COMMENTARY **BC HYDRO**

GOVERNMENT BLOCKS POSSIBLE REDUCTION IN BC HYDRO'S EXCESSIVE PROFITS

A newly-minted cabinet order has again demonstrated the government's contempt for the notion of an independent third-party regulator to set BC Hydro's rates for electricity. Cabinet order OIC 172/21, distributed on Monday, overturned the government's promise to fully restore the BC Utilities Commission's (BCUC) authority to set BC Hydro's rates. The order requires the Commission to set rates for the next two years at a level that allows BC Hydro to continue to generate excessive profits.[1] The cabinet direction also reverses a decision by the Commission respecting the treatment of certain trade. No explanation or justification was provided to explain this decision.

This significant intrusion on the authority of the notionally independent regulator may prompt a qualification on the government's financial statements by the independent auditor general.

It also runs counter to the government's priority of ensuring affordable cost of living for the citizens of the province. Reducing the excessive profits would directly assist residents and businesses as the economy rebounds from the effects of the pandemic.

Return on Equity

Many regulators use a cost of service (COS) model to set "just and reasonable" prices for monopoly or near-monopoly utilities. The objective of the COS model is to ensure that the revenue from customers is sufficient to cover prudently incurred costs, and to allow the utility the ability to earn a return on equity based on the degree of risk.

For the last decade, the government has required the BC Utilities Commission (BCUC) to approve BC Hydro's annual prices to ensure unjustifiably high profits (net income). Beginning in 2008, the government has been manipulating BC Hydro's profit target by ordering the public's electric utility to use an inflated equity base (the "deemed" equity) and a high return on equity percentage to support the high profits.

A 2008 cabinet order required that the equity used to calculate the net income target was an arbitrary number, rather than the actual equity derived from subtracting liabilities from assets. This action, coming during the 2008 economic downturn, was designed to protect the government's net income stream from BC Hydro.[2] Other cabinet

[1] https://www.bcuc.com/Documents/Proceedings/2021/DOC_61819_B-11-BCH-Submission-on-DIR-8-OIC-172.pdf

[2] National public sector accounting standards required that the net income from "government business enterprises" be counted as revenue to the government, even if no cash (dividend) is transferred.

orders required that the BCUC abandon its attempt to set the net income based on a lower benchmark, and eventually (2012) resulted in the government ordering the nominally independent regulator to agree to annual rate changes set by the government. From 2012 to 2018, the government set the annual net income targets, and in recent years the percentage was expressed as a fixed dollar amount of $712 million. Table 1 shows the net income and ROE based on the actual equity from the previous year (BC Hydro calculates the ROE from the mid-year equity).

TABLE 1 – ACTUAL and PLANNED NET INCOME and ROE

	Net Income (mil)	ROE (%)
FY2016/17	683.5	15.2
FY2017/18	684.0	13.9
FY2018/19	(428.2)	n/a
FY2019/20	704.9	14.2
FY2020/21 forecast	690.7	12.2
FY2021/22 budget	712.0	11.2

Source: BC Hydro F2022 Rate Request, Appendix A, Schedule 9. In 2018/19 BC Hydro eliminated the Rate Smoothing Regulatory Account resulting the operating loss.

For the last number of years BC Hydro's profits (net income) has been excessive. In theory, the ROE should reflect the risk to the investor's capital investment, but BC Hydro's large variety of deferral accounts have insulated its profit (net income) from most variances between budgeted and actual costs. Even variances between planned and actual revenues are being deferred (de-coupled to use the latest terminology), which practically eliminates the risk to achieving the planned net income. Table 2 shows the planned and actual net income for the last five years and the budget for 2021/22. The effect of the deferral accounts is obvious.

TABLE 2 – ACTUAL and PLANNED NET INCOME ($=million)

	Planned Net Income	Actual Net Income
FY2016/17	684.0	683.5
FY2017/18	698.0	684.0
FY2018/19	712.0	(428.2)
FY2019/20	712.0	704.9
FY2020/21 forecast	712.0	690.7
FY2021/22 budget	712.0	tbd

Source: BC Hydro F2022 Rate Request, Appendix A, Schedule 3.0. In 2018/19 BC Hydro eliminated the Rate Smoothing Regulatory Account resulting the operating loss

Any Savings from BCUC's Review of the ROE Negated

For the last ten years the government has directed the BCUC to approve a high ROE. While the NDP government loosened the tight controls over the nominal regulator in 2019, it continued to require a net income of $712 million for the budgets for the last two years.[3] The order was to expire on 31 March 2021.

In anticipation of the restored authority to set BC Hydro's rates based on a more realistic ROE, the Commission initiated a review of the appropriate return (the cost of capital). Given that the current economic environment is characterized by very low interest rates and bond yields, and recognizing that most of BC Hydro's potential cost and revenue variances are covered by deferral accounts, it is very likely that the review would have dramatically reduced the allowed ROE.[4]

The government's directive will ensure that any reduction in the net income resulting from the Commission's review will not benefit BC Hydro's ratepayers for at least the next two years.

If the ROE was set at 6.0% for the 2021/22 fiscal year (on the forecasted equity for 2020/21) the net income target be approximately $380 million. The savings of $332 million from the government's $712 million target level would have provided an economic stimulus for residents and businesses. It would also have supported the government's goal of lowering GHG emissions by making the price of hydro electric power more competitive when compared to carbon based fuels.

Warning Signs

The new limitation on the authority of the BCUC comes while the Commission and a variety of interveners were in the final stages of reviewing BC Hydro's request for a 1.16% rate increase for 2021/22. When it filed its application on 22 December 2020, BC Hydro originally asked the BCUC approve a net income of $712 million, the same amount as the government ordered the regulator to approve for the current year.

Knowing that the previous cabinet order expired on 3 March 2021, the utility suggested the net income target be reviewed months into the future, which would provide time for the government to provide direction.

Instead, on 18 January 2021, the BCUC launched a generic capital. BC Hydro responded by requesting that any difference between the requested $712 million in net income and the final determination of the ROE for the coming year be transferred to a new deferral account. Again, the public utility hinted that the government may issue a relatively benign "policy guidance" on the matter, and sought to delay the Commission's decision:

[3] OIC 51/19 of February 2019 ordered the BCUC to set rates to generate a net income of $712 million.
[4] In 2012 the BCUC had decided that the ROE for BC Hydro should be 8.75%. The government over-rode that target by cabinet order.

"BC Hydro expects to await any Government policy direction that may be forthcoming, and will then subsequently file an application as appropriate. We currently expect that such a filing would occur late this calendar year. The nature and scope of the regulatory process has not been determined, nor has BC Hydro's approach. BC Hydro expects that alternative methods of determining BC Hydro's return on equity will be considered as part of that application."[5]

A deferral account would protect the $712 million for 2021/22 and allow the government to record this this amount as BC Hydro's contribution to the government's 2021/22 revenue plan. Unfortunately, the current modified accrual system of public sector accounting implies that this money supports other government programs. This is not the case as explained in an earlier paper.[6] But many observers and politicians believe that a decline in BC Hydro's net income would have negative consequences for the government's borrowing requirement. This may explain why the government would be reluctant to lower the ROE target to better reflect the low risk to BC Hydro's net income.

With the new cabinet order in place BC Hydro withdrew the proposal for a deferral account.

Will New Order May Result in Another Qualification from the Auditor General?

Former Auditor General Carol Bellringer determined that the government's tight control over the notionally independent regulator of BC Hydro contravened the national public sector accounting standards. By establishing a unique accounting standard for BC Hydro, the government tried to justify deferral (regulatory) accounting, which generally kept price increases lower than warranted, and increased the debt liability for future generations.

Ms Bellringer qualified the government's 2016/17 and 2017/18 financial statements in part because of the abnormal accounting at BC Hydro and the government's tight control over the regulator. "Government direction has largely predetermined BC Hydro's allowable costs, rates, use of regulatory accounts, and net income, leading to

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[5] https://www.bcuc.com/Documents/Proceedings/2021/DOC_61151_B-4-BCH-responses-to-BCUC-IR1.pdf Pdf 751/866.

[6] While these papers focus on ICBC the same situation applies with respect to the net income from BC Hydro https://www.bcpolicyperspectives.com/media/attachments/view/doc/accounting_rule_adds_complexity_17_feb_2018/pdf/accounting_rule_adds_complexity_17_feb_2018.pdf and https://www.bcpolicyperspectives.com/media/attachments/view/doc/fact_check_icbc_17_february_2020/pdf/fact_check_icbc_17_february_2020.pdf

rates that have not been designed to recover the costs of service. One result is that BC Hydro's net income is no longer connected to risk or performance."[7]

She withdrew the qualification for the 2018/19 statements after the government allowed BC Hydro to adopt the IFRS accounting standard (which required an independent third-party regulator to oversee the deferral accounts). The government also ordered the elimination of the Rate Smoothing Regulatory Account, which was designed to keep rate increases low by increasing BC Hydro's liabilities.

Another result of the first phase of the comprehensive review into BC Hydro's finances was the directive to the BCUC to retain the high Net income target for the 2019/20 and 2021/22 fiscal years. While the government did not provide the BCUC with full authority to set B.C. Hydro's return on equity (net income), the auditor general decided to lift her qualification based on the government's assurance that BCUC's full authority to set rates and the net income will occur starting in 2021.[8]

In her explanation of her opinion on the 2018/19 statements Ms Bellringer stated that her withdrawal of the qualification was based on the promised independent "framework" for the BCUC; "Government's plans provide for an appropriate regulatory framework and allow BCUC to provide the scrutiny and authority required by the accounting standards."[9]

Later in the document Ms Bellringer again referred to the planned independence of the regulator: "With these changes in government regulation and direction, the removal of the RSRA, and government's **commitment to restore the authority** of the BCUC, we agree with government's assessment that BC Hydro's use of rate-regulated accounting is now appropriately reflected in the SFS [summary financial statements] and have therefore removed our qualification for this year."[10] [my emphasis]

Summary

The latest cabinet order continues the government's politicization of BC Hydro's finances. The question is whether this abrogation of the commitment to the previous auditor general about restoring the independence of the BCUC to approve BC Hydro's rates will result in a confrontation with Mr. Michael Pickup, Ms Bellringer's successor.

[7] https://www.bcauditor.com/sites/default/files/publications/reports/OAGBC%20-%20Final%20Report%20-%20Understanding%20our%20Audit%20Opinion%20on%20BCs%202017-18%20Summary%20Financial%20Statements.pdf

[8] https://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_auditor_general_removes_qualification_19_july_2019/pdf/commentary_auditor_general_removes_qualification_19_july_2019.pdf

[9] https://www.bcauditor.com/sites/default/files/publications/reports/OAGBC_ROTO-2018-19_RPT.pdf p. 10.

[10] Ibid. p. 11.

Requiring the notionally independent regulator to set rates to generate a preconceived and excessive profit target does not seem to conform to the idea of an independent regulator.

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

Auditor General audits delayed

https://www.theglobeandmail.com/canada/british-columbia/article-bc-auditor-general-postpones-10-performance-audits-due-to-covid-19/