thank you for clarifying that. That is our best estimate of what will happen within the Corporation, using the results of our claims forecast, our revenue forecast, our expectations of investment returns over the next five (5) years. So that -- that is the scenario which forms the basis of our rate application, forms the basis of our pro formas that we provide in TI.15, for instance.

MR. WALTER SARANCHUK: And so just looking at page 4, for example, at the top, can you just give us an idea, for the record at least, what the end result is relative to the retained earnings for 2009 throughout the outlook period?

MR. DONALD PALMER: The retained earnings shown in this table are the same as the retained earnings in TI.14, and that -- and we talked about yesterday that start -- our expected retained earnings at the end of this current fiscal year with this forecast as we knew it to be in -- as at the end of February of 2009, without consideration of the current year's results we expected it to be $146 million, going to $155 million next year, and then growing to $274 million the end of '13/'14, again with the assumption -- the important assumption that there would be no rate increases over that intervening time.

MR. WALTER SARANCHUK: Thank you, sir. Let's turn to the first adverse scenario, namely the extremely large hailstorm. And this is addressed at pages 14 through to 16 in that same section of AI.18, and it's also addressed at Tab 36 in the book if documents, being the Corporation's response to Interrogatory Number 32 of the Public Utility's Board in the Second Round. So if you want to keep your finger on those two (2) references, please.

MR. DONALD PALMER: I have them both.

MR. WALTER SARANCHUK: Dealing with the scenario justification shown on page 14, relative to the extremely large hailstorm, could you just review the

Corporation's explanation of that justification?

MR. DONALD PALMER: In terms of catastrophic event within the Corporation's context, the most severe single event that we foresee that we would ever experience is a large hailstorm. And we talked about yesterday the -- the risk profile and the changing risk profile of the Corporation. One (1) of the items that I didn't mention that certainly we have an important eye on is the risk of hail.

And some -- something has changed over the last thirty-eight (38) years within the Corporation. For the first twenty-five (25) years we really didn't experience any catastrophic significant hailstorm. And as I was preparing for the -- the hearings this year and kind of looking back, and one thing about attending these hearings for a twenty (20) year period and you -- you get to have certain memories about many of the hearings, but I do remember in 1995 having to answer some questions about why we even had catastrophe reinsurance at all, and -- and asking us to -- to compare what we had received in -- in benefits versus what the premiums we had paid. And then the 1996, $50 million hailstorm occurred and those questions went away.

But that was certainly the one (1) time event that we were looking that we considered to be catastrophic, and may be a one (1) in a hundred year event is what we thought that was at the time.

Well, then in 2001 we had another hailstorm. So there's -- not quite as big as the first one but certainly a significant event. Had another one -- the biggest one that we've -- or a very major event in -- in Dauphin in 2007 of some $50 million. And that Dauphin hailstorm was different than the other two (2), mainly because it -- it wasn't just an isolated pocket but it came in -- into Dauphin, inflicted severe damage in Dauphin, and certainly higher severity claims than we've ever seen before, and then swept across the province.

So we had claims right from Russell/Roblin area all the way to Falcon Lake. So right across the whole width of the province that storm passed, with the most severe in -- in Dauphin area.

We thought that was quite -- quite an unusual event. Certainly high in severity, and at that point in time we looked and I said, Well, what would have happened to us if that severity of that storm that hit Dauphin and then sort of diminished and headed east, had hit Winnipeg. And through our own modelling model, the footprint of that storm within Winnipeg, the size that we knew it was in -- in Dauphin, the severity that we had seen in Dauphin, and -- and modelled that within Winnipeg, and that's where we came up with that $353 million number.

Again, that was back in the spring that we -- we modelled that. Is it one (1) in a hundred year event, is it one (1) in a thousand year vent, is it -- now is it a one (1) in thirteen (13) year event, there's some debate about that.

Come August of 2009 and we got another hailstorm of fairly similar track to that one in 2009 (sic). Not quite as severe. We're looking at probably a total of $35 million, but again, very severe hail in western Manitoba. Severity's higher in Brandon than it was through eastern province.

But again, you say what would have happened if that -- the severity that we saw in Brandon had hit Winnipeg? Again, that -- and that -- remember that came after we had formulated this particular adverse scenario.

So something is changing. When we were negotiating with re-insurers in 2001, they were saying, Well, you've had two (2) -- two (2) hailstorms in the -- in the past five (5) years, we think something is changing in terms of your coverage. And I'd say, No, no, no, the -- yes, you're right, we've had two (2) in five

(5) years, but really the way you look at it -- have to look at it is we had two (2) in thirty-eight (38) years. And then the 2007 storm came and the re-insurers said, Don, you've now had three (3) in -- claims in eleven (11) years. And I said, No, no, no, no, no, we've actually had three (3) in thirty-eight (38). That argument is getting a little thin as we go into 2009.

So in terms of the formulation of this particular scenario and the plausibility of it, unfortunately, it's kind of a sign of the times and -- and certainly a sign of the more -- the -- the higher frequency of those extreme hailstorms that we're now seeing.

MR. WALTER SARANCHUK: So essentially this scenario pertains to the Winnipeg environment, is that correct?

MR. DONALD PALMER: That's where the highest risk would be, yes.

MR. WALTER SARANCHUK: And can you give us any indication of what the biggest hailstorm was ever to hit Winnipeg?

MR. DONALD PALMER: The biggest one that we've had so far was in 1996. It was about $55 million, that exact num -- between $50 and $55 million. Take that with inflation and could be a higher severity. Time of day is certainly a determining factor into the severity of the storm. Again, when the storm hit Winnipeg this year it was at 2:00 in the morning. If it had hit at seven o'clock in the evening the -- the damage would have been a lot greater.

So the high -- in answer to your question the highest one we've seen so far was $55 million. Subject to inflation, that's probably $80 to $100 million if it happened today.

MR. WALTER SARANCHUK: Is there some merit to the suggestion that Winnipeg has its own climatic condition, so to speak, vis-a-vis the rural, given the heat or warmth from the concrete in the summertime?

MR. DONALD PALMER: I'm not a meteorologist so I really can't comment on that. Certainly, I know that hail has happened and does happen in Winnipeg. If you're talking in terms of cities being hotter that could be true, which in fact could accentuate the severity of hail.

MR. WALTER SARANCHUK: In terms of what your indication was as to the magnitude of the largest or most severe hailstorm to hit Winnipeg, how does that compare with your adverse scenario plausibility? That is the size of it.

MR. DONALD PALMER: The -- with inflation it's probably about a third of the size. I will also -- subject to different climatic conditions, but if you're talking about the city effect of hailstorms, I think the largest hailstorm that -- in severity that Canada has ever seen was in Calgary, so that certainly kind of underlines the fact that hailstorms can hit cities.

MR. WALTER SARANCHUK: Well, I don't know whether it's fair or reasonable to compare cities, because we're talking about a difference in the level of the city, of some 4,000 feet in Calgary, down to 700 in Winnipeg, but we know where you're coming from.

Can you confirm, sir, that when you look at page 4 of the excerpt that we're talking about, the adverse scenario of the large hailstorm causes a drop in basic retained earnings relative to the base forecast in 2010/'11, of some $148 million and a drop of 179 million in 2003/'14. This is shown, I'm sorry, at page 16, the top.

MR. DONALD PALMER: That's correct.

MR. WALTER SARANCHUK: And what management response is assumed in this adverse scenario; that is, if any?

(BRIEF PAUSE)

MR. DONALD PALMER: We, in that kind of one (1) time event, and I'll just read into the record the paragraph under that table:

"Assuming no special management or regulatory action, the retained earnings are $179 million in the base forecast."

MR. WALTER SARANCHUK: Thank you, sir. And now if you take a look at Tab 36, and in particular page 3 and 4, there's reference there to the, if I can call it that, quote -- or let me call it the, quote, "First Public Utilities Board Alternate Scenario," end of quote.

And when looking at that, can you indicate how the modelling of the first alternate scenario, the first PUB alternate scenario, compares to the adverse scenario that you filed?

MR. DONALD PALMER: It's proportionally adjusted because this is a smaller hailst -- hail event that we're modelling in this particular instant -- instance.

MR. WALTER SARANCHUK: And can you confirm, sir, that as shown on page 4, the first PUB alternate scenario causes a drop in the basic retained earnings, relative to the base forecast in 2010/'11 of some $24 million, going to a drop of $29 million in 2013/'14?

MR. DONALD PALMER: I can confirm that.

MR. WALTER SARANCHUK: And of course that's significantly less to the adverse scenario results filed, is it not?

MR. DONALD PALMER: It's less because the severity of the hailstorm is assumed to be less, yes. And let me also say that this is really dependent on our reinsurance coverage as well. We have reinsurance coverage right now that covers up to a $300 million hailstorm, although the layer between 200 million and 300 million is only two thirds (2/3s) covered.

So as you get into anything above two hundred (200), certainly impacts you on a dollar-for-dollar basis or a dollar-for-three-dollar ($3) basis, I guess. If it goes beyond three hundred (300) then we're dollar-for-dollar completely on the hook for that amount.

MR. WALTER SARANCHUK: Now on page 4 of the response indicated in Tab 36, there's reference to the second PUB hail scenario. And could you advise how the assumptions there differ from the one that had been filed.

MR. DONALD PALMER: The severity would be double in the PUB Scenario Number 1, as you've labelled it, again, with 14 percent of Winnipeg being affected, being under the -- our reinsurance limit. So even though a greater effect, the retained earnings being $63 million less than our base scenario as filed, but certainly not as high as the adverse scenario that we have filed within our DCAT.

MR. WALTER SARANCHUK: Yes, with the range being some 52 million of a drop in 2010/'11 to 63 million as you pointed out, at the end of the outlook period?

MR. DONALD PALMER: That's correct.

MR. WALTER SARANCHUK: Now, I would refer you to AI.18.2, that's the same one that we've been looking at in Volume III, Part 3, and pages 32 to 34, which deal with the sustained low interest rates and decline in equities adverse scenario.

THE CHAIRPERSON: Mr. Saranchuk, just before you get into that, Mr. Palmer, if you just please remind us, with respect to the re-insurance coverage of the hailstorm, is it a single occurrence or multiple occurrence?

MR. DONALD PALMER: It's single -- single occurrence. We do have a reinstatement premium that we have to pay to basically reinstate the coverage, but it's -- it is one (1) hail event or hail track. Both the

Dauphin and the Brandon hail storms, even though we had damage as it tracked across the whole province, it was deemed in both of those instances to be one (1) event.

THE CHAIRPERSON: Since the global credit crisis occurred and AIG and some of these other companies got into lots of trouble, have you noticed any diminishment in the interest in reinsurance in the firms or the price that they want for it?

MR. DONALD PALMER: I am going to the AON Rendezvous in two (2) weeks so I'll get a better handle on that. The market does seem to be hardening a bit. It's certainly the experience that we've had, as I've talked about, having four (4) claims in the past thirteen (13) years, will have some effect on our -- our pricing. I'm -- I'm virtually certain of that. In terms of the availability of coverage, we still should have no problem placing the program.

THE CHAIRPERSON: Has the trend in the price been going up for some time or does it vary, depending on the year?

MR. DONALD PALMER: It varies. Depending on worldwide capacity with the credit crunch capacity, was affected last year. We did hear last fall what Rendezvous, as I mentioned, where we meet with all the reinsurance markets, there was some pretty dire predictions, in terms of what the cost of reinsurance would be in -- in -- for the 2009 year. 2009 renewals came in somewhat higher than the previous year, but not quite as high as what the dire predictions were in -- in the fall.

So, depending on capacity it does vary a bit but has been going up.

THE CHAIRPERSON: When you're seeking the reinsurance, do you take into account your adverse risk projections if you want?

MR. DONALD PALMER: Probably the other way around. In terms of -- of the modelling that we do and the determination of what we think we need for reinsurance, we would look at the same model for the adverse scenario that we've described here and for the amount of reinsurance that we would purchase.

THE CHAIRPERSON: So as you reflect on the increasing frequency of the storms and the breadth of them and everything else, it's also reflected in your decisions with respect to reinsurance?

MR. DONALD PALMER: Absolutely, although maybe not the way you might think in terms of the lower levels of coverage. When we buy our -- our coverage again you're buying for that unusual event, just like an individual who would purchase automobile coverage and --

and deductible, essentially you would buy a deductible level that -- at a level that you could withstand the -- the lower level events. There's no reason to do dollar trading with an insurer or -- or a reinsurer. There's an expense that is associated with that, so an expected event you really shouldn't insure.

So as we look at the lower levels of -- of coverage over the next few years as the prices are reflecting our current experience, we may see ourselves increasing our -- our retention at the low-end, that we would have to withstand on a first dollar basis storms up to -- now it's $15 million. It could go up to $20 million or $25 million. And those type of -- of storms we can certainly withstand.

We don't want to do the dollar trading with re -- re-insurance. Our biggest risk is at the higher layer, so -- so we would likely retain at lower levels and -- and maybe buy higher levels of coverage at the top end.

THE CHAIRPERSON: Just one (1) last question, if I could? Geographically, we're on the prairies, just like Saskatchewan and Alberta, do you consult with insurers that are covering risks in those provinces?

MR. DONALD PALMER: We certainly have

discussions with other Canadian insurers. At the Rendezvous I mentioned there are other Canadian insurers that -- that insure in Western Canada, yes.

THE CHAIRPERSON: Are your practices significantly different than the approach taken by say, for example, SGI or the private insurers in Alberta? You say they're in the same ballpark?

MS. MARILYN MCLAREN: I think fairly similar. You know, I think -- I think we've maybe talked in these proceedings before, you know, in -- in Alberta there's a bit of a -- a hail track, you know, that kind of runs out of the, you know, the Rocky Mountain Trench and through kind of the Red Deer area, but they're certainly very vulnerable.

And there are other issues that come to bear, too, in terms of the insurers and their scope of operations. Lots of them re-insure a lot and -- and pay a lot on that basis.

But there's geographic differences other than that even in terms of Saskatchewan. In terms of their population basis, they don't have a Winnipeg. You know, their -- their population is much more evenly spread across the province so that leads to differences as well.

THE CHAIRPERSON: Thank you, that's the

commentary I was looking for.

Mr. Saranchuk...?

CONTINUED BY MR. WALTER SARANCHUK:

MR. WALTER SARANCHUK: Thank you, sir. With reference to the scenarios dealing with the sustained low interest rates and the decline in equities this is also referred to and addressed at Tab 37 in the book of documents, which is the Corporation's response to Information Request PUB/MPI-2-33.

On page 32 of AI.18.2, Mr. Palmer, there is reference to the scenario justification. In this case, I wonder if you would summarize the Corporation's commentary there.

MR. DONALD PALMER: This particular scenario is a combination of two (2) adverse events. We have labelled it an integrated scenario. That's -- you know, the adverse events aren't necessarily mutually exclusive so you could get hit by more than one (1) bad thing at a time.

In this particular case with sustained lower interest rates and declining equity markets, which sounds like the current situation, is in -- in terms of combining those two (2) things with -- both would have an adverse event. So both the combination of a -- low sustained interest rates which causes our liabilities to increase, as well as the decline in equity markets.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: Does the behaviour of the financial markets over 2009, that is to date, does it affect the Corporation's perception of the plausibility of this adverse scenario?

MR. DONALD PALMER: Well, currently if you just look at 2009 to date, we are -- have those sustained lower interest rates, but the market -- the equity markets have bounced back from those dismal levels of 2008, so I wouldn't say necessarily that that would be indicative of -- of our selection of the possibility of that adverse scenario.

In Round 1 PUB-1-71, we have outlined in Part C some history of Canadian economic statistics and -- and found that a scenario of sort of that same nature has occurred as recently as the 2000 to 2004 time period.

MR. WALTER SARANCHUK: Can you give us according to your last information, an indication of what the percentage rebound has been in the markets?

(BRIEF PAUSE)

MR. DONALD PALMER: Subject to check from a year to-date perspective we're in the thirtyish range. There -- there was a decline in the first part of the year so we're probably about 50 percent up from the lowest levels in early March.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: For the current year, sir, in terms of how much your equity investment has rebounded, by way of an undertaking can you give us that information?

MR. DONALD PALMER: In terms of specifics we can get that information. I -- I think most useful to the Board would be when we file our second quarter statement which will be some time during the course of -- of these hearings. That will be certainly evident in the reporting of our AOCI.

MR. WALTER SARANCHUK: Thank you, sir. So we can have that undertaking?

MR. DONALD PALMER: Yes.

--- UNDERTAKING NO. 4: MPI to indicate how much their equity investment has

rebounded for the current
year

CONTINUED BY MR. WALTER SARANCHUK:

MR. WALTER SARANCHUK: Thank you. Now in terms of the impact of the sustained low interest rates and decline in equities scenario, looking at page 34, would you agree that it appears to cause a drop in the basic retained earnings, relative to the base forecast of some $60 million in 2010/'11, and a drop of some $227 million in 2013/'14?

MR. DONALD PALMER: That's the total accumulated impact from the base, yes.

MR. WALTER SARANCHUK: And what is the management response assumed in this scenario?

(BRIEF PAUSE)

MR. WALTER SARANCHUK: And I'm looking at page 34, the second paragraph under that table, sir.

MR. DONALD PALMER: Yes. That in this type of event you probably couldn't implement a rebuilding strategy until 2012/'13, as the '10/'11 results wouldn't be enough to generate a -- an RSR surcharge or -- or a significant increase in -- in

2011/'12. It's kind of that time lag that we've talked about in previous years.

Assuming that the Corporation was holding maximum RSR at the beginning, this scenario would decrease the retained earnings by approximately $111 million by the end of 2012/'13 before you could actually do any special management action, and then you'd require a rebuilding strategy thereafter.

MR. WALTER SARANCHUK: Thank you, sir.

MR. DONALD PALMER: And -- and just -- I may have mis -- misspoke, that would be re -- reduce the retained earnings to minus a hundred and eleven (111), not by a minus a hundred and eleven (111).

MR. WALTER SARANCHUK: Is your rebuilding strategy reflected in the DCAT model, sir?

(BRIEF PAUSE)

MR. DONALD PALMER: The tables themselves don't include that management action. The recommendation, in terms of what the requirement would be, do include it. So that very bottom paragraph under the recommendation does include that -- the effect of that man -- management action.

MR. WALTER SARANCHUK: And just to

summarize that paragraph, sir, just for the record, what is the action?

MR. DONALD PALMER: On the assumption that the special management action will be taken in 2012/'13, the Corporation should apply for an increase to the upper limit of the PUB's RSR range to at least $180 million in 2010/'11. This amount is approximately equal to the expected impact of this scenario on retained earnings in '11/'12.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: So, can you confirm that the adverse impact here is on the RSR and not on the AOCI?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: And so that there would be a further adverse effect on the AOCI?

MR. DONALD PALMER: In our modelling we have recognized the losses, the unrealized losses over a three (3) year time period, so they would all be -- for modelling purposes, they would be recognized over three (3) years.

MR. WALTER SARANCHUK: Thank you, sir. Now, with reference to the information in Tab 37, there are a couple of PUB scenarios introduced there that were addressed, and the first one is on page 2. And I wonder if you would indicate how the first PUB alternate scenario differs from the assumptions in the filed adverse scenario?

(BRIEF PAUSE)

MR. DONALD PALMER: This particular adverse scenario includes an upward shift in the yield curve, as opposed to sustained low interest rates that we had in our adverse scenario, as well as a 10 percent decline in the value of equities. We had modelled a 20 percent decline.

MR. WALTER SARANCHUK: Yes. And can you confirm, sir, as shown on page 2 of the response, that the impact of the first PUB alternate scenario causes in increase in the basic retained earnings, relative to base forecast, of some $97 million in 2010/'11, falling to an increase of 51 million in 2013/'14?

MR. DONALD PALMER: That's correct.

MR. WALTER SARANCHUK: And so it's not really an adverse scenario, is it?

MR. DONALD PALMER: No.

MR. WALTER SARANCHUK: Now, how does the

modelling of the second PUB alternate scenario on page 3 differ from the base of -- or at least the filed adverse scenario that was filed in terms of the assumptions?

MR. DONALD PALMER: It's an upward shift in the yield curve of a hundred (100) basis points, as opposed to no shift at all in our adverse scenario, and a decline in equity values of 15 percent versus 20 percent.

MR. WALTER SARANCHUK: And as indicated on page 3 can you confirm that the second PUB alternate scenario causes an increase in the basic retained earnings relative to base forecast of some $57 million in 2010/'11, and falling to a $15 million drop in 2012/'13, and a drop of $8 million in 2013/'14. In other words, only marginally adverse.

MR. DONALD PALMER: Yes, I will confirm that.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: Now, moving on to the final adverse scenario, which is the increase in inflation as shown at pages 26 to 31 of AI.18.2, and also dealt with at tab 38 in the book of documents, which is the Corporation's response to PUB/MPI Information Request Number 34 in the Second Round.

And with reference to the commentary on page 27 of AI.18.2, sir, I wonder if you would explain the information provided on the justification for this scenario?

(BRIEF PAUSE)

MR. DONALD PALMER: We took a look at the change of inflation rates over the last fifty (50) years and -- and then take a look at cumulative changes over -- over a period of time over a given base year. And, for example, inflation in 1995, inflation was 2.2 percent, and over the next four (4) years it dropped to 1.5 percent and 1.7, 1 percent, and 1.8, so there was in fact a cumulative decrease in inflation of 2.8 percent.

Taking a look at what has happened over that fifty (50) year period, the 95th percentile looking at those fifty (50) years of data occurred in 1979 -- 1974, when inflation was 3 percent in 1970 and then increased to 4.8, 7.8, and 11 percent in the next four (4) years, which on a compound basis is equivalent to about 5.1 percent per year.

MR. WALTER SARANCHUK: And can you confirm that this adverse scenario causes a drop in the basic retained earnings, relative to the base forecast of some 102 million for 2010/'11 and drop to -- sorry, of 228 million in 2013/'14, as shown on page 30?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: And what management response is assumed in this adverse scenario?

(BRIEF PAUSE)

MR. DONALD PALMER: We would assume that there would be a special regulatory action with a RSR surcharge in '11/'12 to reduce the retained earnings impacts in 2012/'13 and after.

(BRIEF PAUSE)

MR. DONALD PALMER: If I could refer you to page 29, and it outlines in detail the actual management actions that are part of the model.

MR. WALTER SARANCHUK: And that would include, I take it, rate line adjustments? Rate level adjustments, I'm sorry.

MR. DONALD PALMER: Rate level adjustments, that's correct.

MR. WALTER SARANCHUK: Now, relative to this particular adverse scenario, again there are a couple of PUB scenarios that were introduced, and could you advise, sir, with reference to that the first PUB scenario, with regard to this adverse one shown on page 3 of the response in Tab 38, can you confirm how the modelling of the filed adverse scenario differs from the assumptions for the first PUB scenario?

(BRIEF PAUSE)

MR. DONALD PALMER: There's a smaller shift in the inflation. Instead of 5.1 percent and 1.5 percent -- oh, sorry, instead of three point one (3.1) in the first year. And then -- and also an upward shift in the yield curve of seventy-five (75) basis points, which we did not have.

MR. WALTER SARANCHUK: And can you confirm, sir, as shown on page 4, that the first PUB alternate scenario causes a drop in basic retained earnings relative to base forecast of some $9 million in 2010/'11, and a drop to 109 million for 2013?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: So they're still significantly adverse?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: Now, how does the

modelling of the filed adverse scenario differ from the assumptions made for the second PUB scenario, as shown on page 5 of the response, sir?

(BRIEF PAUSE)

MR. DONALD PALMER: So this is an additional 2 percent inflation. We have in our base forecast 2 percent inflation, so this would increase it to 4 percent, and also a upward shift in the yield curve of seventy-five (75) basis points, compared to our zero shift.

MR. WALTER SARANCHUK: And can you confirm as shown on page 6, that the second PUB alternate scenario causes a drop in basic retained earnings relative to base forecast of some $44 million in 2010/'11, and a drop of $194 million in 2013/'14?

MR. DONALD PALMER: Yes.

MR. WALTER SARANCHUK: And again it's still significantly adverse?

MR. DONALD PALMER: It's very significantly adverse, yes.

MR. WALTER SARANCHUK: Now, with reference to the narrative in the Corporation's response to this particular interrogatory in Tab 38, sir, and in particular the response to the Part B of the question, which asked:

"Please describe and illustrate how the increased inflation assumption is recognized in the modelling of the provision for unpaid claims."

Could you please read in the answer, sir, shown on page 2.

(BRIEF PAUSE)

MR. DONALD PALMER: "The claims forecasting worksheets were updated to reflect the assumed inflation rate in each year. The growth rate of the twelve (12) month and ultimate incurred claims was assumed to increase by the amount of excess inflation over the base forecast.

For example, if the base growth weight -- rate for a given coverage was 4 percent and inflation is assumed to be 5.1, then the new growth rate would be 4 por -- 4 percent plus 5.1 minus 2 (two), or 7.1 percent.

The interest rate for discounting the liabilities was calculated based on the expected weighted average bond yield in effect at each year-end [described on page 28 of AI.18.2.]

The real interest rate is simply the assumed weighted average bond yield net of assumed inflation."

That would be the 5.1 percent.

MR. WALTER SARANCHUK: Thank you. Can you tell us, sir, how the fiscal year claims incurred are affected for the lines of business with indexed benefits?

(BRIEF PAUSE)

MR. DONALD PALMER: With indexed higher inflation would -- would yield higher benefits, so they -- those would be updated in our forecast.

MR. WALTER SARANCHUK: And for lines of business with benefits not subject to indexation, how does this approach to adjusting for inflation capture the three (3) remaining years worth of elevated claims inflation and the discounted unpaid claims provision at the end of 2010/'11?

(BRIEF PAUSE)

MR. DONALD PALMER: The -- the non-indexed benefits would also be subject to inflationary increase and they would be reflected in the updated forecasts. So, specifically, collision rates, or collision repair rates, are subject to some inflation, even though it's not mandated in the Act like inflationary increases in -- in PIPP coverages. But the higher inflation rates were taken into effect for those coverages.

(BRIEF PAUSE)

MR. WALTER SARANCHUK: So there appears to be, sir, some three (3) remaining years worth of elevated claims inflation. And how was that accounted for in the discounted unpaid claims provision at the end of 2010/'11?

(BRIEF PAUSE)

MR. DONALD PALMER: The effect of those discount rates, the prevailing discount rates at the time when we model the assets, would be taken into account in the discounted value of the liabilities. So there would be an adjustment for those discount rates.

MR. WALTER SARANCHUK: And how has your model reflected the effect of a change in market interest rates on the market value of assets classified as Held For Trading?

MR. DONALD PALMER: The effect on those Held For Trading assets is included in the calculation of that discount rate.

MR. WALTER SARANCHUK: Thank you, sir. Mr. Chairman, I have, to wrap up all of the cross-examination relative to the RSR target establishment, I have some six (6) questions that I estimate would take some ten (10) to fifteen (15) minutes. I don't know if you want me to continue or whether you wish that we have a break at this time.

THE CHAIRPERSON: We'll take the break now and we'll be back at 1:15. Thank you.

--- Upon recessing at 12:03 p.m.

--- Upon resuming at 1:00 p.m.

THE CHAIRPERSON: Okay, welcome back, everyone.

Mr. Saranchuk, I think we interrupted you.

You weren't quite finished.

CONTINUED BY MR. WALTER SARANCHUK:

MR. WALTER SARANCHUK: Thank you, Mr. Chairman. I was going to proceed to seeking the Corporation's views in respect of some of the conclusions drawn in the Hum & Simpson Report, at page 25. And I'll be doing that in a moment.

But just to conclude this discussion relative to the adverse scenarios, Mr. Palmer, can you confirm that the three (3) adverse scenarios that we just reviewed namely the extreme large hailstorm, the sustained low interest rates, and decline in equities, and the increase in inflation, represent the three (3) most adverse scenarios from the Corporation's standpoint and therefore are reflected in the filed DCAT report.

MR. DONALD PALMER: Yes, I will confirm that.

MR. WALTER SARANCHUK: Now, with reference to the conclusions in the Hum & Simpson Report -- they are page 25 of that report and they number six (6) in total. I guess, I should draw to your attention what they do state. So, for example, in Number 1, for the record, the first conclusion is, quote:

"The new RSR range calculated by MPI

using the RAA method is 102 million to 255 million, while their DCAT target is 185 million, suggesting a degree of agreement between the two (2) methods for 2010/'11. Nonetheless, because the two (2) methods vary considerably in objective, scope, tools, and information, this consensus is unlikely to be maintained in the future." End of quote.

Do you agree with that or do you have any comments relative to it?

MR. DONALD PALMER: Just one (1) clarification was the -- the range being one-o-two (102) to two fifty-five (255), that was subsequently amended into some other numbers, to two forty-six (246), so just from that point of clarification.

I would -- I would agree with Hum and Simpson in terms of our analysis for the decision that's facing this Board is more about the methods to get to the answer than the answer itself.

And the fact that these two (2) methods do conform, that you get there in very different ways, although when we look at what happened in -- in the '08/'09 fiscal year as certainly in -- in anybody's estimation would have qualified as an adverse scenario, the -- the fact that the addition of that data point in the value-at-risk calculation got us to sort of -- about the same point kind of does add some validity -- or it confirms the -- the DCAT approach as being something that -- that had we relied on it beforehand it would have been a valid exercise.

So from that standpoint I -- I would agree somewhat with this statement, but, yes, the two (2) methods are very different. The risk analysis is retrospective, you know, very much dependent -- dependent on observations, not the risks that we face as the cor -- as a corporation that could affect ratepayers in the future.

So I -- I guess I don't have any huge argument with that first statement.

MR. WALTER SARANCHUK: And, of course, the second one states, quote:

> "The RAA method more directly applies to the stipulated RSR objective of a fund to ensure stability of Basic rates. The DCAT objective is more broadly concerned with the future satisfactory financial health of the Corporation." End of quote.

I take it that's exactly what you were just addressing? The latter part.

MR. DONALD PALMER: The latter part, yes. I would really strongly disagree with the first part. And it might be helpful to the Board also to refer to MPI Exhibit Number 12, our rebuttal evidence, as I will be referring to that as well in this discussion. Page -- pages 7 and 8 of our rebuttal evidence speaks directly to some of these conclusions that Hum & Simpson has.

The stability of future rates and the financial health of the Corporation are not mutually exclusive. If -- if we have financial health on an ongoing basis, we'll probably have more stable -- stable rates. So for Hum and Simpson to say that one (1) measures one (1) and the other one (1) measures the other one (1), I -- I just absolutely disagree with that statement.

There -- there's no question that the DCAT talks about that financial health, and that's the determination of whether rates are stable or not.

MR. WALTER SARANCHUK: Okay. And I'm sure your counsel will be getting into the rebuttal evidence that MPI has filed. I'm just really looking at this juncture for some response at a high level to these conclusions.

So, with regard to Conclusion Number 3 by Hum and Simpson, it states, quote:

"The RAA method is based on the as yet limited historical experience of adverse events for the client motorists of MPI, while the DCAT method is based on plausible adverse scenarios chosen internally by MPI." End of quote.

MR. DONALD PALMER: I would agree with that statement. And -- and I think the important words in historical experiences are in the parentheses as "as yet limited". I'm not sure how this can measure the effect on the -- the Corporation on those ad -- that adverse scenarios would have if -- if this historical experience doesn't contain any.

So I agree with this statement and I think this statement really does underline one (1) of the weaknesses of the risk analysis.

MR. WALTER SARANCHUK: Thank you, sir. And with regard to Conclusion Number 4, which states, quote:

"The horizon for the RAA method is one (1) year, while the horizon for the DCAT method is five (5) years." End of quote.

What is your comment in relation to that conclusion?

(BRIEF PAUSE)

MR. DONALD PALMER: Again, I would basically agree with what they've -- they've said in this comment. And -- and, again, the measurement of adverse scenarios or -- or the adverse events that could affect the ratepayer in Manitoba would be spread over a number of years, not just limited to one (1) year.

So, again, I think, from this perspective, this statement by itself would underline that the DCAT is a better methodology for determining the RSR.

MR. WALTER SARANCHUK: Now, with regard to Conclusion Number 5, which states, quote:

"The various scenarios chosen for the DCAT exercise are selected adverse events without specified probability of occurrence. No offsetting favourable scenarios are considered." End of quote.

Do you agree with that conclusion?

MR. DONALD PALMER: I do not agree with that. We have selected the adverse scenarios with some assigned probability, either in a 95 percent or up to a 99 percent confidence.

In terms of when they say, "no offsetting favourable scenarios are considered," that's true. We're not defining our -- what our capital requirements for adverse events based on favourable scenarios. So although I'd like to see favourable scenarios over the -- and favourable results for the Corporation over the next little while, that's not really what we're protecting our -- ourselves against.

So when they happen, that's great. We're happy with that. We're happy that they will benefit the ratepayers in Manitoba, but that's not what we're setting up an RSR to protect ourselves from.

MR. WALTER SARANCHUK: Thank you, sir. And finally, the conclusion drawn by Hum and Simpson as Number 6 states, quote:

> "The RAA and DCAT methods both require an element of judgment, but the RAA procedure is constrained by its reliance on published historical data and non-proprietary statistical procedure that are relatively easily subject to external replicability. The DCAT methodology is constrained

only by the speculative future
scenarios MPI might construct that may
or may not find external support." End
of quote.

What is your comment, relative to that conclusion?

MR. DONALD PALMER: First of all, it seems to imply that the DCAT method is proprietary. It's not. We are following the standards of practice of the Canadian Institute of Actuaries.

And we are absolutely testing future scenarios that we think could threaten the Corporation. And in formulating those scenarios we have used significant historical information, both internal to the Corporation. The claims experience that we've -- we've observed over the last few years is the basis of our base forecast. The possible investment and economic scenarios that we've tested have all been chosen because they have been justified by past history.

So from that standpoint, I -- I think this statement is -- is somewhat flawed.

MR. WALTER SARANCHUK: Thank you, sir. Those are all my questions, relative to the RSR, Mr. Chairman and panel members. And My Learned Friend, Ms. Everard, will now assume conduct of the cross-examination, on behalf of the Board.

THE CHAIRPERSON: Thank you, Mr. Saranchuk.

(BRIEF PAUSE)

CROSS-EXAMINATION BY MS. CANDACE EVERARD:

MS. CANDACE EVERARD: Thank you, Mr. Chairman. I'm going to begin by getting into some questions with respect to the Corporation's investments. So I'd ask the panel to turn to Tab 15 of the Board's book of documents where we find the answer to Question 7 posed by the Board in the First Round.

(BRIEF PAUSE)

MS. CANDACE EVERARD: Once you're --

MR. DONALD PALMER: I have it.

MS. CANDACE EVERARD: Thank you, Mr. Palmer. Once you're at that tab, if you could turn to page 3 which is the attachment at 1-7(a).

Looking at the top table on that page, it appears to reflect that the Corporation's investment portfolio has a balance of just over $2 billion as at the close of 2006/2007.

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: And the overall balance in the portfolio increased to just under 2.2 billion in the following year, 2007/2008, and then went back to just over 2 billion, as of the end of 2008/2009.

Is that right?

MR. DONALD PALMER: It was just under $2.2 billion in '07/'08, and back to just over 2 billion in '08/'09, yes.

MS. CANDACE EVERARD: That's not what I said, that's what I meant to say, so I apologize if I misspoke.

So in other words between 2007/2008 and 2008/2009 there was a drop of about 166 million in the corporate portfolio?

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: Now, for the end of the current year 2009/'10, there's a projected value of almost 2 billion, just under 2 billion, which would be a reduction of an additional approximately 23 million from the previous year?

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: So to tie together the number from '07/'08 through to 2009/'10, that is the projected number for the current year, there's a difference or a reduction of approximately 189 million.

Is that right?

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: Now, would it be fair to say in previous years, and I appreciate we only have '06/'07 in front of us, that the portfolio generally speaking would grow by about $150 million a year?

Does that accord with your recollection?

MR. DONALD PALMER: That sounds about right, yes.

MS. CANDACE EVERARD: Just in ballpark terms?

MR. DONALD PALMER: Ballpark, I can accept it.

MS. CANDACE EVERARD: So to what does the Corporation attribute the reduction in the portfolio over the last couple of years?

MR. DONALD PALMER: There are a couple of things. First of all, and -- and I've talked about the decrease in the market for -- in the '08/'09 year, and that certainly the market value of equities plummeted at that point in time, from $417 million at the end of '08 to two hundred and seventy-one (271) at the end of February '09.

In terms of the projected into this year, one (1) further factor is that this is the investments of the Corporation, this is not all the assets of the Corporation. We did purchase a building that was $80 million. Only something under $30 million of that is considered an investment, the rest is a capital asset, so that is not included in that. So that's also included in the reduction so that's a reduction of some $50 million.

MS. CANDACE EVERARD: Okay. Looking forward, the Corporation is forecasting a growth in the portfolio from the current year of 2009/'10 through the outlook period, as reflected here. And if we -- we look at the spread between 2009/'10 to 2013/'14, we see an increase of about $802 million.

Is that correct?

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: So in other words, by 2013/'14, at this point the Corporation is forecasting the balance in the portfolio to be about 2.8 billion?

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: And it would be fair to say that this type of growth from '09/'10 through to 2013/'14 is more typical historically than what's happened in the last couple of years?

MR. DONALD PALMER: We are assuming a growth in our investment portfolio that it will be growing because it will attract an investment return rather than the investment loss that we've seen over the last year.

MS. CANDACE EVERARD: Okay. If I can ask you then to turn over the page at that tab, I want to get into a little bit about the composition of the portfolio, and the lower table under the heading of "Yield Percentage" on that page.

If we look at the yield percentages as set out there, it would be fair to say that the relative allocation for 2009/'10 has changed fairly substantially from the year before?

MR. DONALD PALMER: You've characterized that as a allocation. It would be a percentage yield, not an allocation. And, yes, it -- it has changed over the actual observed over the last year.

(BRIEF PAUSE)

MS. CANDACE EVERARD: Thank you. And I do have some additional questions on that table, which I'll come back to. If I can get you to go back to the previous page that we were just looking at, page 3 of the exhibit.

So if we look at this table, this would be the percentage allocation table relating to the content of the portfolio?

MR. DONALD PALMER: Sorry, can you repeat that, please?

MS. CANDACE EVERARD: For sure. I just wanted to confirm that the lower table on page 3 of this exhibit is the table that sets out the percentage allocation of the portfolio among the various asset types.

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: So, looking at 2008/2009, the first line relates to cash and short-term investments, which were some 13.4 percent of the portfolio in that year, and that's projected to drop to 3.3 percent for the current year?

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: And with respect to Long Term Bonds, just a couple of lines down...

MR. DONALD PALMER: I apologize, Ms. Everard.

MS. CANDACE EVERARD: No worries. I just didn't want to keep talking because I thought you were listening to something else. So the third line, the Long Term Bond line, reflects that in 2008/2009 there was about 72.8 percent of the portfolio in Long Term Bonds, and that's projected to increase in the current year to 79.3 percent.

Is that right?

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: And what's the reason or rationale behind that increase?

(BRIEF PAUSE)

MR. DONALD PALMER: It's approaching our Investment Policy Statement, and we have it labelled "Long Term Bonds," it probably should be 'all bonds', and we are buying some long-terms as per our Investment Policy Statement, so that gets us closer to that.

MS. CANDACE EVERARD: And I do have some questions on the Investment Policy Statement coming up a little later.

What I'm wondering, if we just continue to look at that line, it does appear that through the outlook period the component of bonds in the portfolio is set to decrease back to roughly what it was last year, in the lower 70s.

What's behind that?

MR. DONALD PALMER: That's fun -- funding the alternatives, the infrastructure EAFE and real estate that are in the bottom, which have -- up until now a zero percent al -- allocation, and the amounts coming from -- to fund those will be coming from the bond port -- portfolio.

I'd also just direct you in terms of -- of the increase in the bonds is also -- we were holding a fairly ha -- high cash component that would -- would be used, both for bonds and for the purchase of City Place.

MS. CANDACE EVERARD: So in other words, the changes, or the reduction in the bonds, is really to enable the Corporation to go to its new asset mix?

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: And just for the record, you mentioned EAFE, E-A-F-E, which is reflected here. Can you just confirm what that stands for?

MR. DONALD PALMER: It's Equities in Europe, Austral -- Australasia, and the Far East.

MS. CANDACE EVERARD: Now, it would be fair to say, other than the changes that we've discussed, that is the reduction in cash and short-term investments, the changes in the Long Term Bond component, and the purchase of the EAFE equities infrastructure in real estate, things are staying fairly constant throughout this period of years?

(BRIEF PAUSE)

MR. DONALD PALMER: I don't know that I would necessarily agree with -- with that statement. There is a gradual flow into the alternative asset classes from having zero percent in EAFE infrastructure and real estate, to something over 10 percent at the end of '13/'14. So I don't know if I would call that necessarily stable for those particular asset classes.

MS. CANDACE EVERARD: And -- and if you -- if you haven't said this and I -- I don't think you have, the reduction in the cash in short-term investments from '08/'09 to '09/'10 relates to the purchase of City Place?

MR. DONALD PALMER: City Place and the purchase of longer term bonds, yes.

MS. CANDACE EVERARD: Now, I note from this table that the Corporation throughout all of the years referenced maintains a small investment in venture capital.

What investments does the Corporation classify as venture capital?

(BRIEF PAUSE)

MR. DONALD PALMER: Both of those venture capital -- we have small participation into local funds that largely are funding startup business. And we've had those venture capital funds for a very long period of time, but they're both small.

MS. CANDACE EVERARD: What kind of returns does the Corporation get on those investments, roughly?

MR. DONALD PALMER: It's been very flat over the last little while. By the nature of venture capital, you have a number of assets hoping to hit a few home runs with some of the assets, and -- and maybe other ones are more speculative. I don't know that we've hit many home runs but we haven't lost much either, so it has been very, very flat.

MS. CANDACE EVERARD: Now, would it be fair to say just in its approach to the portfolio, generally, that MPI as a first principle regards asset mix maintenance as something that instructs its decisions, or is it driven more by market timing?

MR. DONALD PALMER: No, I think asset mix policy is -- would be the first consideration. There may be some timing considerations when you get into an asset. Some of it is -- is market timing, some of it is also opportunities that may present itself -- themselves, from time to time.

MS. CANDACE EVERARD: Now, you mentioned in passing earlier today that the Corporation's target for its equity component of the portfolio is 20 percent, and we will go to that paper where that's set out later.

That's right?

MR. DONALD PALMER: For public equity that's -- that's correct and the Investment Policy Statement will also have an allocation target of 5 percent in private equity.

MS. CANDACE EVERARD: So when you combine the two (2) it's 25 percent?

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: And I believe it's -- it's reflected in the record that, as of the close of the '08/'09 fiscal year, the end of February of '09, the Corporation's actual invest -- or equity investments were about 12 1/2 percent of the portfolio?

MR. DONALD PALMER: Is there a reference? I'm just looking at this table and the equity it shows is thirteen point four (13.4).

MS. CANDACE EVERARD: And I -- it -- it does. We can use that number since that's the one that we have in front of us. It's not that different from the twelve point six (12.6), and I don't have that reference at my fingertips at the moment.

So if we go with the thirteen point four (13.4), my question is: Has there been anything since the close of the '08/'09 fiscal year whereby the Corporation has increased its equity holdings?

MR. DONALD PALMER: No.

MS. CANDACE EVERARD: And why not?

MR. DONALD PALMER: The -- the decrease was largely due to market declines. And you see that we have projected in this to 14.5 percent and -- and I can get you -- or I would -- I would suspect at the end of the second quarter that the percentage is -- is bigger than that again because we've had some market rebound.

So that percent allocation is very dependent on when you look at it. So it is a policy but it will -- it's somewhat cyclical and kind of will look after itself.

We do, from time-to-time, re-balance the portfolio, but we have not done anything of that nature in the first two (2) quarters. Not specifically, other than the market changes.

MS. CANDACE EVERARD: I guess what I'm getting at is given the Corporation's approach and being driven by asset mixes, we spoke about a moment ago, at least that's a primary driving factor, and with the market conditions that we've experienced with -- in the earlier part of '09 things in the stock market being on sale, if you will, at low values relative to where they may be normally, that did not play into the Corporation's decision making at all to -- to buy some stocks while they were on sale, so to speak?

MR. DONALD PALMER: No. This is -- this is still within our acceptable guidelines of target on the Investment Policy Statement.

MS. CANDACE EVERARD: So if I understand you correctly, the Corporation stuck with the plan that it had in place, rather than to make any significant different decisions as a result of the market conditions?

MR. DONALD PALMER: That is true.

THE CHAIRPERSON: While Ms. Everard's looking at her notes, Mr. Palmer, you'd indicated before that you'd set aside cash to buy the building and sold bonds.

Did you sell any equities as part of that process, to fund the building?

MR. DONALD PALMER: No, we did not. Yeah, the -- the bonds, rather than sell them, they do come due on a cyclical basis as well. So -- so when they came due it was not immediately reinvesting them.

(BRIEF PAUSE)

CONTINUED BY MS. CANDACE EVERARD:

MS. CANDACE EVERARD: Mr. Palmer, can you give us an indication if the Corporation hadn't purchased City Place, what if any of those available funds would have been put into equities.

Is that something you can answer?

MR. DONALD PALMER: It's pretty difficult for me to answer. Certainly the -- and again, with all our investment decisions they're under the direct control of the Department of Finance. So -- and I'm -- I'm just going back into some of the Investment Committee Working Group meetings that we've had and -- and that with the purchase of City Place imminent, I mean we didn't really speculate what -- what would have been done with -- with those funds.

So it's very difficult for me to answer that questions, what would have happened.

(BRIEF PAUSE)

MS. CANDACE EVERARD: Okay, we've been speaking in some general terms about the asset mix of the Corporation, and we know that last year the Corporation retained AON Consulting to do an asset liability mix review. We will all recall that, at last year's GRA, the Board received a report from AON and heard evidence from Mr. Bell about AON's recommendations.

I'd ask you then to turn to Tab 14 of the Board's book of documents, which is the answer to Question 5 posed by the Board in the first round. And what I'd ask you to do -- the response reflects a chart that sets out, a) the recommendation made by AON, b) the Corporation's response to that recommendation from last year, and then in the third column, what, if any, action the Corporation has taken to date on that point.

If you can go through these and -- and summarize and explain to the Board where the Corporation sits with -- with respect to each of these points.

MR. DONALD PALMER: The first recommendations were with regard to Long Term Bon -- Bonds versus Universe Bonds, to either change the allocation from Universe Bonds to Long Term Bonds or change the fixed income using a defined transition schedule. Last year we told the Board that the Corporation had adopted a 10 percent allocation to long bonds and intends to fund that allocation as conditions in the capital markets become favourable, and to date we have started to increase our long bon -- bond allocation.

With regard to illiquid asset classes, alternative assets of real estate, private equity, and infrastructure, the Corporation will be gaining significant exposure to illiquid asset classes, and it is unrealistic for some of the illiquid asset classes to increase by more than 2 percent per annum. That was the recommendation by AON.

In our response last year to the Board, we said that the Corporation anticipates it will take several years to reach the normal policy where it waits for these alternative asset classes. And this year the Corporation has purchased the parking lots associated with City Place. We have developed a short list of Canadian real estate pooled fund managers, and we are undergoing research with regard to private equities and infrastructure.

(BRIEF PAUSE)

MR. DONALD PALMER: With regard to currency hedging, the recommendation was that -- hedge the foreign currency exposure for all asset classes that target a consistent absolute return: real estate and infrastructure. We told the Board last year that we were adopting that recommendation for -- to date, the mandate for real estate is Canadian real estate, which does not have to be hedged, and we do not have any infrastructure assets to date, so that recommendation is largely moot at this point in time.

The next recommendation with regard to currency re -- hedging was do not hedge the foreign exposure to US public equity or private equity. Last year we advised the Board that the Minister of Finance has directed the Corporation to continue to hedge the foreign currency exposure for all public equity investments. And, to date, the US public equity is currently being hedged, and we do not have any assets in foreign private equity.

In regard to T-bills, the recommendation was at a level of cash in the investment allocation. The response last year was, for operational purposes, the Corporation has provided an allocation to cash of up to 3 percent in the Investment Policy Statement. To date in the Investment Policy Statement, the minimum and maximum range for cash in short-term is zero to 3 percent.

MS. CANDACE EVERARD: Thank you. I'll ask you then to turn to Tab 16, two (2) tabs over, where the Corporation's Investment Policy Statement is reflected. And if you'd look at the -- the second version which is attached to the Board's Question 2-8. That's the black line copy, so it's a little more convenient to work with. Page 18, if you would, of the Investment Policy Statement reflects the asset allocation targets.

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: So this table reflects in numbers where the Corporation ended up, if you will, after going through the process with AON that we -- that you just spoke about?

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: And the -- the intention, as I understand it, is that this portfolio is expected to provide higher returns with a lower level of asset liability mismatch risk.

Is that correct?

MR. DONALD PALMER: Not quite. I would say that the asset liability mismatch risk is more confined to the bond portfolio and the durations of the fixed income portfolio itself, rather than the equities or the other alternative investments.

MS. CANDACE EVERARD: Now, we know that the -- while the Corporation accepted some of the recommendations of AON, it did not accept all of them, in particular recommendations with respect to mortgages, Canadian Long Term Bonds, Canadian Universe Bonds, Canadian equities, and EAFE.

Is that correct?

MR. DONALD PALMER: Going back in time I would have to check the report in detail, but overall I would agree with, in general, with that statement, yes.

MS. CANDACE EVERARD: Now, speaking in a little bit more detail about the bond component of the portfolio, I'll ask you to turn back to Tab 15 of the book of documents, and in particular the last page at that tab, which is the last page of the answer to 2-5 posed by the Board.

MR. DONALD PALMER: I have it, yes.

MS. CANDACE EVERARD: According to the lower chart on the page, Real Return Bonds, which are the -- the third line item, will be phased out of the Corporation's portfolio by 2012/'13.

Is that correct?

MR. DONALD PALMER: That's the assumption in this chart, yes.

MS. CANDACE EVERARD: Is that the plan of the Corporation?

MR. DONALD PALMER: It's -- it's the plan to -- to phase them out, yes, but not -- not necessarily by '12/'13. We don't have a policy in place for that.

This is again dependent -- somewhat dependent on market conditions, and dependent on the Department of Finance and when they -- when they do those trades.

MS. CANDACE EVERARD: So what's reflected in this chart is subject to changes, possibly, prior to the '12/'13 year arriving?

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: Now, it's my understanding that real return bonds included a feature that they protected as a hedge against inflation.

Is that correct?

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: And you -- you spoke a minute ago when you were going through that other chart about inflation protection now coming to the Corporation through its real estate and infrastructure investments.

MR. DONALD PALMER: They provide some protection to inflation, as -- as some equity investments do as well.

MS. CANDACE EVERARD: Now, according to the chart that we're looking at, under the year of the Application, 2010/'11, there is a component for infrastructure, and I'm looking at the third last line of the chart, of .4 percent. I believe when you were reading in the answer to one (1) of my earlier questions at Tab 13 of the book of documents -- or 14, rather -- where went through what AON had recommended and where the Corporation was at with respect to each of those, there was as statement that the Corporation didn't have any assets in infrastructure to date, so it would appear that the plan is to acquire some in the next fiscal year?

MR. DONALD PALMER: And just let me step back and you're characterizing this as a -- as a plan and it really is not a plan. It's an outlook. This is the investment mix that we have chosen for modelling purposes. It's not really a -- a road map to get us to the investment mix. It's some assumptions that we put together in order that we could properly model our investment income.

But to categorize it as a plan, I don't think is accurate.

(BRIEF PAUSE)

MS. CANDACE EVERARD: Are the investment allocations reflected on this table consistent with the Corporation's financial forecasts?

MR. DONALD PALMER: Yes.

(BRIEF PAUSE)

MS. CANDACE EVERARD: It would be the Corporation's financial forecast that underpin its business plan going forward, right?

MR. DONALD PALMER: Yes.

(BRIEF PAUSE)

MS. CANDACE EVERARD: So if -- if I'm understanding your evidence correctly, the percentages reflected on this chart form part of the financial forecasts, the financial forecasts drive the business plan of the Corporation.

And I -- I appreciate you're saying that the investment percentage allocations here are subject to change, but I -- I am not fully understanding I think the extent of your hesitancy to have us rely on this chart when it has been put forward in the manner that it has.

MR. DONALD PALMER: And -- and I -- I apologize if -- if I seem to be clouding -- clouding the issue. This is the assumption of -- as we get into the new investment classes, and assuming that there's opportunities to get into those investment classes, assuming that we -- we are somewhat dependent on the

Department of Finance, as I -- like completely dependent on the Department of Finance in terms of the actual triggering of the investments.

So it certainly is the plan within some finite period of time to get to the asset mix that's outlined in the Investment Policy Statement, and to say that we will get there in five (5) years, probably is not an unreasonable assumption. To -- and that -- and again that's dependent on the available assets infrastructure funds.

For instance to -- to find infrastructure funds that match the -- the requirements of the Corporation and of the Government of Manitoba, may or may not be completely available. If we find a fund or fund of funds that we find that meets all the considerations that we -- requirements of the Corporation, maybe we would get that completely in one (1) year. We have shown a .4 percent allocation next year. That's not to say that we couldn't get the entire 5 percent -- 5 percent in one (1) year. We have just staggered it over a period of time for forecasting purposes.

But as I say, they are forecasts, and we haven't given anybody a timetable to say that you have to have .4 percent in infrastructure by the end of next year.

So -- so I didn't mean to confuse the issue by saying that this will or will not come true. It's just that we don't have a formal road map to get to these allocations in these periods of time.

MS. CANDACE EVERARD: And if I understand you correctly, that's in large part because it depends on what opportunities become available and when?

MR. DONALD PALMER: Yes.

THE CHAIRPERSON: If you do not mind, Ms. Everard, just something -- we're a little bit confused going back to past hearings, and maybe Mr. Palmer or Ms. McLaren could remind us a little going back to look at the documents.

But, as we understand the situation, the Corporation depends upon investment income to hold down the premium rates. You are not counting on underwriting losses that are not to be covered by investment income, so investment income is clearly important.

At a previous hearing I think you have outlined who is responsible for what. And if I recall properly, you have an investment department and you have an Investment Committee. And my understanding is, and this is what I would like to have corrected, was that the Corporation sets its investment policy and manages and gives direction with respect to equities, and the

Department of Finance has been basically managing the bond portfolio.

Do I have that correct?

MS. MARILYN MCLAREN: No, Mr. Chairman, not -- not quite. But statute, the Minister of Finance is responsible for the investments of the Corporation. We have a collaborative process where the -- the operationalization of -- of the Corporation's investment decisions really are in the Investment Committee Working Group, which is a group of people comprised of both Department of Finance and Manitoba Public Insurance that works together.

The Department of Finance, the Treasury Branch, has, for years, since the beginning of time, I believe, assumed direct responsibility for managing the bonds, absolutely. But it is also the Department of Finance that -- that enters into contracts with equity managers. They work with us. And the Minister of Finance vets the Investment Policy Statement and -- and all the other pieces of that are -- are done collaboratively with the final decision making at the Department of Finance.

So it's not like we take care of the equities and they take care of bonds. It really does flow into the Department of Finance on all as -- sorry, all aspects. Decisions about real estate, decisions about, you know, infrastructure and so on will -- will still flow into and final decisions made by the Minister of Finance.

So they have direct conduct -- conduct over the bonds, but they and we jointly oversee the managers who they hire to invest the equities.

THE CHAIRPERSON: So a matter, for example, like re-balancing a portfolio, no instructions would be -- basically blanket in nature, would all be subject to discussion between the Corporation and the Department of Finance.

MS. MARILYN MCLAREN: Right.

THE CHAIRPERSON: Thank you.

MS. MARILYN MCLAREN: And -- and I think, sir, Mr. Chairman and Ms. Everard, you know, in terms of the last little bit of the conversation between you and Mr. Palmer, that -- that's exactly the heart of it. You know, this is -- these alternative classes are a new territory for the Basic insurance investment portfolio, a new territory for the Department of Finance.

And, yes, this is our plan. We stand behind it. It is a plan. It's part of our business plan. It is where we're headed. But not in the absence of appropriate opportunities. And there are constraints, we talked about one (1). As the real estate will be Canadian I'm prepared to bet that we'll end up with some sort of infrastructure that's closer to home than rather than not two (2) so -- so there are constraints.

CONTINUED BY MS. CANDACE EVERARD:

MS. CANDACE EVERARD: Thank you. Just speaking about this chart a little bit more, and I appreciate the -- the comments that have been made with respect to how these numbers will actually unfold, we do note that there is an intention to increase the component of Universe Bonds in the portfolio.

And that was something that flowed from AON, if I'm correct?

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: Now, the numbers here are to increase from, in the current year, 38.5 percent of the portfolio, up to about 52.7 through the end of the outlook period.

Is that something that the Corporation is -- is unsure about it, in terms of whether it will unfold, or is there more certainty, given the nature of the asset?

MR. DONALD PALMER: Again, there's market opportunities with regard to interest rates and whatnot, so I would say that, again, this is a roadmap more than fixed numbers, that should be relied upon on a year-by-year basis.

MS. CANDACE EVERARD: And what are the features of Universe Bonds compared with the other types?

MR. DONALD PALMER: Universe just means that they cover all maturities, both short, medium, and Long Term Bonds.

MS. CANDACE EVERARD: So what makes what's characterized here as Universe Bonds different from the line above which is characterized as Long Term Bonds?

MR. DONALD PALMER: Long is solely looking at longer duration bonds. The two (2) categories are not mutually exclusive. Universe would include some Long -- Long Term Bonds.

MS. CANDACE EVERARD: And I -- I appreciate the context of our discussion and -- and with respect to how married the Corporation is to this chart. Can you give us an idea or an indication of when the transition to the new mix will be complete.

Is that something you can give us a ballpark on at this point?

MR. DONALD PALMER: I -- I indicated five (5) years. I think that's a -- a reasonable timeframe.

MS. CANDACE EVERARD: Okay. Thank you. I'm going to ask you to turn back to the Investment Policy Statement, which we looked at a little bit and Ms. McLaren spoke about it a little bit a minute ago.

Is it the case that the Investment Policy Statement is created or revised as between the Corporation and the Department of Finance?

MR. DONALD PALMER: Yes, it is a document that is drafted by the Investment Committee Working Group. It is endorsed or approved by our board of directors, so both the Department of Finance and the Corporation would be considered owners of this document.

MS. CANDACE EVERARD: And we know from the evidence Ms. McLaren just gave and from prior hearings, that the Investment Committee Working Group is comprised of representatives of the Corporation as well as representatives of the Department of Finance.

Who from the Corporation sits on that committee?

MR. DONALD PALMER: It's myself and Mr. Bunston sitting beside me; Ottmar Kramer, our corporate controller; Brian Jackson, who is our manager of treasury and disbursements, and of course I'm -- I'm missing the most important member of all, the president, Ms. McLaren. I just saved the best till last.

MS. CANDACE EVERARD: Okay, I was already going to make a brown-nosing comment and now I just can't -- not, so I'll just leave it at that.

Okay. Now, Ms. McLaren, you said a minute ago that the Investment Policy Statement is certainly vetted by the Department of Finance and, Mr. Palmer, you've stated that it's sort of a -- a jointly owned document, and we've heard that the decisions with respect to the management of the portfolio are basically made by the Department of Finance.

What kind of input though does the Corporation's representatives have into those decisions?

MR. DONALD PALMER: Certainly we're -- we're the experts when it comes to the liabilities of the Corporation. The Investment Policy Statement cannot be drafted without consideration of the liabilities that these investments are covering, so with regard to the duration of our liabilities that's certainly the calculations that are done within the Corporation.

There are sometimes other operational considerations that the corporate representatives would know about that maybe the Department of -- that we would have to inform the Department of Finance about, some cash requirements for instance. When -- in the past years when for instance the Board has ordered a -- a rebate, had to make sure that we had enough cash on hand to -- to fund that, so any sort of immediate cash requirements.

The opportunity with regard to City Place came to the Corporation first as far, as a capital asset. That of course was discussed at the Investment Committee because it did include a component of -- of investments that would satisfy some of our real estate requirement in the asset mix in the Investment Policy statement.

So it's both from a -- the operational and -- and insurance considerations are certainly what the Corporate representatives would bring to bear to that committee.

MS. MARILYN MCLAREN: And the Corporation's Investment Department is a resource to the senior members of the Investment Committee Working Group. They do the analysis, they do the research, they're often the people in direct contact with equity managers, you know, to -- to execute the direction of the more senior members of the Investment Committee Working Group.

So in -- investment decisions are -- are made collaboratively and then it is -- the committee as a whole, it's their responsibility to get the support of the Investment Committee of the Board. It is the Department of Finance representatives to get the support of their senior management and the Minister in the

Department of Finance.

MS. CANDACE EVERARD: So -- and I -- I do want to confirm something that you just said, Ms. McLaren.

But just going back for a minute to your evidence, Mr. Palmer, it would be fair to say then that the Department of Finance relies fairly heavily on the Corporation's representatives with respect to operational considerations as well as insurance considerations?

MR. DONALD PALMER: Yes, and the investment monitoring as well, which is done by the Investment Department within the Corporation.

MS. CANDACE EVERARD: And that was going to be my next question further to Ms. McLaren's contribution, which was that the Department of Finance does rely on the Corporation, certainly to an extent, with respect to the investment details also. If -- if I understood your evidence correctly.

MS. MARILYN MCLAREN: In -- in terms of doing the, you know, the -- the work, the analysis, the research, bringing forward -- and I mean this in the best possible sense -- almost an -- an academic source of information about these new asset classes, good quality research that informs the discussion. But having said that the way the group does work together though is -- is that, you know, the senior leadership from the Department of Finance is -- is -- has the recognized expertise with respect to the issues and the -- the specifics. You know, the formal professional expertise of the investments resides there.

MS. CANDACE EVERARD: Are you aware of a -- a situation or do you recall a situation where the investment people from the Corporation and the expertise of the Department of Finance were in conflict, where there was disagreement as to a particular step that -- that should be taken, whether it was an investment or something in the policy statement or anything?

Or -- does the group make decisions by consensus?

MS. MARILYN MCLAREN: Largely consensus. And, no, I don't remember a specific situation where there was, you know, divergent opinions amongst the groups in terms of the information in front.

I think it's fair to say that the people in the Investment Department are -- are investment professionals and tend to look at issues first from that perspective, and -- and almost everything in that investment world is all about economic strength, economic impart. Whereas, you know, the CFO and sometimes the more senior members from the Department of Finance are looking at it more as a financial and, you know, fiscal year kind of situation, as well as longer term economic impact.

And -- and there are issues that probably the more senior members of both organizations have different perspectives on, on occasion, than the investment analysts working for the Corporation: issues with respect to are we going to stick with Canadian equity, are we going worldwide; things like that; those more public policy, policy decisions with respect to what's appropriate for this compulsory insurance program.

Those perspectives, in my experience, are very well aligned between the senior Department of Finance people and senior corporate officials, but that broader perspective is that -- is probably one of the few places there would be any different approach, or different perspectives, from the members of the committee as a whole.

MS. CANDACE EVERARD: And if that situation arose, who would have the casting vote, or the deciding word, if you will? Is it a situation where the Department of Finance can simply pull rank and make the decision over objections of the Corporation's representatives, or is that not the case?

MS. MARILYN MCLAREN: At -- at the -- the ultimate decision making? Absolutely, the Minister of Finance would have that authority. Absolutely. Within the Investment Committee Working Group, I -- I don't recall a situation like that, that's every evolved, you know, but -- but clearly the legislated authority sits with the Minister of Finance.

(BRIEF PAUSE)

THE CHAIRPERSON: So I take it decisions are taken cautiously?

MS. MARILYN MCLAREN: MPI, stability, stability, stability, was that -- we -- we are not aggressive investors at the Investment Committee Working Group, no.

THE CHAIRPERSON: Has there ever been an outside agency to be hired or engaged to look at the general functioning of the decision making, related to investments rather than the asset class mix?

MS. MARILYN MCLAREN: No.

THE CHAIRPERSON: Thank you.

CONTINUED BY MS. CANDACE EVERARD:

MS. CANDACE EVERARD: Ms. McLaren, just to follow-up, I -- I think you said that the senior management of the Corporation considers more the financial fiscal year, is it? I'm not sure if I heard that correctly, but I just would ask you to clarify that statement, if you would

MS. MARILYN MCLAREN: Yeah, I think it's a good opportunity to clarify both of that. What I said is, when it comes to broader public policy considerations -- and sometimes that includes the impact of a potential investment decision on the financial situation of the Corporation, which generally means, you know, income statement fiscal year basis, as opposed to assets and -- and economic.

With respect to those broader issues of pubic policy, if there's ever different perspectives discussed at the Investment Committee Working Group, the senior management of the Corporation and the senior management from Department of Finance tend, in my experience, to be very well aligned on those issues. And sometimes the staff from the Investment Department tend to have a more pure investment -- professional investment approach to it without those broader policy issues.

So senior management from both MPI and the Department of Finance are aligned on those issues, in my experience.

(BRIEF PAUSE)

MS. CANDACE EVERARD: So -- and -- and not to get too much detail on this, but just to -- to ensure that we understand, has there been a situation where the investment staff, who you said look more at the pure investment side of it, where they may have a view of a particular investment, say whether to keep or -- or to sell off that particular investment, whereas the -- the more senior management, who are more concerned with the finances, in terms of the fiscal year as well as the policy issues, may want to make a sale to generate the -- the income that would follow?

Do -- do you understand my question?

MS. MARILYN MCLAREN: I understand the question. And -- and, no, both of those examples wouldn't be something that's happened, in our experience.

I can give you an example though. You know, I mean I think the AON report was also from a very pure investment, professional investment perspective. It talked about 'don't hedge US equities'. And, quite frankly, the disconnect between the changing value of those investments themselves, based on the US dollar that sits up in, you know, the balance sheet, as opposed to the changing value of the hedge that hits the income statement, is an example, a good example, of where we've had conversations about sort of the -- the financial impact.

When the dollar was appreciating and we had extra money flow into the income statement, formed part of a rebate a few years ago, the money is gone now, is rebated back to customers. $25 million out of the under-budget investment income we had last year was by the other side of that equation, taking a hit when the dollar started to fall.

So, you know, $25 million impact/$35 million impact, on net income of the Corporation, that's significant to us and that bears consideration, whereas from the pure investment, you see recommendations come in that say, you know, just don't worry about the hedge at all. What we're worried about is the disconnect between where the hedge hits and where the actual change in the value of the investment hits.

So those are the kinds of things -- that would be an example of some of those discussions.

MS. CANDACE EVERARD: Thank you, that's helpful.

We were looking at the Investment Policy Statement, which is at Tab 16, and we were looking at the blackline version, which is 2-8, or part of the response to 2-8.

If we look at the narrative portion of that answer, prior to the actual policy statement being provided, the Corporation has identified three (3) major amendments to the Investment Policy Statement since last year. And so what I'd ask you to do is just, Mr. Palmer, explain, in rough detail, what the three (3) major changes were and then we'll go from there.

MR. DONALD PALMER: The first change was with regard to the benchmarks that are -- that are used. The benchmark for non-marketable bonds was changed from the DEX Universe Total Return Bond Index, to the DEX Provincial Total Return Bond Index, just because it better matches the composition of the non-marketable bond portfolio, with regard to duration of those bonds.

We had added Canadian real estate and infrastructure into our Investment Policy Statement the year before. We had not determined what the benchmarks that we would use for those two (2) assets would be. We added those benchmarks, Canadian real estate being the ICREIM/IPD Canadian Property Index and the CPI plus 5 percent for infrastructure.

We had -- there's a requirement, in terms of credit rating of -- of companies' bonds we hold, and previously it said if the security has a split credit rating -- rating then the credit rating agencies, the lower rating will be accepted, so there are some companies that may have two (2) ratings from different rating agencies. And we just added that requirement, if that happens we would take the lower.

And the third one was with regard to compliance rules. A sentence was added that explicitly provided the Investment Committee Working Group the authority to provide exemptions for compliance rules, rather than go directly to the Investment Committee of the Board. There are a number of instances where our investment managers will not be in compliance, in strict compliance, with the Investment Policy Statement or -- or the terms of the individual investment contract, and often they're minor in nature, temporary in nature. For instance there's market -- markets changes, there may be a difference in the make-up of a manager's individual portfolio, and they sometimes ask for exemptions to -- to the rules.

When -- and we've just added a clause that says that the Investment Committee Working Group could provide those exemptions rather than going right to the Investment -- Investment Committee of the Board.

The Investment Committee Working Group meets monthly, with the exception of July. The

Investment Committee of the Board meets less often than that, I think it's five (5) or six (6) times a year. So some of that is just the timing of that. It was just operationally more effective to do it that way.

MS. CANDACE EVERARD: And as the change provides, the exemptions, once granted, will still be reported to the Investment Committee?

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: Now, you said that in -- if I heard your evidence correctly, that, in most cases, the exemptions are requested just because there's a minor or a temporary divergence at play.

Is that the case and -- and what arises -- or what occurs if there is something that is more significant than that that's perhaps not minor, but major, or -- and is not particularly temporary?

Has that situation arisen in the last year?

(BRIEF PAUSE)

MR. DONALD PALMER: There are some exemptions that aren't granted, that we -- we have -- one (1) manager who is specifically fond of financials, has been from time to time overweight in those financials and

-- and asked for -- that a change to the asset -- or recommended asset mix, in terms of amount he can have in one (1) sector or another, that, again, if it's something very minor and short-term, we would grant that, but, in other cases, when it's some larger amount, we would ask him to reduce the exposure to a give sector.

So another manager -- there's a requirement in -- in the cash being held by a certain -- for each manager, from time to time, as opportunities present themselves, that cash may be -- they may be higher in cash. Last year cash was a great place to be, so we weren't too upset about that.

So there are a number of those situations that arise from time to time. Certainly, we don't grant all exemptions that are being requested.

MS. CANDACE EVERARD: I -- and I'm surmising from your answer that these requests are considered on a case by case basis, but if that's not true, tell me. And, also, can you tell me whether there's a set of criteria that are considered, or is there anything formal in that regard?

MR. DONALD PALMER: They are case by case, and -- and we certainly have the Investment Policy Statement as our overriding policy from that standpoint. But there are some special cases that come up. We didn't necessarily have a criteria regarding how good a place cash was the last year.

So there are overriding policy be -- based on the policy statement, but there are some special circumstances that come up, as well. So I would say it would be a -- be a mix of predetermined criteria and some circu -- some decisions just based on individual circumstances. The -- and each one of our investment managers does have manager's contract, and that certainly would be an overriding guide, as well.

MS. CANDACE EVERARD: Thank you. I'm going to ask you to turn to SM.8.8 for a moment, which is of course in Volume I of the Application.

(BRIEF PAUSE)

MS. CANDACE EVERARD: Just, for the record, it's Section SM.8.8 of Volume I.

MR. DONALD PALMER: I have it.

MS. CANDACE EVERARD: In particular I'd ask you to look at page 10, where we see Section SM.8.8.4 entitled "Selling of Securities".

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: This relates to a recommendation in last year's order by this Board, that the Corporation quote:

"Restrict or prohibit the selling of
securities for the sole purpose of
generating investment gains, only to
repurchase the identical securities."
Closed quote.

If you could read in what follows and then add any additional commentary that you may wish to add on the subject.

MR. DONALD PALMER: "Securities will be
bought and sold based on specific
economic circumstances in the opinions
of the fund managers, in order to
maximize returns.
The Corporation provides no direction
to the fund managers as to specific
assets that are to be purchased or sold
or to facilitate taking of gains. The
selling and repurchasing of securities
for the purpose of generating gains has
not been done since June 2007."

And that's still true, we have not taken any gains since then.

MS. CANDACE EVERARD: Thank you. I'd ask you to turn back to Tab 15 in the book of documents, which is the answer to Question 7 posed by the Board in the First Round. And in particular look at page 4 of that IR. In the table that's reflected there, there's a line in the third section of the table entitled "Management Fees," which reflects in and around $3 million in management fees from '06'/'07 through to '08/'09.

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: Can you tell me, firstly, how the quantum of the management fees is determined in a given year?

(BRIEF PAUSE)

MR. DONALD PALMER: It would be a combination of percent of assets and some transaction fee, as well.

MS. CANDACE EVERARD: Is there any performance criteria that's built into the compensation package for managers?

MR. DONALD PALMER: No.

MS. CANDACE EVERARD: Are the -- the whole of these management fees paid to the outside investment managers, or is any portion of this paid to the province or the Department of Finance?

MR. DONALD PALMER: It would be the combined management fees to the province and to the investment managers. The amount paid to the province is about a million dollars per year.

MS. CANDACE EVERARD: And that's for the services provided by the Department of Finance, or for what?

MR. DONALD PALMER: Yes. Yes. And -- and again, since they're the investment managers for the fixed income part of our portfolio, which is approximately 80 percent.

MS. CANDACE EVERARD: Now we noted a moment ago, that for the last three (3) years the fees have hovered in and around the $3 million mark. And it would appear from this table that, that number is projected to drop fairly considerably in the current year to about 2.3 million, and to stay there in the year of the application.

What is behind that decrease?

MR. DONALD PALMER: Because they're based on percentage of assets and we dropped in the value of assets. That would certainly be a large part of that.

MS. CANDACE EVERARD: Thank you. While we're on this chart and looking at the management fee line, I'll ask you to look at the line immediately below, which is entitled "Pension Fund Transfer".

Can you explain, for the record, what that is, to whom it's paid, and for what?

MR. DONALD PALMER: It's not really paid to anybody. What it is is there is an assumed investment return within our pension evalu -- our evaluation of liabilities for employee benefits. So we already take credit for that and the discounting of those liabilities, so this is a deduction from that.

So it's -- essentially we've taken pre-credit for it. So from that standpoint it's -- it doesn't get paid to anybody, it's just we take credit for it in the discounting of those pension liabilities.

MS. CANDACE EVERARD: Thank you. Mr. Chairman, I'm about to move into investment income and I note the time, so it may be a good time for our afternoon break.

THE CHAIRPERSON: Sounds great. Thanks.

--- Upon recessing at 2:42 p.m.

--- Upon resuming at 3:07 p.m.

THE CHAIRPERSON: Ms. Everard...?

MS. CANDACE EVERARD: Thank you, Mr. Chairman. Just before I resume the cross-examination, a couple of housekeeping matters that I wanted to put off the record -- put on the record rather.

The first of which was a suggestion from Ms. Kalinowsky so I thank her for that. As the procedural outline reflects and has -- has been referenced on Tuesday, next week we will be hearing from Richard Olfert from Deloitte with respect to cost allocation issues. What has not been said yet on the record is that the intention is that Mr. Olfert will be sworn in basically as part of the MPI panel.

So I just wanted to ensure that Mr. Williams and all of the other Intervenors are aware of that. Now I note Mr. Oakes and Mr. Dawson aren't here but hopefully they will read this in the transcript or I'll mention it to them tomorrow. So that is that anything cost allocation related whether it's for Mr. Olfert or for the MPI witnesses, should be dealt with on Tuesday. And it is the intention also that Mr. Olfert will have a direct examination by Ms. Kalinowsky first-off, then cross-examination by Board counsel, and lastly cross-examination by the Intervenors.

So that's the -- the game plan for Tuesday.

The other point that's become apparent is although we had planned to hear from Doctors Hum and

Simpson next Thursday, it's probably not going to be able to work for the simple reason that it doesn't look like the, possibly Board counsel, or certainly the Intervenors, will have finished their cross-examination of the MPI panel by then. Hopefully I'll be done, but -- but it doesn't look like the Intervenors will be and of course it wouldn't be appropriate to have Doctors Hum and Simpson testify until the cross-examination of the panel is closed.

So for that reason Mr. Williams is going to enquire into whether Doctors Hum and Simpson could be produced on Monday the 26th, which will be the next hearing date after next Thursday.

Do you have word from them?

MR. BYRON WILLIAMS: I -- I don't have heard, thank you, Ms. Everard. We've enquired into the 26th and also November the 2nd. And hopefully we'll be able to accommodate the Board schedule.

MS. CANDACE EVERARD: And we'll continue to deal with that as we have more information. But everyone should be aware of those details, so...

CONTINUED BY MS. CANDACE EVERARD:

MS. CANDACE EVERARD: Alrighty then, moving back into the cross-examination and in particular issues related to investment income, we've had a bit of evidence already from the panel that investment income is typically very important for rate setting purposes and to the operating results of the Corporation.

That would be correct?

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: Now we've been spending a lot of time at Tab 15 of the book of documents, so let's spend some more time there and look at page 4, which is actually the same page that we were looking at. This is a breakout of the Corporate investment income, and we'll get into allocation and Basic share a little bit later on.

So it would appear that the corporate total investment income for the year that just finished, '08/'09, was some $4.6 million.

Is that right?

MR. OTTMAR KRAMER: Yes, that's correct.

MS. CANDACE EVERARD: And it would appear that for the current year, 2009/'10, there's a projection of some 97.4 million in investment income. Hopefully, that number will increase for the year of the application to some 101.6 million.

Is that right?

MR. OTTMAR KRAMER: Yes, that's correct,

on a corporate basis.

MS. CANDACE EVERARD: And through the outlook period, as reflected here, it's hoped that the investment income for the Corporation will reach 133 million in 2013/'14.

Is that right?

MR. OTTMAR KRAMER: Yes, that's the forecast for 2013/'14.

MS. CANDACE EVERARD: And the components of the investment income to the Corporation, as reflected on this table, are short-term interest, Long Term Bond income, equity dividends, equity gains, or losses, as the case may be, gains or losses on the sale of Held For Trading Bonds, unrealized gains or losses on Held For Trading Bonds, as well as EAFE, which we previously defined, dividends or gains, infrastructure income, and real estate income.

Is that correct?

MR. OTTMAR KRAMER: Yes, those are the categories.

MS. CANDACE EVERARD: And the majority of the investment returns inflowing to the Corporation are from Long Term Bonds.

Is that right?

MR. OTTMAR KRAMER: Yes, that's correct.

MS. CANDACE EVERARD: And this would be due to the significant weighting of Long Term Bonds in the investment portfolio?

MR. OTTMAR KRAMER: Yes, that's generally true.

MS. CANDACE EVERARD: Now, does the series of forecasts set out in this table for investment income reflect the new weightings in the portfolio?

MR. OTTMAR KRAMER: Yes, the weightings that are on the previous page that were discussed earlier, those are the weightings that are used to calculate these forecasted incomes.

MS. CANDACE EVERARD: Now, if we look at some of these components individually, the first line item is short-term interest, which for the year that just ended, 2008/2009, was some $4.2 million, and that's projected to decrease in the current year to some six hundred and ten thousand dollars ($610,000).

Is that correct?

MR. OTTMAR KRAMER: Yes, that is correct.

MS. CANDACE EVERARD: And for clarity, what was the reason for that decrease?

MR. OTTMAR KRAMER: The -- the reason for the decrease is driven by two (2) factors, the first one being the yield percentage which is also shown on page 5.

The short-term yield percentage decreases considerably from a -- from an average of 1.9 percent to a forecast of .44 percent. That's the first factor.

The second factor is, as you had already discussed with Mr. Palmer earlier, the cash to short-term investment portion of the total portfolio also decreases.

So both of those factors cause short-term interest income to decrease.

MS. CANDACE EVERARD: Now, it would appear from the forecasts reflected in this table that that figure is hoped to increase throughout the outlook period, and the figure reflected here for 2013/'14 is some $2.3 million.

Is that correct?

MR. OTTMAR KRAMER: Yes, that is correct.

MS. CANDACE EVERARD: Now, looking at the Long Term Bond income, which we've already identified is the majority of the investment income, it would appear that for the year that just ended, 2008/2009, there was some 84.4 million, which is projected for the current year to decrease somewhat to about 77.1.

Is that correct?

MR. OTTMAR KRAMER: That's partially correct. In that Long Term Bond income, I'm not sure if your future question or your next question will be the gain and loss on Held For Trading Bonds and unrealized gain or loss from Held For Trading Bonds, while we've shown the actuals separately, any of the projects would include held for trading gains and losses also.

MS. CANDACE EVERARD: Okay. So if I understand your evidence correctly, where we have the -- the last two (2) line items under that first section of the table, which both relate to Held For Trading Bonds, we have entries there for '08/'09, but we have nothing for any subsequent year, you're telling us that those figures, what would notionally be there is included in the Long Term Bond line?

MR. OTTMAR KRAMER: Yes, that's correct.

MS. CANDACE EVERARD: Does the Corporation have the ability to break out those numbers and give us the specifics on the two (2) HFT lines?

MR. OTTMAR KRAMER: No, we don't. We really do not know what the unrealized gains or losses, or realized gains or losses, will be on Held For Trading.

Generally, within the Long Term Bond income, I believe that was in '07 that we introduced a bond gain into the income line of $5 million. We've got a general provision to have bond gains included in that Long Term Bond income of $5 million on a corporate basis.

MS. CANDACE EVERARD: So, if I understand you correctly, the approximation that the Corporation is using is 5 million?

MR. OTTMAR KRAMER: Yes, 5 million is included.

MS. CANDACE EVERARD: Now, as we look along the Long Term Bond line, continuing through the outlook period, the figure for the year of the application, has that just under 74 million, and then it's hoped that it will rebound to about 78 in the next couple of years.

Is that right?

MR. OTTMAR KRAMER: Yes, that is correct.

MS. CANDACE EVERARD: Now, if we look at the corporate total line at the bottom of this table, it appears that the corporate total of investment income in the '07/'08 year was 125 1/2 million, which has -- has already been indicated, decreased to about 4.6 last year?

MR. OTTMAR KRAMER: Yes, that is correct.

MS. CANDACE EVERARD: And that was due to the equity losses reflected here, of some 80.4 million?

MR. OTTMAR KRAMER: That's correct. I think Don gave some -- Mr. Palmer gave some earlier evidence on the equity losses, the foreign exchange losses, and some write-downs that we had last year.

MS. CANDACE EVERARD: And -- and I'm

going to come to that a little bit later on, getting into those three (3) components of that eighty point four (80.4).

I'd ask you now to look across the page to page 5 of this IR response, and the first table, which compares the actual results for '08/'09 with that, which was forecasted for last year at last year's GRA. We note that in the short-term interest line there was almost a 64 percent increase in the actual, versus that which was forecasted a year ago.

What was behind that significant increase?

MR. OTTMAR KRAMER: That was really driven by the increase in the cash and short-term investments that we had discussed earlier.

MS. CANDACE EVERARD: That was the cash that was accumulated to fund the real estate purchase at City Place?

MR. OTTMAR KRAMER: Some of the funds were used to purchase real estate, others were just a maturity that hadn't been reinvested, based on market timings and other factors.

MS. CANDACE EVERARD: And looking at the next line on that table, relating to Long Term Bond income, there was a decrease in the actual over what was forecast of about 6 percent.

That was caused by lower interest rates than anticipated, or some other cause?

MR. OTTMAR KRAMER: That -- that's primarily lower interest rates, that's correct.

MS. CANDACE EVERARD: And then the equity dividend line, the next one, was down by some 37 percent, and on the fourth line there was an equity loss of about 110 percent.

Is that right?

MR. OTTMAR KRAMER: Yes, that's correct.

MS. CANDACE EVERARD: Now, looking at the next two (2) lines that relate to the Held For Trading Bonds, it's indicated that there was a gain on the sale of some bonds at six point five (6.5), as well as an unrealized loss of five point five (5.5).

Do those figures relate to the change in designation of bonds that -- that had been acquired on '08/'09?

MR. OTTMAR KRAMER: No, that's not as a result of the change in designated. Those are as a result of bonds that were purchased as Held For Trading, that either increased and -- increased and/or decreased or -- on an unrealized basis and on a realized basis. It has nothing to do with a change in designation, but the -- the fact that those bonds at the time of purchase were designated as Held For Trading.

(BRIEF PAUSE)

MS. CANDACE EVERARD: So, looking at the subtotal line on this particular chart, it's reflected that the Corporate investment income was about 93.4 million less than what was forecasted, and that was driven primarily by the equity losses?

MR. OTTMAR KRAMER: Yes, that's correct.

MS. CANDACE EVERARD: Just coming back to the question of management fees for a moment. We spoke about those a little bit earlier on -- on a corporate basis. I note that the management fees were forecasted to be 2.7, almost 2.8 million, and turned out to be about 2.9, and we spoke about the management fees being based in part on the balance in the portfolio.

Why the increase when there was a downturn in the portfolio itself?

MR. OTTMAR KRAMER: The portfolio downturn happened fairly late in the year. So for the first six (6) months or even longer, the portfolio was actually quite a bit higher than forecast and -- and the downturn happened late in the year.

MS. CANDACE EVERARD: Okay. I'd ask you

turn the page to 1-7(d), still at Tab 15 in the book of documents. This is a table that reflects the differences between the investment income forecasts that were projected and then forecast over a number of years. We'll start at the right-hand side which is the earliest year, the '04/'05 fiscal year.

If I'm reading this correctly, at the '04 GRA it was projected that investment income for the Corporation would be some 81.9 million, that was revised down to 75.2 at the '05 GRA, and then at the '06 GRA it became apparent that the actual for that year was 88.6 million.

Is that right?

MR. OTTMAR KRAMER: Yes, that is correct.

MS. CANDACE EVERARD: For the next year 2005/2006, the original projection at the '05 GRA was some 82.9 or 83 million, revised up to 135.6 at the '06 GRA, and revised up again when the actual figures were available at the '07 GRA, to 166.5.

Is that right? MR. OTTMAR KRAMER: Yes, that's correct.

MS. CANDACE EVERARD: And then in the next year '06/'07, we had an original projection at the '06 GRA of 86.3 million, which was revised at the '07 GRA upwards, and then again the actuals turned out to be

120.4 million at the '08 GRA.

Is that correct?

MR. OTTMAR KRAMER: Yes, that's correct.

MS. CANDACE EVERARD: In '07/'08, the original projection at the '07 GRA was 95.8 million, revised up to a 139.3 at the '08 GRA, and the actual was 125.5, and that became apparent at the '09 GRA.

Is that correct?

MR. OTTMAR KRAMER: Yes, that's correct.

MS. CANDACE EVERARD: Now, in each of these years the final outcome was higher, and in some cases very significantly higher, than the original projection on which that year's rate application was based?

MR. OTTMAR KRAMER: Yes. I think we would discuss this in prior years, that it was higher primarily due to the equity gains.

MS. CANDACE EVERARD: So it would be fair to say that in those years the level of equity gains that was forecasted originally was significantly lower than that which was actually received?

MR. OTTMAR KRAMER: Yes, that the AV actuals came in due to the market forces applicable at that time, the actual equity loss -- or equity gain, sorry -- I said losses -- which we went through this year. But the actual equity gains were -- were higher than initially forecast.

MS. CANDACE EVERARD: And in this past year as you've just indicated and as we've referred to a couple of times, there was a -- a large swing again, but this time in the other direction. A loss rather than a gain?

MR. OTTMAR KRAMER: That's correct.

(BRIEF PAUSE)

MS. CANDACE EVERARD: Now, I'll ask you to turn back a page again to page 5, and this time I want to look at the chart on the middle of the page, which compares the actual figures for last year, versus that which has been forecast for the current year. And it would appear that for the current year, 2009/'10, the Corporation is forecasting equity gains of about 12.8 million, which would contribute to a corporate total forecast of investment income for 97.4 million.

Is that correct?

MR. OTTMAR KRAMER: Yes, that is correct.

MS. CANDACE EVERARD: And as is reflected here, Basic's share of that 97.4 million is forecasted to be about 84.1 million, or 86.38 percent?

MR. OTTMAR KRAMER: Yes, that's correct.

MS. CANDACE EVERARD: And if we look at the next table, the last table on the sheet, which refers again to the current year, we see again the -- the figures that we just looked at, the $97.4 million forecast for Corporate, eighty-four point one (84.1) of which is allocated to Basic, that's decreased from last year's projection, which is in the second column, of about 7, close to 8 million.

Is that correct?

MR. OTTMAR KRAMER: The -- the decrease of 8.9 million on a corporate basis.

MS. CANDACE EVERARD: Yeah, I -- I was looking at -- whether you look at the corporate line or Basic's share -- why don't we just focus on Basic's share for the moment. The projection last year for the current year was ninety-one point nine (91.9) and that's reduced to eighty-four point one (84.1), so that's almost 8 million, I believe.

MR. OTTMAR KRAMER: Yes, that's correct.

MS. CANDACE EVERARD: Okay. And if we continue to speak about investment income, and in particular investment yields, for a couple of moments, we look at page 4 -- so just over from where we were just looking in the very bottom part of what appears on page

4, under the heading of "Yield Percentage".

This would be a reflection of investment yields in the various asset categories.

Is that correct?

MR. OTTMAR KRAMER: Yes, that's correct.

MS. CANDACE EVERARD: The first two (2) lines -- or the first two (2) rows, entitled "Short Term and Long Term" relate to bonds, I believe, and reflect certainly for '08/'09 and ensuing years, higher yields for the Long Term Bonds than the short-term?

MR. OTTMAR KRAMER: Yes, the -- the Long Term Bonds for '09/'10 onward are -- are higher than the short-term.

MS. CANDACE EVERARD: I think -- well, they were higher for '08/'09 also, right?

MR. OTTMAR KRAMER: Yes, that's correct.

MS. CANDACE EVERARD: Is the Corporation generally satisfied with the level of returns that it's forecasting on the bond portfolios?

MR. DONALD PALMER: Satisfied from a rate of return perspective, or satisfied that we -- for an accuracy perspective?

MS. CANDACE EVERARD: A rate of return perspective.

MR. DONALD PALMER: Certainly these are

correlated with inflation, right? Inflation is low, so our requirement for investment income is dampened somewhat.

You're also not -- not asking about the other side of that risk and reward equation, that these are very stable sources of income as well. So we're happy that -- with our risk reward trade-off, so to speak.

MS. CANDACE EVERARD: And I wasn't implying that you should or shouldn't be satisfied. I was just asking whether the Corporation is.

MR. DONALD PALMER: Sure. And, again, to -- to quote Ms. McLaren, "stability, stability, stability". So, from that standpoint, stable returns may -- are what we're after.

MS. CANDACE EVERARD: Certainly those comments applying to bonds are probably conversely applicable to equities, because we see here the -- the yield percentages for '07/'08 being over 12 percent, and then, of course, for last year being a negative eighteen (18).

MR. DONALD PALMER: Yes.

THE CHAIRPERSON: I understand your comments earlier over the shared jurisdiction, but you weren't too disquieted by the rebound in equity values, and the fact by not re-balancing your portfolio at the end of your fiscal year, your participation in the revival was somewhat muted?

I'm reflecting on the fact that interest rates right now are, how do you put, at historic lows, with respect to short-term, driven mainly by macro moves of various central banks, which are not necessarily reflective of anything other than a desire to create an economic rebound. And with short-term money that was described at a recent Centra hearing as being sale, the only opportunity for yield really is apparently with equities. That seems to be the drive.

MR. DONALD PALMER: Well, our asset mix has gone up just because of the return on the equities that we have, so, no, I'm not really disquieted, based on -- on that, in terms of -- again, our -- our goal is to break even over the long-term. So from a standpoint of making sure that we cover the liabilities and that we have a stable income stream coming from our investment incomes, or investment income, I'm not necessarily disquieted by -- by that, no.

THE CHAIRPERSON: I understand your comment. I was just reflecting -- not to be troublesome, but just since we are here, reflecting on it the fact that you had indicated before the Corporation re-balances from time to time.

And, of course, when things go down, as the markets, when they collapse by say whatever percent, 60 percent, when they go up by 60 percent you do not necessarily recover it because it is on a lower base. And the only way that a portfolio could recover is by re-balancing.

So if you were eighty twenty (80:20) say at the beginning, and because the market went down on the 20 by 60 percent, if you did not re-balance, the 60 percent going the other way would prevent you from recovering.

That's true, is it not?

MR. DONALD PALMER: To a certain point. The other part of low interest rates, or rates coming down, is that the value of a bond portfolio goes up. So there are also significant unrealized gains in -- in the bond portfolio as well, that will occur when the interest rates come down to the levels that they currently are.

THE CHAIRPERSON: And I grant you that no one has a crystal ball, so to speak.

Ms. Everard...?

CONTINUED BY MS. CANDACE EVERARD:

MS. CANDACE EVERARD: Thank you, Mr.

Chairman.

Mr. Palmer, continuing to look at the investment yield percentage chart here, can you tell us how the projection for 2009/10 was determined for equities, that is the 6.23 percent, which we see for that year and a number of the ensuing years.

MR. DONALD PALMER: And that's outlined in our revenue forecast book of TI.18. These number change every year, and I don't necessarily have it right, but TI.18.

We have traditionally used a equity risk premium of a point and a half. And with our bond rates so low we -- and in the short-term, but looking to recover over the longer term, we didn't think it was reasonable to have a -- an equity return that necessarily parallelled the short-term swing in -- in bond rates.

So we smoothed it out over a five (5) year period and -- and still maintained that 1 1/2 percent equity risk premium, but that was on the -- for the longer term, rather than the -- the short-term returns that we're seeing on Long Term Bonds.

(BRIEF PAUSE)

MS. CANDACE EVERARD: So, just to

clarify, Mr. -- Mr. Palmer, is the Corporation applying the 1.5 percent equity risk premium to the ten (10) year bond rate? Is that -- that's what used to happen, and I just want to make sure that that's what you're saying.

MR. DONALD PALMER: Spread over a long -- a longer -- the long-term ten (10) year bond rate, if that makes sense, rather than -- we have a -- ten (10) year bonds are projected, right now they have a very your -- low yield and they're projected to recover over a longer period of time, so that it's that eventual ten (10) year bond rate that we're applying the equity-risk premium to.

MS. CANDACE EVERARD: So you're not using just the current rate of the day because it's so low?

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: And I -- I gather, based on your evidence, that the Corporation's historical return on equities does not factor into the forecast?

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: So the losses that were suffered in the market in '08/'09 will not factor into the forecasts for the future?

MR. DONALD PALMER: That's correct.

(BRIEF PAUSE)

MS. CANDACE EVERARD: Now, I note on the yield percentage chart that we've been look at, that the projections and forecasts for the EAFE equities, which we've previously defined, are the same for the remaining equities.

Is that percentage calculated on the same basis or...?

MR. DONALD PALMER: Yes, we used the same equity-risk premium for EAFE as we did for other equities.

MS. CANDACE EVERARD: And why is that? Not -- not specifically, why it's the same equity-risk premium, but obviously the whole calculation method is the same for EAFE as it is for North American Equities, so we're just wanting to understand the why behind that.

(BRIEF PAUSE)

MR. DONALD PALMER: There is a high correlation between the rates of EAFE and -- and other -- other equity markets.

There is a -- a simplicity materiality factor in here too. We're talking about a -- a fairly low allocation to EAFE. We could spend a lot of time to -- and EAFE is fifty (50) different markets, as opposed to either just one (1) Canadian market or a US market. So we -- we just used the Canadian and US equities as a benchmark and -- and applied the same number.

MS. CANDACE EVERARD: Thank you. And just one (1) more question on this table. The following two (2) rows, or line items, relate to real estate and infrastructure, and the yield percentages that are projected and forecasted for those, in the case of real estate, are 5.5 percent for the current year and 6 percent thereafter, and the infrastructure percentage is 7 percent through the outlook period.

How were those arrived at?

MR. DONALD PALMER: Real estate is CPI plus 4 percent, and infrastructure is CPI plus 5 percent. The CPI plus 5 is -- is the benchmark that we're using for infrastructure, and for real estate it's kind of a long -- a long-term average.

MS. CANDACE EVERARD: And is that calculation, or those calculation methods being employed because these types of investments are hedges against inflation?

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: Okay. I'm going to ask you to turn to Tab 16 of the Board's book of documents and the -- back to the Investment Policy

Statement that we've looked at in a couple of places. I'm going to ask you to go to Section 5.5, which is found on page 12.

What's reflected at 5.5, as I understand it, is a representation of the Corporation's investment return objectives.

Is that correct? Once you're there, sorry.

(BRIEF PAUSE)

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: Now, we've spoken about the equities and the alternative investments, but I don't believe that we've spoken about the bonds.

Can you give us an idea of how the Corporation, I guess, together with the Department of Finance as the joint authors of this document, concluded that theses particular benchmarks were the appropriate ones for bonds?

(BRIEF PAUSE)

MR. DONALD PALMER: They correlate with the bonds that we're holding, so they're unavail --

easily available benchmark, and one that's applicable to the investment mix that we're talking about. And -- and DEX is the, basically the -- the generally accepted benchmark that's used for bond portfolios.

MS. CANDACE EVERARD: Thank you. Still at Tab 16, if I can get you to turn back to the first page at that tab, which is the answer to Question 10, posed by the Board in the First Round. And in particular, I'm looking at Answer B, which reflects a table setting out the actual and expected returns for each benchmark over a period of years.

Who is it that manages the returns against the benchmarks? Is it the investment managers?

MR. DONALD PALMER: The individual investment managers are -- are measured against those -- those benchmarks. I'm not sure that that's quite what you asked.

(BRIEF PAUSE)

MS. CANDACE EVERARD: Just to clarify, Mr. Palmer, we've had evidence already that the compensation that the managers receive isn't related to performance, so what if any consequences are there to managers, if benchmarks are not achieved?

MR. DONALD PALMER: Well, we have terminated two (2) managers in the last year and a half, so I think that's the consequence.

We do have a discipline procedure in the Investment Committee Working Group if -- and -- and those benchmarks are -- form part of the contracts, the investment manager's contracts, that they are measured against, if they fail to perform against those benchmarks, and we continue monitoring them. That rate of return isn't the only criteria on which they're measured, but it's certainly one of them.

And if they fail to -- to meet the -- the benchmark, then they are basically brought before the Investment Committee to -- to explain themselves, to explain the circumstances by which they didn't meech the -- meet the benchmarks, and are continued to be monitored on that basis.

That and other considerations, just in terms of -- of service, client relationship, those are a couple of the other criteria. And -- and if they continue to fail to meet the ma -- meet the benchmarks and provide what we consider a quality service, then they will be terminated.

MS. CANDACE EVERARD: And I -- I had noted the information that the Corporation had provided about the two (2) managers that were terminated. The -- the evidence, and this was in response to a CAC request, eighty-eight (88) -- if you want to go there; I don't know that you need to but -- but you certainly can if you want -- that answer reflects that there was an equity manager terminated on '08/'09 and that the assets managed by that manager went into the Exchange Traded Fund.

The first question is: Why was -- was that manager terminated? In a nutshell, I don't -- I don't need all the -- the dirt, just give me the -- the general overview.

MR. DONALD PALMER: Their performance could only be referred to as really, really, really bad. They were a poor performer, in terms of overall returns to the Corporation, not only from an absolute perspective or a benchmark per -- perspective, but certainly compared to their peers, and their grouping as well. So -- so that was -- that was the reason that they were terminated.

MS. CANDACE EVERARD: And -- and what is the Exchange Traded Fund, into which that manager's assets were transferred?

MR. DONALD PALMER: It's a passive fund of small and mid-cap. This was our US small cap manager, and we transferred those funds into a passively -- a passive fund to get index returns.

MS. CANDACE EVERARD: And did that manager manage the whole of the US small and mid-capitalization equities?

MR. DONALD PALMER: Yes.

MS. CANDACE EVERARD: Looking at the chart at the response to 1-10(b), and in particular the results at the end of '07/'08, it would appear for the US equities, and this is the very last line of the table, for the small to mid-capitalization equities, that the benchmark was a negative 8.2 percent and the actual result was a negative 24.8 percent.

We know that the -- that was -- that was them, okay.

MR. DONALD PALMER: That's them.

MS. CANDACE EVERARD: And we know that they were terminated in the next fiscal year. And we see that the result at the end of that fiscal year was a negative 52 1/2 percent, against a benchmark of a negative 43.7.

Is that right?

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: Now, you mentioned that there was a second manager that was also terminated, and the -- the response to the CAC IR Number 88, that I had mentioned, reflected that that termination took place in the current fiscal year -- so within the last eight (8) months or so, I guess -- and that the assets managed by that manager were transferred to another existing manager.

Why was that manager terminated and what type of assets were they managing?

MR. DONALD PALMER: That was gro -- Canadian Large Cap, was a growth manager. Again, terminated for repeated poor returns. There was also a poor service component of that termination, as well. And that was transferred to a -- an existing manager, also Canadian Large Cap, one that has a value style more than a growth style. We still have one (1) growth manager and currently two (2) value managers.

MS. CANDACE EVERARD: So my next question was going to be, and you may have partially answered that, whether or not the -- these subject assets of both of the managers that were terminated have enjoyed better performance since this -- the changes.

Can you comment on that.

MR. DONALD PALMER: It -- it's pretty difficult to -- to comment on that, especially with the Canadian manager, given it's been such a short period of time, and probably an unfair comparison. Before the termination the markets in general were very bad, and since -- since we transferred those funds the markets in general have been very good.

So from a direct comparison that's probably not really fair to -- to compare on that basis. Certainly, in a historical perspective, the -- we're happy with the performance of the manager that we transferred to, and that's why we transferred it to -- to that particular manager.

MS. CANDACE EVERARD: And if we just take a -- a look, for the moment, at the actual versus benchmark on the table for the Large Cap Canadian equities, we see that -- if we look a year back to '07/'08, the benchmark was eight point (8.3), the actual result was 3.5 percent. And then for the year that -- that ended this February, the '08/'09 year, the benchmark was a negative thirty-six point seven (36.7) and the actual result was a -- a negative 38 percent.

Is that right?

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: And just reviewing a couple more of the line items on this chart, staying with the Canadian equities for the moment, the small to mid-cap equities, again dealing with the '07/'08 year first, the benchmark was a negative 4.7 percent and the actual result was quite better -- the -- it was a positive two point three (2.3).

MR. DONALD PALMER: That's correct. That's one of the managers that we're very happy with.

MS. CANDACE EVERARD: And similarly, in the subsequent year, the '08/'09 year, the benchmark was a negative 47 1/2 percent, but the actual result was only a negative 36.3.

MR. DONALD PALMER: In terms of comparing to benchmarks, it's hard to say that our shining light of our portfolio had a return of minus 36 percent. But certainly they exceeded the benchmark by more than the other managers did.

MS. CANDACE EVERARD: They can only work within the market conditions, right?

Now, while we're on that line, I take it from the -- the letters "NA" appearing in the two (2) columns at the far right, which are '04/'05 and '05/'06, that the Corporation did not invest in those types of equities in those years.

Is that correct?

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: And we spoke about the US equities, small to mid cap. We didn't speak about the large capitalization. Just reviewing those benchmarks and actuals for the last two (2) years, we see in '07/'08 the benchmark was a negative two point one (2.1), and the actual, a negative seven point seven (7.7). And then for the last year, '08/'09, we see a benchmark of negative forty-one point eight (41.8), and an actual of negative forty-two point three (42.3).

So pretty close, is that correct?

MR. DONALD PALMER: That's correct. We were somewhat disappointed with that performance, being somewhat less than a benchmark. That is again one of the managers that has very recently spoke to the Investment Committee Working Group, in terms of explaining that performance.

So if you want to use the term that they've been put on notice, in terms of that discipline procedure they have been, but there's no action -- further action contemplated at this point in time.

MS. CANDACE EVERARD: And who is it? Who is that manager?

(BRIEF PAUSE)

MR. DONALD PALMER: We have actually never explicitly named the manager in any public document.

MS. CANDACE EVERARD: That's fine, it's not -- not a major issue.

Just -- I just want to go through some of these -- or at least one (1) of the bond lines before we leave this table, and that would be with respect to the Real Return Bonds. It would appear for the '07/'08 year that the benchmark was 2 1/2 percent and the actual result was 3 1/2 percent. And then in the last year, '08/'09, the benchmark was a negative 5.4 percent and the actual was a negative 8.1 percent.

Is that right?

MR. DONALD PALMER: That's correct.

MS. CANDACE EVERARD: Okay. Mr. Chairman, I'd be moving now to a -- a line of questions dealing with the allocation of investment income to Basic, and I note it's almost 4:00 so I'm in your hands as to whether you want me to keep going or call it a day.

THE CHAIRPERSON: Let's call it a day. Thanks, we'll see you all tomorrow at 9:00.

(MPI PANEL WITNESSES RETIRE)

--- Upon adjourning at 3:57 p.m.

Certified correct,

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Cheryl Lavigne, Ms.