

ATTACHMENT to EMAIL from RICHARD McCANDLESS to CAROL BELLRINGER, AUDITOR GENERAL of BRITISH COLUMBIA. December 2, 2016.

**ADDITIONAL INFORMATION CONCERNING THE RECORDING OF UNAPPROVED FUTURE REVENUE BY BC HYDRO**

On October 14, 2016, I wrote you on this matter and advised that BC Hydro had been recording and deferring unapproved future revenue in addition to that recorded in the Rate Smoothing Regulatory Account (RSRA). The RSRA was created by a 2014 cabinet directive to record and defer the difference between the “indicated” revenue and that generated by the revenue requested by BC Hydro.

The additional unapproved future revenue, which is the difference between the requested (and approved by the BC Utilities Commission under cabinet order) and the actual revenue received, is being recorded in the Non-Heritage Deferral Account (NHDA).

AS part of the BC Utilities Commission’s review of BC Hydro’s rate request for 2016 to 2018, the Commission requested BC Hydro to identify the accounting standard that allows the revenue recording and deferral as practiced by the Crown corporation; see Information Request No. 1.159.5 in [http://www.bcuc.com/Documents/Proceedings/2016/DOC\\_48161\\_B-9\\_BCH-Responses-to-BCUC-IRs.pdf](http://www.bcuc.com/Documents/Proceedings/2016/DOC_48161_B-9_BCH-Responses-to-BCUC-IRs.pdf)

**Context and Dimension**

The following table shows the actual amount of unapproved future revenue recorded and deferred by fiscal year to 2015/16, and the forecast included as part of BC Hydro’s three-year rate request (\$=million)

**Revenue Reported and Deferred**

	<b>FY12/13</b>	<b>FY13/14</b>	<b>FY14/15</b>	<b>FY15/16</b>	<b>FY16/17</b>	<b>FY17/18</b>	<b>FY18/19</b>
NHDA	176	138	207	269	?	?	?
RSRA	--	--	166	121	210	286	300
<b>TOTAL</b>	176	138	373	390	210	286	300
Net Income	509	549	581	655	684	698	732
Adj. Net Income	333	411	208	265	474	412	432

Source: NHDA from BCUC, BC Hydro F17-F19 RRA, IR1 BCUC 1.126.1

RSRA from same source BCUC 1.124.2; Net Income from BC Hydro annual reports and OIC 590/16.

In reply to the Commission’s IR 1, number 1.129.1-3, BC Hydro attempted to justify how the NHDA evolved to record unapproved future revenue in addition to the more standard cost variance deferrals.

It should be noted that the larger net income made possible by the recording of the additional revenue allowed the government to take \$972 million in dividend payments from FY2012/13 to FY2015/16; payments that would not have been made had the additional revenue not been recorded.

The larger net income also increased the government's revenues during these years.

### **In Compliance with Accounting Standards?**

In IR1, No. 1.159.5 the Commission asked:

On page 8-14, BC Hydro states that for external reporting purposes, transfers to the Rate Smoothing Account are included in Domestic Revenue.

Given that the amounts transferred to the Rate Smoothing Account in a given year will not be recovered in rates in that particular year and therefore do not result in actual revenues, please explain how the Prescribed Standard allow for the transfers to the Rate Smoothing Account to be reported as revenue in F2017, F2018 and F2019. Please reference the applicable accounting standard that allows for this treatment.

This is BC Hydro's justification for recording the unapproved future revenue in the current reporting periods' and for the deferral of this revenue.

### **RESPONSE:**

The response below is in respect of this question and McCandless IR 1.3.3.

Rate smoothing accounts serve to mitigate the rate impact of either large one-time costs or overall general rate increases that may otherwise be required to recover BC Hydro's approved revenue requirements. The Government, as part of the 2013 10 Year Rates Plan, Direction No. 7 (and resulting British Columbia Utilities Order No. G-48-14) required BC Hydro to establish the Rate Smoothing Regulatory Account in fiscal 2015. This account was created to keep rate increases as gradual and predictable as possible, by spreading costs that occur in the earlier years of the 2013 10 Year Rates Plan over the later years of the Plan. The account is forecast to be paid down to zero by the end of fiscal 2024. The account requires the deferral for recovery in rates in future fiscal years, those portions of the allowed revenue requirement in a particular fiscal year that were not, or are not to be recovered in rates in that particular fiscal year.

BC Hydro follows the Prescribed Standards, which are discussed in section 8.12 of the Application. The Prescribed Standards are based on accounting principles of International Financial Reporting Standards (IFRS), combined with regulatory accounting in accordance with Financial Accounting Standards Board Accounting Standards Codification 980, Regulated Operations. Accounting Standards Codification 980 is a United States GAAP standard.

*Allowable Costs - "All costs for which revenue is intended to provide recovery. Those costs can be actual or estimated. In that context, allowable costs include interest cost and amounts provided for earnings on shareholders' investments".*

The key criteria from Accounting Standards Codification 980 are the requirement that the item is an

- Incurred cost; and General guidance for the recognition of regulatory assets, Accounting Standards

Codification 980-340-25-1 states:

*"Rate actions of a regulator can provide reasonable assurance of the existence of an asset. An entity shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:*

*(a) It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.*

*(b) Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost".*

Accounting Standards Codification 980 defines the terms Incurred Cost and Allowable Costs as follows:

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*Incurred Cost - "A cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and has been or must be paid for".*

- It is probable that the cost will be recovered in future rates.

Incurred Cost Criteria

British Columbia Utilities Commission Order No. G-48-14 specifies that the account is to be used to defer for recovery in rates for future fiscal years those portions of the allowed revenue requirement (i.e., BC Hydro's costs) in a particular fiscal year that were not, or are not to be recovered in rates in that particular fiscal year. The transfers into the Rate Smoothing Regulatory Account are attributable to actual costs incurred.

## Probable Recovery

The British Columbia Utilities Commission has approved the establishment of the Rate Smoothing Regulatory Account for inclusion in future rates. British Columbia Utilities Commission No. Order G-48-14 specifically states “defer for recovery in future fiscal years”. The Rate Smoothing Regulatory Account is designed only to transfer the recovery of costs between periods covered by the 2013 10 Year Rates Plan and is designed to be fully recovered by the end of the 2013 10 Year Rates Plan term.

In the Application, we state on page 1-4 that “BC Hydro is forecasting to be able to meet the targets in its 2013 10 Year Rates Plan.” On pages 1-17 and 1-18, BC Hydro states that “the 2013 10 Year Rates Plan also includes fully recovering the balance in the Rate Smoothing Regulatory Account at the end of fiscal 2024.”

BC Hydro has a history of recovering deferred costs in subsequent rates. As the Rate Smoothing Regulatory Account has been designed to be fully recovered and BC Hydro expects full recovery of deferrals in rates, the Rate Smoothing Regulatory Account meets the probable recovery criterion in Accounting Standards Codification 980.

## Presentation

Accounting Standards Codification 980 does not provide guidance regarding the income statement presentation of the transfer to the regulatory account. BC Hydro reports regulatory transfers on the net basis on the income statement. Under the net basis, the regulatory transfer items are recorded in the same nature classification as the originating item.

As the Rate Smoothing Regulatory Account is a transfer of a pool of costs, with no specific identification of which costs it comprises, it would be arbitrary to pick specific cost nature line items. As a result, while the transfers represent a pool of costs, BC Hydro has presented the transfers to the account as revenue. The presentation of the regulatory transfer on the income statement does not impact net income.

Transfers to the Rate Smoothing Regulatory Account are incurred costs that are probable of recovery in future rates. Therefore, the Rate Smoothing Regulatory Account balance meets the criteria for recognition of an asset under the principles of Accounting Standards Codification 980.

BC Hydro’s external auditors conducted their audit in accordance with Canadian generally accepted auditing standards. Their audit included performing procedures to obtain audit evidence about the amounts and disclosures in our consolidated financial statements. They issued an unqualified opinion on the financial statements in their report dated June 1, 2016.

## Observations

Clearly, the Office of the Auditor General has staff with the training and experience to determine if the reporting and deferral of future unapproved revenue conforms to generally accepted accounting standards, both in Canada or the US standard 980.

My comments and observations are based on past practice and a reading of the intent of the revenue recognition standards.

### *Widening of Scope*

- Until the 2014 cabinet Direction 7, deferrals were assumed to be confined to cost variances, not revenue variances.
- The BCUC is now questioning (see IR1, 1.129.1-3 noted earlier) how future revenue was deferred in the NHDA prior to 2014.

### *Blurring of Costs and Revenues*

- BC Hydro quotes from the US accounting standard that refers to costs, not revenue.
- It then assumes that the two concepts are the same since the deferred cost will be, or the entity believes that the deferred cost will be, recovered in the (presumably) next rate adjustment.
- It says the revenue is attributable to costs incurred, but cost variances (of actual to the approved plan or budget) are already deferred.

### *Deferred Costs Are Assets*

- Regulatory accounting rules equate cost deferrals as an asset (adding to equity) as they are treated as a loan to ratepayers.
- Does an unapproved future rate increase qualify as a loan, especially when the customer was unaware of the potential future new price for the “contracted” electricity received?

### *Probable Recovery*

- Normally, the regulated entity will record the cost as a deferral if it believes that it is probable that the regulator will include the cost in a future rate approval (usually the net rate period).
- BC Hydro has not requested that the deferred RSRA balance be included in the F17 to F19 rates.
- BC Hydro has not identified how the FY2020/21 RSRA balance of \$1.59 billion will be paid down to zero by FY2023/24, especially when it states that the 10-year financial plan assumes annual rate increases of about 2.9% in the later years.
- BC Hydro assumes that the deferred revenue in the NHDA will be paid down from revenue from the Rate Rider surcharge, although this also assumes no further deferrals after FY2015/16.

### *Presentation*

- BC Hydro says transfers to the RSRA is “a transfer of a pool of costs” which it has presented as revenue. This is a strange way to explain and present credible financial statements using generally accepted accounting principles.
- The cost variances have already been transferred to BC Hydro’s multiple deferral/regulatory accounts.

BC Hydro states that the presentation of the future unapproved revenue on the income statement does not impact net income. As noted in the table above, if the future revenue was not reported the net income would have been significantly lower. This was confirmed by BC Hydro in response to my intervener request RM 1.3.7:

Is it correct to assume that in the absence of the revenue shortfall deferral to the NHDA the actual net income for F2012 to F2016 would have been significantly less than what BC Hydro reported on its financial statements?

RESPONSE:  
Confirmed.

I would recommend that your Office review BC Hydro's accounting practice respecting the recording and deferral of unapproved future revenue at the earliest opportunity.

The current practice appears to be a device to allow BC Hydro to achieve the net income required by the OIC 590/16 (July 28, 2016), and give the 10-year financing plan a sheen of credibility. It allows the government to understate the F17 to F19 rate requirement, and it adds to the debt liability faced BC Hydro's customers.

Richard McCandless December 2, 2016.