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June 8, 2016

Carol Bellringer  
Auditor General  
P.O. Box 9036 Stn Prov Govt  
Victoria, BC V8W 9A2

Dear Ms. Bellringer,

I am writing to seek your opinion on whether BC Hydro is reporting revenue, and thereby net income that has been inappropriately increased by the government-mandated Rate Smoothing Regulatory Account (see Directive 7 of March 2014). It would appear that the Rate Smoothing Regulatory Account does not conform to Canadian or American revenue recognition accounting standards.

BC Hydro has become increasingly dependent on regulatory accounts since 2005 and in particular over the past 4 years. In 2011, a previous Auditor General reviewed the growth in the number and the value of the deferral accounts, so the OAG staff are familiar with their use at BC Hydro. As noted in that report, BC Hydro and the government's use of those accounts has the effect of "creating the appearance of profitability where none actually exists."

I note that in 2014/15, the net deferral account balance to equity at BC Hydro was 130.3% compared to 7.4% for Quebec Hydro and 11.7% for Manitoba Hydro. Addicted is not too strong a word to describe the government's current dependence on deferral accounts.

Even given all of this, the Rate Smoothing Regulatory (Deferral) Account is an audacious attempt to use deferral accounts to mislead the ratepayer and the taxpayer as to the true state of government finances and BC Hydro finances – one inconsistent, in my view, with accounting rules. It is on this question of accounting rules that I seek your advice.

#### BC HYDRO'S RATE SMOOTHING REGULATORY (DEFERRAL) ACCOUNT

Regulatory accounts are not uncommon in the utility industry, and BC Hydro is not alone in their use. Regulatory accounts are often used to reflect timing differences between when a utility spends money to provide a service or acquire an asset, and when that expenditure is recovered from ratepayers.

Most regulatory accounts, both those ordered by cabinet or initiated by BC Hydro, relate to the deferral of expenditure variances to minimize, or smooth, the impact on electricity rates over a longer time period.

The cabinet, as part of the 10-year financing plan, required BC Hydro and the BC Utilities Commission to establish a new Rate Smoothing Regulatory Account in 2014/15, to smooth the impacts of the rate increases that would otherwise be indicated for that and future years. This account allows BC Hydro to record as revenue, and defer the difference, between the indicated revenue required and the actual revenue generated by the approved rates in any year.

In planning sessions between senior government officials and senior BC Hydro management in August and September of 2013, BC Hydro advised that they believed the BC Utilities Commission (BCUC) would not approve such a future revenue deferral account.<sup>1</sup>

As part of its F2015 and F2016 rate requirements application, filed with the BCUC three days after the OIC was signed, BC Hydro provided a multi-year forecast for the new Rate Smoothing Regulatory Account, where the total deferred rose to \$785 million by 2020/21. The balance in the account was to be eliminated by unspecified means by 2023/24.<sup>2</sup> BC Hydro's financial statements show that \$166 million was transferred to this account in 2014/15. The utility's interim rate request for F17, filed with the BCUC on February 26, 2016, forecasts the balance in the RSRA at \$287.4 million for 2015/16, rising to \$537.8 million by year-end 2016/17.<sup>3</sup> It is expected to be well over a \$1 billion by 2022.

The effect of the additional revenue recorded in 2014/15 was to add \$166 million to the net income, which allowed BC Hydro to achieve the return on equity target mandated by the government. This increased the government's revenue from BC Hydro by this amount, and allowed the transfer of \$264 million as a dividend to the government. Without the accelerated revenue being deferred, BC Hydro would likely have not achieved the 80/20 debt to equity ratio necessary in order to provide any dividend.

For 2016/17, the government has budgeted a surplus of \$264 million, assuming net income from BC Hydro of \$692 million. Included in the net income is \$250.4 million in accelerated revenue showing as an addition to the RSRA. The government has also budgeted for a \$260 million dividend from the power utility, assuming the 80/20 debt to equity ratio. In the absence of the accelerated revenue the operating surplus would be practically eliminated, and the dividend would not be paid as the 80/20 ratio requirement would not be achieved.

When questioned about precedents for such a revenue acceleration regulatory account being used by any regulated electrical utility in North America, the minister responsible for BC Hydro could not cite any examples,<sup>4</sup> nor could the minister of finance when questioned as to the use of

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<sup>1</sup> See page 58 of 180 in the FOI package.

[http://docs.openinfo.gov.bc.ca/d21976014a\\_response\\_package\\_egm-2014-00216.pdf](http://docs.openinfo.gov.bc.ca/d21976014a_response_package_egm-2014-00216.pdf)

<sup>2</sup> BC Hydro, Revenue Requirements F2015 and F2016, 7 March 2014, Appendix H.

<sup>3</sup> BC Hydro, Revenue Requirements F2016, 26 February 2016, Appendix B, p, 10 of 33.

<sup>4</sup> Hansard, 7 April 2016, p. 11986-87.

revenue acceleration to inflate the net income of BC Hydro.<sup>5</sup> A review of a number of regulated electrical utilities in Canada and the United States found no examples of accelerated revenue practices, for the simple reason that such acceleration does not conform to accepted accounting practice.

## ACCOUNTING FOR REVENUE

The Budget Transparency and Accountability Act (Section 23.1) mandates that the provincial accounts, including the self-supporting Crowns, must conform to standards and guidelines that comprise generally accepted accounting principles for senior Canadian governments, as modified by an alternative standard. I believe that BC Hydro is using US generally accepted accounting principles for its deferral and regulated accounts.

The two standards are very similar. Transaction based revenue recognition is based on the concept of contractual obligations between the seller and the purchaser of a good or service, including performance obligations. There appear to be four main criteria: collection probability, completion of delivery, evidence of an arrangement, and that the price can be predetermined.

The Public Sector Accounting Board (PSAB) developed a statement of principles for revenue recognition in August, 2013. In the published principles, the PSAB equated government business enterprises (self-supporting Crowns) to profit-orientated entities, where a contract underlies the recognition of revenue. The revenue is recognized when the performance obligations of the contract are met. The performance obligations are considered to be met at a point in time.

If a future change in price is not established the entity can only report the change if it has an expectation that the price modification will be approved. The approval authority is the BCUC.

The government took full control of rate setting in 2012, and set the electricity rates for April 2014 and April 2015 by cabinet order to the BCUC. For 2016 to 2018 rates, the government has capped the increases at 4.0, 3.5 and 3.0 percent respectively.<sup>6</sup> The government has stated that the BCUC will again have full authority to set the BC Hydro rates commencing in April 2019.

The BC Hydro RSRA forecast assumes that the approved rates for the 2022 to 2024 period will generate sufficient revenue to eliminate the balance in the account by year-end 2024. No justification has been provided to support this expectation, and the BCUC has no track record to judge such an expectation.

If the government was concerned about rate shock to BC Hydro's customers, it could have lowered the return on equity target (which is already higher than the BCUC benchmark for the lower risk electrical utility) and reduced the net income expectation. Instead, it created the RSRA as a means to maintain the high net income and the dividend. The effect has been to increase the debt of BC Hydro, while growing the net income.

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<sup>5</sup> Hansard Blues, 18 May 2016, afternoon session.

<sup>6</sup> See Directive 7.

In short, the cabinet ordered BC Hydro to create the Rate Smoothing Regulatory Account. This account would not have been approved by the BCUC and the government has not been able to provide an example of such conduct in any other jurisdiction.

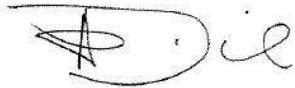
They are essentially taking unapproved revenue from 2022 to 2024 and applying to the present fiscal year, providing a misleading impression of BC Hydro's and the government's finances.

I have the following specific questions for you to consider

1. Does the recording of future, unapproved revenue by BC Hydro fail to meet generally accepted accounting standards for revenue recognition?
2. If the answer to this question is yes, what corrective action is required to the Public Accounts for 2014/15 and for the 2015/16 Public Accounts which are under development?
3. If the answer is yes, what corrective action is required to the 2016/17 budget?

Thank you for your attention to this matter.

Sincerely,

A handwritten signature in black ink, appearing to read "Adrian Dix". The signature is stylized and cursive.

Adrian Dix MLA  
Vancouver Kingsway