

**B.C. HYDRO IGNORES THE AUDITOR GENERAL'S REPORT AND MAINTAINS THE B.C. UTILITIES COMMISSION IS INDEPENDENT**

Despite the opinion of B.C. Auditor General Carol Bellringer to the contrary, B.C. Hydro continues to insist that the B.C. Utilities Commission (BCUC) is independent. While not unexpected, this position misrepresents the current reality.

B.C. Hydro's financial structure and its net income (profit) targets depend on deferring expenditure and revenue variances through rate-regulated accounting. National public sector accounting standards require an independent third-party regulator to oversee the application of rate-regulated accounting schemes. Hence, to admit that the BCUC is not independent would require B.C. Hydro to eliminate approximately \$3.6 billion in net assets currently deferred.

While the NDP government has repealed some of the most egregious restrictions on the discretion of the BCUC, will the changes result in the auditor general withdrawing her qualification of the province's financial statements for FY2018/19?

**Rate-Regulated Accounting**

B.C. Hydro uses rate-regulated accounting to smooth potential rate shocks for its customers. Rate-regulated accounting is widely used in the regulated utility sector in North America and allows the utility to smooth the impact of unanticipated expenditure pressures in the rates by deferring these expenses rather than record them in the financial statement for that year.<sup>1</sup>

Rate-regulated accounting has the effect of transferring risk from the shareholder to the customer. This is because if actual costs are greater than the amount budgeted in the rate (price) the variance can be deferred and included in future prices. In the absence of regulatory accounting the greater expenditure would result in lower net income.

A fundamental requirement for the use of rate-regulated accounting is that an independent third-party regulator approves the individual deferrals and the period or cost recovery. The BCUC was intended to provide this independent oversight of B.C.

---

<sup>1</sup> A detailed review of rate-regulated accounting at B.C. Hydro can be found in the B.C. auditor general's report of February 2019; [https://www.bcauditor.com/sites/default/files/publications/reports/OAGBC\\_RRA\\_RPT.pdf](https://www.bcauditor.com/sites/default/files/publications/reports/OAGBC_RRA_RPT.pdf) See also [http://www.bcpolicy Perspectives.com/media/attachments/view/doc/occasional\\_paper\\_no\\_63\\_1\\_october\\_2018/pdf/occasional\\_paper\\_no\\_63\\_1\\_october\\_2018.pdf](http://www.bcpolicy Perspectives.com/media/attachments/view/doc/occasional_paper_no_63_1_october_2018/pdf/occasional_paper_no_63_1_october_2018.pdf)

Hydro but, beginning in 2012, the provincial government took control of the rate setting process through a series of highly prescriptive cabinet directives to the BCUC.<sup>2</sup>

Carol Bellringer, the B.C. Auditor General, cited the lack of independence of the B.C. Utilities Commission when regulating B.C. Hydro as a reason to qualify the province's 2016/17 and 2017/18 financial statements. By requiring the regulator to defer certain costs and record unbilled and uncollected revenue at B.C. Hydro the government was inflating the net income and effectively directing its own bottom line.<sup>3</sup>

### **NDP Government Begins to Clean Up B.C. Hydro's Books**

When the NDP was in opposition it severely criticized the Liberal government's prescriptive directives to the BCUC which kept rate increases lower than required by increasing the debt liability faced by future customers. The manipulation of B.C. Hydro's finances preserved the structure of an independent third-party regulator, but really left the BCUC no rate-setting discretion. The most blatant example of the abuse of the generally accepted accounting principles came when the government directed the BCUC to approve the "Rate Smoothing" deferral account (2014) which funded the shortfall between the required rate increase and the increase allowed by the government.

In August 2018 Finance Minister Carole James announced that the government accepted the auditor general's opinion that the BCUC was not independent and set aside \$950 million from the 2017/18 year-end surplus as a prospective adjustment to begin to fix the books at B.C. Hydro.<sup>4</sup>

In 14 February 2019, energy minister Michelle Mungall announced that the government would be restoring most of the BCUC's authority to oversee B.C. Hydro, and that the public utility would fully adopt the public sector accounting standards (IFRS) starting in the 2018/19 fiscal year, as recommended by the auditor general. The government also announced that the Rate Smoothing (revenue deferral) account was closed at the end of December.<sup>5</sup>

### **Two Year Transition to Full Discretion to Set Rates**

While the Mungall announcement is a major step toward restoring its rate-setting authority to the BCUC, the government would not allow a return to a full cost of service model for establishing the required rate increase. It will continue to require the BCUC to

---

<sup>2</sup> This included exempting B.C. Hydro from the requirement for an independent third party to oversee the rate-regulated accounts.

<sup>3</sup> [https://www.bcauditor.com/sites/default/files/publications/reports/OAGBC\\_RRA\\_RPT.pdf](https://www.bcauditor.com/sites/default/files/publications/reports/OAGBC_RRA_RPT.pdf) p. 23.

<sup>4</sup> <https://vancouver.sun.com/opinion/columnists/vaughn-palmer-ndp-makes-impressive-start-managing-b-c-s-finances>

<sup>5</sup> [http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary\\_ndp\\_five\\_year\\_hc\\_hydro\\_plan\\_15\\_february\\_2019/pdf/commentary\\_ndp\\_five\\_year\\_hc\\_hydro\\_plan\\_15\\_february\\_2019.pdf](http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_ndp_five_year_hc_hydro_plan_15_february_2019/pdf/commentary_ndp_five_year_hc_hydro_plan_15_february_2019.pdf)

set rates to generate a net income of \$712 million for a two-year transition period. The government explained the delay in restoring the BCUC's rate-setting authority as providing the regulator time to determine an appropriate return on equity (ROE) – even though the BCUC had adopted a ROE formula some years ago.<sup>6</sup>

The government also excluded the BCUC from initiating any rate rebalancing between the main customer classes (residential, commercial and large industrial), stating this was a political matter.

In effect, while the government has moved to correct many of the accounting deficiencies at B.C. Hydro it is ignoring Auditor General Bellringer's opinion that the BCUC should be determining B.C. Hydro's annual net income (the return on equity),<sup>7</sup> and that the rates for each customer class should cover the costs of electricity.

### **B.C. Hydro Claims the BCUC is Independent**

Ignoring the opinion of the ultimate accounting authority for the provincial government, and the two-year transition to full rate-setting authority, B.C. Hydro continues to maintain that the BCUC is independent.

During the B.C. Utilities Commission's review of B.C. Hydro's rate request for 2019/20 and 2020/21 the corporation was asked if, because of the cabinet directive setting the utility's net income, the BCUC was an independent regulator. Apparently, the management at B.C. Hydro had not read the auditor general's February report where she clearly cited the fixing of B.C. Hydro's net income as an example of the BCUC's lack of independence.

In classic "old thinking" B.C. Hydro replied on 6 June 2019 that the BCUC was independent.

BC Hydro does not agree that rates are not being set by an independent regulator. The BCUC states on its website that it is an independent agency: 'The BCUC is an independent agency of the Government of British Columbia that is responsible for regulating BC's energy utilities, the Insurance Corporation of BC's compulsory automobile insurance rates, intra-provincial pipelines and the reliability of the electrical transmission grid.'

The BCUC has the authority to establish BC Hydro's rates for the test period.<sup>8</sup>

---

<sup>6</sup> [https://www2.gov.bc.ca/assets/gov/farming-natural-resources-and-industry/electricity-alternative-energy/electricity/bc-hydro-review/final\\_report\\_desktop\\_bc\\_hydro\\_review\\_v04\\_feb12\\_237pm-r2.pdf](https://www2.gov.bc.ca/assets/gov/farming-natural-resources-and-industry/electricity-alternative-energy/electricity/bc-hydro-review/final_report_desktop_bc_hydro_review_v04_feb12_237pm-r2.pdf) p. 17.

<sup>7</sup> The auditor general specifically referenced the government directed net income as an example of BCUC's lack of independence; Ibid. p. 23.

<sup>8</sup> See BCUC, BC Hydro F20 to F21 RRA, IR1, RM 1.2.2, (pdf 2014); [https://www.bcuc.com/Documents/Proceedings/2019/DOC\\_54173\\_B-6-BCH-Response-to-Intervener-IR1.pdf](https://www.bcuc.com/Documents/Proceedings/2019/DOC_54173_B-6-BCH-Response-to-Intervener-IR1.pdf)

Despite what the BCUC may say on its website, when it comes to meeting the criteria in the Canadian public sector accounting standards for the use of rate-regulated accounting one would expect B.C. Hydro to defer to the opinion of the province's independent external auditor (and soon to be B.C. Hydro's external auditor as well).

Legally the BCUC must approve B.C. Hydro's rates, but from 2012 to 2018 its rate-setting authority was being directed by cabinet orders. The new government repealed most of the prescriptive cabinet directions, but a new cabinet order (Direction 8) continues to direct the BCUC to set B.C. Hydro's rates for 2019/20 and 2020/21 to achieve an annual net income of \$712 million.

Despite Direction 8's requirement for a certain net income for the next two years B.C. Hydro continues to insist that the BCUC is using the cost of service model to set the rates for 2019 and 2020!<sup>9</sup> This was essentially the same response that B.C. Hydro provided in November 2016,<sup>10</sup> before the auditor general weighed-in and before the new government conceded that the BCUC was not independent.

Clearly, B.C. Hydro is defending the government's position that it has re-empowered BCUC to act as its independent regulator. It remains to be seen whether Auditor General Bellringer accepts that the government has done enough to restore BCUC's independence. We will know when the 2018/19 public accounts are released in early August.

### **Premature Revenue Recognition**

By closing the Rate Smoothing deferral account the government eliminated a key tool that the previous government used to game the system. By recording the variance between the required revenue and the allowed revenue in this deferral account the government was able to understate the required rate increase while still achieving a high net income (and increasing the debt liability).

Auditor General Bellringer highlighted the Rate Smoothing deferral in her 6 February 2019 report, calling the resulting revenue recognition "premature."<sup>11</sup> Commenting on the Ontario government's plan to recognize potential future revenue as part of its 2017 Fair Hydro plan Ontario's auditor general was more emphatic, stating that recording potential future revenue was not permitted.<sup>12</sup>

---

<sup>9</sup> BCUC, B.C. Hydro RRA F20 to F21, IR1, RM 1.2.1 (pdf 2014);

[https://www.bcuc.com/Documents/Proceedings/2019/DOC\\_54173\\_B-6-BCH-Response-to-Intervener-IR1.pdf](https://www.bcuc.com/Documents/Proceedings/2019/DOC_54173_B-6-BCH-Response-to-Intervener-IR1.pdf)

<sup>10</sup> BCUC, B.C. Hydro RRA F17 to F19, IR1, RM 1.1.4 (pdf 1736);

[https://www.bcuc.com/Documents/Proceedings/2016/DOC\\_48164\\_B-10\\_BCH\\_Responses-Intervenors-IR.pdf](https://www.bcuc.com/Documents/Proceedings/2016/DOC_48164_B-10_BCH_Responses-Intervenors-IR.pdf)

<sup>11</sup> [https://www.bcauditor.com/sites/default/files/publications/reports/OAGBC\\_RRA\\_RPT.pdf](https://www.bcauditor.com/sites/default/files/publications/reports/OAGBC_RRA_RPT.pdf) p. 23.

<sup>12</sup>

[http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional\\_paper\\_no\\_63\\_1\\_october\\_2018/pdf/occasional\\_paper\\_no\\_63\\_1\\_october\\_2018.pdf](http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_63_1_october_2018/pdf/occasional_paper_no_63_1_october_2018.pdf) p. 5.

Yet B.C. Hydro plans to continue to record all sales revenue shortfall as revenue received and record the asset (or liability) in the Non-Heritage Deferral Account. This was the practice used from 2011/12 to 2015/16 when over \$850 million in domestic revenue shortfalls were added to this account.

B.C. Hydro was asked if its new external auditor (the auditor general) had been consulted on the plan to record unbilled and uncollected revenue in a deferral account. It replied that it had not consulted with the new external auditor, but she would have an opportunity to comment as part of her audit of the 2019/20 year. It noted that its current external auditor had provided a clean opinion on the 2017/18 statements, which included the recording of hypothetical revenue.<sup>13</sup> It failed to note that Auditor General Bellringer was assuming the role of B.C. Hydro's external auditor because she believed that there was significant room for improvement in the financial oversight of the public utility.<sup>14</sup>

## Summary

In a few weeks the government will release the province's 2018/19 financial statements (and the annual report of B.C. Hydro). The provincial statements will incorporate the results of the financial changes at B.C. Hydro, including the adoption of the IFRS accounting standard and the wind-up of the "Rate Smoothing" revenue deferral account.

The outstanding question is whether the auditor general will continue to qualify the statements because of the continuing lack of an independent regulator for our public electric utility. Given the tone and substance of her February 2019 report it would be surprising if she did not qualify the statements one again.

Richard McCandless June 27, 2019. <http://www.bcpolicy Perspectives.com/>

The writer is a retired senior BC government public servant whose paper describing the BC government's manipulation of the finances of BC Hydro from 2008 to 2014 was published by *BC Studies* in November 2016. *BC Studies* published his paper on the 40-year financial history of ICBC in 2013. He is an intervener in the BC Utilities Commission's current reviews of ICBC's and B.C. Hydro's rate requests.

---

<sup>13</sup> BCUC, B.C. Hydro F20 to F21 RRA, IR1, RM 1.4.2 [https://www.bcuc.com/Documents/Proceedings/2019/DOC\\_54173\\_B-6-BCH-Response-to-Intervener-IR1.pdf](https://www.bcuc.com/Documents/Proceedings/2019/DOC_54173_B-6-BCH-Response-to-Intervener-IR1.pdf) (pdf 2024).

<sup>14</sup> The auditor general request for additional funds to undertake this expanded role was supported by the Legislature's public accounts committee.

