COMMENTARY **BC HYDRO**

HAS BC HYDRO ENDED ITS ILL-CONCEIVED GAMBLE ON INTEREST RATES?

A new report suggests that BC Hydro has ended its disastrous program to hedge future interest rates. The future debt hedging program was intended to protect ratepayers from the impact of higher future interest rates on BC Hydro's borrowing costs. Instead, a decline in interest rates during the last three years resulted in ratepayers facing a massive $1.03 billion liability because of the hedging program.

Background

BC Hydro entered the highly volatile world of derivative plays in 2016, as it began to speculate on the trend of future interest rates. At the time senior management believed that interest rates would increase, which in turn would result in increased rates. The highly risky strategy required the creation of a deferral account to accumulate the gains, or protect the shareholder (the BC government) from any losses. BC Hydro received approval from the BC Utilities Commission to create the Debt Management regulatory account, to offset the higher borrowing costs in future rate applications. More detail is available in my papers of October 2019 and September 2020.[1]

The first future debt hedging contracts began in May 2016 and showed early gains, as the actual interest rate on the debt issued was higher than the contracted rate. Table 1 shows a net $187 million credit to the ratepayers in the deferral account by 31 March 2017.

However, as BC Hydro hedged more debt interest rates began to decline, resulting in growing actual losses on expired contracts, or higher liabilities on the current contracts. By 31 March 2020, the deferral account showed a $953 million liability, which increased to $1.0 billion by 30 June 2020.

Thus, rather than protecting BC Hydro's ratepayers from increased borrowing costs, the hedging program had the effect of denying its future domestic customers the benefit of the lower borrowing costs. The Association of Major Power Consumers, which

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1 http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_hydro_hedging_8_october_2019_2/pdf/commentary_hydro_hedging_8_october_2019_2.pdf and http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_bc_hydro_hedging_gamble_17_september_2020/pdf/commentary_bc_hydro_hedging_gamble_17_september_2020.pdf

represents many of the largest electricity consumers, stated that in the current low rate environment BC Hydro should avoid future short-term hedging.[2]

BC Hydro's Hedging Contracts are Winding Down

Apparently, senior management at BC Hydro decided to stop gambling on the direction of future interest rates almost two years ago. In its recently filed application for the 2021 rate increase BC Hydro included a status report on the deferral account and future debt hedges for the 2019/20 fiscal year.[3] The report includes a listing of all the individual contracts beginning in May 2016, including the settlement date for those that have expired (but not the settlement date for the current contracts).

The last new contract was entered into on 17 January 2019. There does not appear to have been any new contracts since then. Since inception there have been 56 contracts, with 29 still open as of 31 March 2020. The amount (the notional principal) of hedged contracts peaked at $6.0 billion as of 31 March 2019, and declined to $3.2 billion as of 30 September 2020.[4]

The hedging contracts were originally intended to cover from 50% to 75% of the value of the new debt issued. From 1 April 2019 to 30 September 2020, BC Hydro reported that approximately $3.4 billion in net long-term debt was issued, while no new hedging contracts were signed. This would confirm that the program is being allowed to unwind.

BC Hydro noted that the remaining hedges had maturity dates ranging from three months to 4.2 years, so it may be some time before the risk exposure is eliminated.

TABLE 1 – GROWTH IN INTEREST RATE HEDGE LOSSES ($=million)

	2016/17	2017/18	2018/19	2019/20	Q2 20/21	f2020/21
Contracts Value	3.60	4.90	6.05	5.03	3.23	unknown
Period Losses	n/a	(29)	(321)	(615)	(71)	(197)*
DMRA Balance	(187)	(158)	163	953	1,030	1,150

*For the full year

Source: BC Hydro annual reports and the Q2 report to 30 September 2020. The forecast for 2020/21 is from the 2021/22 rate request, Chapter 7, Table 7-3: https://www.bcuc.com/Documents/Proceedings/2020/DOC_60299_B-2-BCH-F22-RRA-Application.pdf

[2] https://thetyee.ca/News/2020/10/07/BC-Hydro-Bets-Interest-Rates/

[3] https://www.bcuc.com/Documents/Proceedings/2020/DOC_60301_B-2-2-BCH-F22-RRA-Appendices.pdf Appendix V, Pdf 568/650.

[4] https://www.bchydro.com/content/dam/BCHydro/customer-portal/documents/corporate/accountability-reports/financial-reports/quarterly-reports/F20-Q2-Report.pdf p. 29.

Table 1 shows the value of the hedged contracts, the losses incurred and the balance in the Debt Management deferral account as of 31 March for the last four fiscal years, and for the first half of the current year. The forecast for year-end is part of BC Hydro's recently filed rate request for 1 April 2021.

Mid-Term Outlook

The ultimate cost of the hedging gamble will depend on the change in interest rates when the current contracts settle. BC Hydro estimates that a 1% increase in long-term rates could eliminate most of the $1.0 liability; conversely, a 1% decrease could double the current liability. Such a significant change in interest rates is highly unlikely in the medium term.

In its rate request BC Hydro forecasts that the balance in the deferral account will decline marginally from $1.15 billion in 2020/21 to $1.05 billion in 2025/26.[5]

The decline in the liability balance is small because BC Hydro is adding this cost to the rate calculation based on the duration of the debt issued. If the average duration is 30 years, for example, the $1.15 billion liability will be eliminated over the next 30 years.

For 2021/22, a 1% rate increase equals approximately $51 million in revenue. Therefore, as an alternative, a 2% rate surcharge would eliminate the hedging loss in approximately 11 years.

Further details about the hedging program will be available in late February when BC Hydro responds to questions from the BCUC and interveners during the review of its 2021 rate increase request.

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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 recent reviews of ICBC's and B.C. Hydro's rate requests.

[5] See Chapter 7, Table 7-3 (Pdf 354/434) in https://www.bcuc.com/Documents/Proceedings/2020/DOC_60299_B-2-BCH-F22-RRA-Application.pdf