COMMENTARY **BC HYDRO**

THE BC HYDRO WATCHDOG VOLUNTARILY MUZZELS ITSELF

In a curious decision the BC Utilities Commission (BCUC) has decided to adopt a formulistic method of setting BC Hydro's rates, and to extend the period between detailed reviews to a minimum of five years.[1] If pursued, this performance based approach will not achieve the objectives that the Commission expects, and it will significantly reduce BC Hydro's accountability to the regulator and the public.

This less accountable model for rate-setting comes only a few years after the Commission regained most of its authority to approve rate changes. From 2012 to 2017 rate changes were set by cabinet order. From 2018 to 2021 the Commission exercised more authority, subject to complying with a cabinet order specifying a profit target. The same order expires in 2022, so in theory the Commission will regain full discretion after 12 years of some form of prescriptive cabinet order limiting its rate-setting discretion.

Performance-Based Ratemaking versus Cost of Service

Governments have established independent commissions to regulate monopoly utilities to protect the public from monopoly pricing power. In addition, in the case of public monopolies, another objective of the independent authority is to lessen, if not eliminate, the politicization of rate-setting.

Most regulators in North America use a form of the Cost of Service (COS) model for determining the allowable rates for electricity. In essence, the regulator determines an acceptable level of expenditure of the utility for the period under review, determines the forecasted status quo revenue, and approves a change in the price of the electricity to allow the utility to meet its projected expenditures and allow it to earn a pre-determined return on equity (ROE) based on the risk profile of the utility.

Under a Performance-Based Ratemaking (PBR) system once an acceptable base operating/expenditure level is agreed, and the rates are established to cover the expenditures and the ROE, future rate changes are determined by predetermined performance metrics. For example, future rate increases could be limited to the change in the consumer price index, regardless of the status quo change in costs.

The PBR model –or incentive regulation—is seen by its proponents as a way to incent the regulated utility to "achieve desired goals by granting some, but not complete,

[1] https://docs.bcuc.com/Documents/Other/2021/DOC_65178_G-388-21-BCUC-Review-BCH-PBR-Report-Decision.pdf

discretion to the firm."[2] The primary incentive for utilities operating under this form or regulation is the ability to increase profits (ROE) for the shareholders by becoming more cost-efficient.

A second key component of the PRB model is the use of multi-year rate plans, such as five years. This longer period allows the utility to institute efficiency programs that many require more than one or two years to show results.

Background to the Decision

In its decision on BC Hydro's 2016 to 2018 rate request the Commission expressed concern regarding BC Hydro's expenditures rising faster than revenues and suggested that this would not be sustainable. It noted that a PBR system is being used by FortisBC Energy Inc. and FortisBC Inc., both firms being regulated by the Commission. The BCUC seemed to believe that the COS model was expensive and inefficient.[3]

Following a request from the BCUC, BC Hydro prepared a detailed report on the opportunities and challenges of a PBR model, which led the Commission to establish a separate review of the report and the broader issue of the applicability of and incentive-based model of regulation for BC Hydro.[4]

The proceeding spanned 26 months and involved BC Hydro and nine interveners. Both BC Hydro and the BCUC engaged expert witnesses to review the applicability of a looser incentive-based form or regulation to the BC Hydro operation.

Incentive Model Not Applicable to BC Hydro

BC Hydro advised the Commission that incentive-based models do not apply to the Crown utility because the BC Hydro has no direction from the shareholder (the government) to maximize profits. In its final argument it noted that:

> BC Hydro's mandate established by the Government of B.C. does not include exceeding its allowed ROE (i.e., to maximize profits for its shareholder). The absence of a mandate to exceed the allowed ROE is a unique feature of BC Hydro's regulatory framework that distinguishes BC Hydro from investor-owned utilities and other publicly owned utilities under PBR. It limits the efficacy of incentive mechanisms premised on the opportunity to earn more than the allowed ROE.[5]

---

[2] Ibid., p. 4.

[3] While the amount of change to the rates has declined in recent years, the number of intervener questions has greatly expanded, as has the time required to complete the reviews.

[4] https://www.bcuc.com/OurWork/ViewProceeding?ApplicationId=712

[5] Page 5 in https://docs.bcuc.com/Documents/Arguments/2021/DOC_62400_2021-05-03-BCH-Final-Argument.pdf

Maximizing Profits May Provoke Public Criticism

BC Hydro also pointed out that there could be public opposition if it is perceived that the Crown utility was exceeding its approved ROE target. This is what occurred in Quebec respecting Hydro Quebec, where the large profits generated by the public utility became a political issue.[6]

The BC Old Age Pensioners Association *et al,* an experienced intervener, agreed.

> … BCOAPO concurs with BC Hydro's view that "the public may not accept profit maximization as a legitimate objective of a Crown Corporation" although "may" is likely an understatement of the level of any resulting public outcry. As a result, BCOAPO submits that PBR approaches that rely on profit-maximization as the incentive for performance improvement are unlikely to be effective if applied to BC Hydro and are likely to draw the unwanted attention of the flaming eye of government legislators unhappy with the resulting controversy.[7]

Most of the other interveners agreed with the BC Hydro position that an incentive-based rate-setting model would not apply to BC Hydro. A sample of their comments can be found in the Appendix.

Lengthening the Period Between Reviews

Under the PBR model the detailed review of operations and performance occurs less frequently compared to the COS model. In recent years under the COS model, the term of the rate reviews spanned from one to three years, and the current request before the BCUC is for the years 2022 to 2023.

The BCUC advanced the proposal that the period between detailed reviews of BC hydro's operations be extended to five years. This would mirror the period adopted for the PBR system in operation at FortisBC Inc., and FortisBC Energy. The BCUC believes that a longer period is more efficient as the expense of the detailed review (some might say micro-management) is repeated every five years rather than for shorter periods.

BC Hydro argued that a three-year test period was a good compromise between the goals of greater efficiency (less cost) and public accountability and public acceptance of the regulatory model generally. Forecasting electricity demand and expenditures beyond three years is highly problematic, although the extensive use of deferral accounts ensures that ratepayers will eventually pay the actual costs.

---

6 https://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_hydro_quebec_26_september_2019/pdf/commentary_hydro_quebec_26_september_2019.pdf

7 https://docs.bcuc.com/Documents/Arguments/2021/DOC_62899_2021-06-01-BCOAPO-Final-Argument.pdf p. 16.

All of the interveners who commented on this matter supported BC Hydro's three-year term proposal, including two that preferred a two-year separation. The Commercial Energy Consumers, another experienced intervener, noted that: "constraining the scope of Annual Reviews in the interests of reducing regulatory costs is very likely a false economy…. Reducing regulatory oversight, while simultaneously diminishing information openness and transparency will lead to BC Hydro's disconnect from its ratepayer's interests and acceptance."[8]

The Decision[9]

In its decision dated 21 December 2021, the BCUC panel determined that it believed that a PBR system would be used for BC Hydro's controllable operations and maintenance costs, although the definition of controllable depends on the period under review.[10] It believed, despite the unanimous opposition of BC Hydro and the major interveners, that a formulistic model would provide the best incentives for cost control, productivity improvements and performance at BC Hydro. It was not persuaded by the argument that an incentive to increase BC Hydro's profit (ROE) was not a factor in determining the most appropriate regulatory model for a publicly owned power utility.

The BCUC panel noted that the Crown utility and the interveners supported a three-year test period. However, it disagreed and said that its authorizing legislation allows it to be the sole judge on the matter, and that a test period of "at least" five years (the current period for FortisBC Energy and FortisBC Inc.) is reasonable.[11] Again, the BCUC panel placed more weight on the goal of regulatory efficiency (lower cost), than on accountability and public acceptance.

It did note that the final decision on the term of the next test period following the current three-year (2022 to 2024 rate increases) would be made by the panel reviewing the existing rate request. Three of the four members of this rate structure panel are members of the current panel deciding BC Hydro's rate requests for 2022 to 2024 (including Chair Morton). Yet despite this assurance it still ordered BC Hydro to submit a rate request spanning "at least" five years for the next review no later than 31 December 2023.[12]

---

[8] https://docs.bcuc.com/Documents/Arguments/2021/DOC_62904_2021-06-01-CEC-Final-Argument.pdf p. 7.
[9] https://docs.bcuc.com/Documents/Other/2021/DOC_65178_G-388-21-BCUC-Review-BCH-PBR-Report-Decision.pdf
[10] For example, wage and benefit costs could be uncontrollable in a single year, but controllable over three or five years.
[11] https://docs.bcuc.com/Documents/Other/2021/DOC_65178_G-388-21-BCUC-Review-BCH-PBR-Report-Decision.pdf p. 29.
[12] Order G-388-21; https://docs.bcuc.com/Documents/Other/2021/DOC_65178_G-388-21-BCUC-Review-BCH-PBR-Report-Decision.pdf pdf 67/77.

A Policy Error

The decision by the BCUC panel to opt for a PBR system and a longer test period is at variance with the advice provided by the public power utility and the interveners. The PBR systems, where they exist, seem to operate best when setting electricity rates for privately-owned utilities. This is because of the incentive to achieve a higher than budgeted profit (which could be shared with the ratepayers). Profit maximization is not part of the mandate of BC Hydro, and some wonder why it is required to generate a profit at all. Thus, the fundamental basis of the PBR model is lacking.

The potential extension of the review period, also considered the re-balancing of the baseline costs and load forecasts, will result in a significant loss of accountability to the public as represented by the BCUC. It would severely restrict the ability of the representatives of the consumer groups to receive detailed information from the public utility. By weakening these accountability mechanisms, the whole regulatory model and process could be undermined. This could lead to even more political direction over the rates and finances of BC Hydro.

The BCUC is rightly concerned about the high cost (and presumably the lengthy review process) of approving BC Hydro's electricity rates. Abandoning the COS model in favour of a complicated formulistic model is not the answer. The BCUC should focus its rate reviews on examining the load forecasts and the key operational changes from the previous review. This will eliminate the regular detailed review of all aspects of BC Hydro's operations, which should focus the reviews and reduce the length and cost of the proceedings.

Given the close supervision exercised by the provincial government over BC Hydro, as shown by the sting of cabinet directives to the public utility and the regulator, it is quite possible that the cabinet will reverse this decision. This would be in the public interest.

©Richard McCandless January 27, 2022 https://www.bcpolicyperspectives.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 was an intervener in the BC Utilities Commission's current review of B.C. Hydro's rate request

APPENDIX

In general, the interveners in the proceeding supported the position of BC Hydro that a performance, or incentive, based system to determine annual changes in rates was not appropriate to BC Hydro. The government (the shareholder) is not expecting the Crown power utility to be maximizing its profit, and the public would probably object if it did.

The interveners also supported BC Hydro's position that a three-year period between rate reviews is the maximum that is achievable.

The following are some of the key comments on these points.

Association of Major Power Consumers (AMPC)

https://docs.bcuc.com/Documents/Arguments/2021/DOC_62898_2021-06-01-AMPC-Final-Argument.pdf

AMPC supports the continued use of a Cost-Of-Service Regulation ("COSR") framework for the purpose of rate setting, with a few exceptions detailed below. In general, a COSR approach provides greater transparency for ratepayers, is more intuitive, and ensures rates are set based on costs that are prudently incurred. (p. 1)

BC Old Age Pensioners' Organization *et al* (BCOAPO)

https://docs.bcuc.com/Documents/Arguments/2021/DOC_62899_2021-06-01-BCOAPO-Final-Argument.pdf

… in BCOAPO's view … from a residential ratepayer point of view, regulatory effectiveness takes precedence over regulatory efficiency….(p. 27)

As noted earlier in BCOAPO's submissions, the premise that a utility's ability to retain efficiency savings longer (i.e., before rebasing) will increase the incentive to more aggressively pursue cost savings assumes the utility main objective is to maximize profits. This is not the case for BC Hydro. Indeed, as discussed earlier profit maximization is not even one of its mandated objectives. (p. 27)

Commercial Energy Consumers Association (CEC)

https://docs.bcuc.com/Documents/Arguments/2021/DOC_62904_2021-06-01-CEC-Final-Argument.pdf

The CEC is of the view that in general, from a ratepayer perspective, PBR has perverse incentives; in the case of BC Hydro, these incentives become useless or even dysfunctional incentives, and the Commission's oversight of BC Hydro would be poorly served by a PBR regime. (p. 2)

The CEC further submits that constraining the scope of Annual Reviews in the interests of reducing regulatory costs is very likely a false economy.... Reducing regulatory oversight, while simultaneously diminishing information openness and transparency will lead to BC Hydro's disconnect from its ratepayer's interests and acceptance. (p. 7)

MOVEUP

https://docs.bcuc.com/Documents/Arguments/2021/DOC_62867_2021-06-01-MoveUP-Final-Argument.pdf

First , most obvious, and most remarked throughout this proceeding, BC Hydro is not a profit-seeking company. Incentive mechanisms that leverage private utility corporate objectives to achieve performance results are alien to this environment. Hydro is oriented toward maintaining affordability, along with safety and reliability. The financial incentives at the heart of more rarified versions of PBR to (as the rationale goes) better align the interests of utility and ratepayer have no purchase here. Aside from BC Hydro's corporate disinterest in maximizing shareholder returns, its executive compensation is governed by the Public Sector Employer's Act and the mechanisms to apply government policy to employee compensation throughout the province's broad public sector. Under these rules, BC Hydro cannot provide financial bonuses to its executive and management staff based on either individual or collective performance. (p. 2)

Clean Energy Association of BC (CEABC)

https://docs.bcuc.com/Documents/Arguments/2021/DOC_62895_2021-06-01-CEABC-Final-Argument.pdf

CEABC agrees with BC Hydro that certain special circumstances may make it very difficult for some PBR measures to be either effective or accepted, in BC Hydro's case. BC Hydro has summarized a few of these as follows:

1. BC Hydro is mandated as a Crown Corporation. It has no incentive to exceed its allowed return, and hence no motivation that would respond to any earnings-based incentive mechanisms.

2. Management compensation is constrained. Since management is not rewarded for higher earnings, it has no incentive to maximize profits.

3. Regular BCUC reviews establish credibility and public confidence. Less scrutiny by the BCUC could undermine that credibility and confidence. A profit maximizing motive for BC Hydro could make public acceptance problematic. (p. 5)