COMMENTARY **BC HYDRO**

LOSSES ON BC HYDRO'S INTEREST RATE HEDGING GAMBLE NOW EXCEED $1.0 BILLION

The purpose of BC Hydro's interest rate hedging program was to protect ratepayers from higher future borrowing costs resulting from increasing interest rates. Instead, as interest rates declined the program has had the perverse effect of preventing ratepayers from benefiting from lower the lower borrowing costs.

As of 30 June 2020, BC Hydro reports that the combined losses and liability on its interest rate hedging gamble now exceed an astounding $1.0 billion.[1]

The hedging program assumed that interest rates would increase, but they have gone in the other direction. The lower interest rates resulted in a significant increase in the potential liabilities faced by BC Hydro's ratepayers because of the negative consequences of the utility's decision to enter into an ill-fated program to hedge against an increase in future interest rates.

This paper is an update to my paper of 8 October 2019, which discussed the large losses incurred by the future interest rate hedging gamble.[2]

Deferring Hedging Gains and Losses

BC Hydro's hedging strategy depends on having the ability to defer gains and losses over many years. Under normal accounting rules the mark-to-market gains or losses on the hedge contracts are recorded as interest costs each year. By using rate-regulatory accounting the gains or losses are amortized over the term of the associated future long-term debt. These could range up to 30 years.

In 2016, B.C. Hydro asked the BC Utilities Commission (BCUC) to endorse the hedging strategy and to approve the new DMRA regulatory account. The Commission declined to

[1] https://www.bchydro.com/content/dam/BCHydro/customer-portal/documents/corporate/accountability-reports/financial-reports/quarterly-reports/BCHydro-F21-Q1-Report.pdf p. 19.

[2] http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_hydro_hedging_8_october_2019_2/pdf/commentary_hydro_hedging_8_october_2019_2.pdf

endorse the hedging strategy because it did not have the authority to regulate the operation of B.C. Hydro's borrowing, but it did agree to a new deferral account.[3]

At the time B.C. Hydro management was confident that interest rates would increase, resulting in higher borrowing costs in the future.[4] The gains on the hedging instruments would help offset the higher costs of the new borrowing thereby stabilizing customer rates, as the gains on the hedging contracts would offset the increased borrowing costs. Conversely, stable or decreasing interest rates would result in losses on the hedging contracts, thereby negating any benefit to the ratepayer from the lower borrowing cost.

Apparently, the BC Hydro planners did not believe that hedging against a decrease in interest rates (to reduce the risk of the hedge against an increase in interest rates) was necessary. Using a deferral account provided the means to transfer losses to future ratepayers.

When asked if it would proceed with the forward interest rate hedging strategy without a deferral account (which transfers the risk to the ratepayer from the shareholder) Fred James, a manager in B.C. Hydro's regulatory group, told a 2016 workshop that the risk of loss to the shareholder was too great to proceed without a deferral account backstop.[5]

The Hedging Liability Balloons by $904 Million in 15 Months

In the first year of the hedging program the higher interest rates resulted in a gain for ratepayers, but as interest rates began to decline the losses began to grow. The significant drop in interest rates in March 2020 drove the losses much higher.[6]

BC Hydro's first quarter financial results to 30 June 2020 reported that the regulatory assets in the DMRA increased by $111 million in April to June period, and now total $1.067 billion. In the last 15 months the balance in the account grew by a staggering $904 million.

We do not have details about each hedging agreement, such as the duration of the contract. B.C. Hydro does report the mark to market gains or losses in the "financial

[3] https://www.bcuc.com/Documents/Proceedings/2016/DOC_46024_G-42-16_Reasons.pdf

[4] The BC ministry of finance had forecast long term rates rising from 3.05% in 2016/17 to 4.55% by 2018/19; see https://www.bchydro.com/content/dam/BCHydro/customer-portal/documents/corporate/regulatory-planning-documents/service-plans/BCHydro-Service-Plan-2016-17-2018-19.pdf p. 14. In February 2016, BC Hydro said that rates "have more room to go up than to go down. In these circumstances, locking in low long-term interest rates now serves to protect customers from the risk of higher interest rates, and also serves to provide some measure of certainty in regard to BC Hydro's future revenue requirements and rate increases." https://www.bcuc.com/Documents/Arguments/2016/DOC_45754_02-19-2016-BCH_FinalSubmission.pdf p. 2.

[5] https://www.bcuc.com/Documents/Transcripts/2016/DOC_45581_Transcript_Volume_1_Workshop_01-27-2016.pdf p. 77/78.

[6] Central banks in Canada and the United States dropped their interest rates and restarted their quantitative easing programs. The Bank of Canada lowered the yield on 1 to 3-year bonds from 1.5% to 0.5%, while the prime lending rate dropped by 1.5% (from 3.95% to 2.45%) between 31 March 2019 and 31 March 2020; see https://tradingeconomics.com/canada/bank-lending-rate

instruments-hedges" footnote to its year-end and quarterly financial statements. The total value of the interest rate hedges and the mark to market aggregate valuation losses of contracts, including the just released first quarter of 2020/21, were:

TABLE 1 – GROWTH IN INTEREST RATE HEDGE LOSSES

	2016/17	2017/18	2018/19	2019/20	Q12020/21
Contracts Value $=billion	3.60	4.90	6.05	5.03	4.13
Annual Losses $=million	n/a	(29)	(321)	(615)	(111)
DMRA Balance $=million	(187)	(158)	163	953	1,067

Source: BC Hydro annual reports and the Q1 report to 30 June 2020.

Is a Reversal Through Higher Interest Rates Likely?

The accumulated hedging losses could be reduced if interest rates were to increase. However, it appears that neither the Bank of Canada nor the US Federal Reserve has any intention of raising interest rates in the next 12 to 24 months. "The Consumer Price Index (CPI)increased only 0.1 per cent in July from a year earlier, and the Bank of Canada's latest projections imply it will be at least a couple of years before the economy gains enough strength to put sustained upward pressure on prices."[7]

If correct, this means that the $1.0 billion balance in the DMRA will continue to increase.

BC Hydro maintains that the objective of the hedging program is price stability, therefore the foregone savings in borrowing costs – and by extension the affordability of the rates – is of less importance than stable rates.

 http://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 is an intervener in the BC Utilities Commission's current reviews of ICBC's and B.C. Hydro's rate requests.

[7] https://vancouversun.com/news/economy/bank-of-canada-holds-interest-rate-at-0-25/wcm/0280b35a-b824-4a1e-b922-97e7aa5644b3/ see also https://www.cbc.ca/news/business/federal-reserve-interest-rate-1.5726583