COMMENTARY **ICBC and BC HYDRO**

LOW INTEREST RATES BAD NEWS FOR ICBC's and BC HYDRO's BALANCE SHEETS

The recent announcement by the US Federal Reserve of continuing low interest rates is bad news for the balance sheets of BC Hydro and ICBC, and ultimately for their customers. The 10 June 2020, announcement stated that the bank expects its fund rate to remain near zero through to the end of 2021.[1] It is likely that the Bank of Canada will follow suit and keep interest rates at the current low level.

The central banks cut their lending rates in March in response to a dramatic drop in the financial markets resulting from the COVID-19 pandemic. These unforeseen events negatively impacted government and corporate balance sheets, including those of BC Hydro and ICBC, which closed the 2019/20 fiscal year on 31 March 2020.

There are three ways to restore the financial health of our two Crown corporations; wait for economic activity (including interest rates) to rebound, reduce expenditures and/or increase revenues. The poor financial health of these two important public corporations would appear to preclude any government move to meet its affordability objective by reducing premiums.

But how severe is the damage to the balance sheets?

The March 2020 Collapse in Interest Rates and Financial Markets

The rapid spread of the COVID-19 virus, and the government-ordered economic restrictions, resulted in March in a rapid drop in the equity markets. The Toronto stock exchange index dropped by approximately 25% from its February high to 31 March 2020. On a year-over-year basis the decline was approximately 17%.[2]

Since April there has been a moderate rebound in the equity markets. As of 12 June, the TSX index is 14% higher than the 31 March 2020 level, and only 5% below the level of 31 March 2019.

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[1] https://www.bloomberg.com/news/articles/2020-06-10/fed-puts-floor-under-bond-buying-sees-zero-rates-through-2022?cmpid=BBD061020_BIZ&utm_medium=email&utm_source=newsletter&utm_term=200610&utm_campaign=bloombergdaily

[2] https://www.google.ca/search?source=hp&ei=HRjlXufCMdjL0PEPsKKosAw&q=tsx+index+history&oq=tsx+index+&gs_lcp=CgZwc3ktYWIQARgHMgUIABCDATIFCAAQgwEyAggAMgUIABCDATICCAAyAggAMgIIADICCAAyAggAMgIIADoFCAAQsQM6CggAELEDEEYQ-gFQvwhYjTNgp19oAHAAeACAAYwBiAH3B5IBAzYuNJgBAKABAaoBB2d3cy13aXo&sclient=psy-ab#spf=1592072234897

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.[3]

While the drop in the value of equity investments lowers the value of assets for insurance and pension funds, the drop in interest rates increases the market value of fixed income (government and corporate bonds) investments, as these bonds usually have a higher yield compared to the new interest rate.

ICBC's Year-End and Outlook for the Current Year

The government will not disclose ICBC's 2019/20 financial statements until mid-July when the government's public accounts are released. But it is likely that the combination of the drop in equity values and the decline in interest rates have combined to result in a negative equity position.

The lower interest rates will reduce the discount rate used to value the estimated $15 billion in unpaid injury claims. ICBC says that a 1% decline in the discount rate will add approximately $400 million to the cost, but this is mostly offset by and increase in the value of its fixed income investments.[4]

The 17% drop in the average value of ICBC's estimated $4.4 billion equity investments would result in a loss of approximately $750 million by year-end.

Finally, ICBC's pension plans would have recorded an increase in the cost of the obligations and a decline in the value of the investment assets. The corporation says that a 1% decline in the discount rate would result in an increase of $610 million in the pension obligation. Equities comprise about 67% of the pension assets, therefore a 17% drop in value might result in a loss of approximately $250 million, partially offset by an increase in the value of the fixed income assets. It is quite possible that the pension funds suffered a combined loss of at least $700 million. If true, this would reduce the solvency ratio from a reasonable 95.5% for 2018/19 to approximately 75.0%.

We will have to wait for the audited financial statements to review the impact of the economic slowdown on ICBC's premium revenue and claims costs. A drop in claims costs would moderate the equity market losses. However, based on this simple analysis it is likely that by 31 March 2020, ICBC will record significant negative equity – perhaps in the order of $600 million.

[3] https://tradingeconomics.com/canada/bank-lending-rate
[4] https://www.icbc.com/about-icbc/company-info/Documents/service-plan-2020-2023.pdf pp. 19-20.

This may be a conservative estimate. The ICBC report on the financial effects of the pandemic was not detailed enough to analyze the 2019/20 impact,[5] but David Eby, the minister responsible, did state that in March ICBC's investments fluctuating "by $1 billion as world stock markets collapsed."[6]

For the current year, the partial rebound in the equity markets in the first quarter will reduce the negative equity, but if interest rates remain at the current low levels ICBC will remain in poor financial health. The lack of an adequate capital (equity) reserve could jeopardize the promised 20% rate reduction starting in May 2021 due to the adoption of a no-fault liability model. Proceeding with the reduction with little or no equity could be seen as a reckless policy designed to pander to voters.

BC Hydro's Year-End and Outlook for the Current Year

On 10 May 2020, BC Hydro released a summary of the impact of COVID-19 on its operations. The document focussed on the sharp decline in electricity sales and did not discuss the year-end financial implications.[7] While there is little doubt that the decline in sales and the drop in interest rates had a negative impact on BC Hydro's 2019/20 finances, BC Hydro's reliance on rate regulated (deferral) accounting to protect the net income will mask some of the most obvious impacts.[8]

BC Hydro has stated that the drop in sales revenue in March will be recorded as though it was received and the variance to the budget will be added to the Non-Heritage Deferral Account (NHDA). The decline in actual revenue, with no off-setting decline in expenditures, will increase the debt. But the offsetting increase in NHDA asset will protect the corporation's equity target.

Unlike ICBC and WorkSafeBC,[9] which rely on investment returns to partially offset claims costs, BC Hydro has large debt servicing costs. A drop in interest rates should lower its borrowing costs and thereby lower the price of electricity. Unfortunately, BC Hydro's losses from its gamble on derivatives market to hedge against increasing

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5 http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_icbc_s_covid_19_impact_report_19_may_2020/pdf/commentary_icbc_s_covid_19_impact_report_19_may_2020.pdf

6 https://www.timescolonist.com/pandemic-reduces-icbc-s-claim-costs-but-crashes-investments-says-eby-1.24135248

7 http://www.bcpolicyperspectives.com/media/attachments/view/doc/fact_check_bc_hydro_sales_drop_12_may_2020_2/pdf/fact_check_bc_hydro_sales_drop_12_may_2020_2.pdf

8 BC Hydro prefers to present the large number of deferral accounts as a wat to ensure that ratepayers pay the actual costs…eventually. For the 2018/19 fiscal year the net balance in the regulatory accounts comprised some 85% of BC Hydro's equity.

9 In May, WorkSafeBC's investment losses raised some controversy; see https://vancouversun.com/news/worksafebc-has-lost-billions-cant-afford-to-help-businesses-buy-ppe/wcm/ad676cbb-c00d-4fc2-a715-50a2b87899d1/

interest rates has eliminated any opportunity for ratepayers to benefit from the drop in borrowing costs.

In its quest for stable rates, or to eliminate a risk to the net income, in 2016 BC Hydro began purchasing hedging contracts against future increases in interest rates. A rise in interest rates results in a credit to ratepayers in the debt management deferral account to offset the increased borrowing cost. Steady or declining rates has the opposite impact, where the benefit of lower interest rates is offset by losses in the hedge contracts.[10]

In its most recent service plan BC Hydro states that a 1% drop "in forward interest rates results in an $800 million to $900 million increase/decrease in the fair value of the financial contracts that hedge interest rates on future debt issuances. Any ... losses on interest rate hedges are amortized starting in the next test period over the remaining term of the underlying debt (e.g., 10 to 30 years)."[11] With the Bank of Canada rate dropping by 1.5% as of 31 March 2020 compared to the prior year, the increase in the hedging losses could be $1.2 billion.

If low interest rates persist through 2020 and 2021, as predicted by the US Federal Reserve, many of these notional losses will be realized as the hedge contracts expire, which increases the debt burden faced by future customers. The notional and actual losses are deferred and added to electricity prices over an extended period.

Regarding the BC Hydro pension plans, the drop in interest rates, combined with the losses in the equity markets, will have worsened an already poor financial position. For the last few years, the defined benefit pension obligations have exceeded the assets such that the solvency ratio was only in the low 70's. This compares to other public sector plans that were fully funded, or nearly fully funded.

BC Hydro estimates that a 1% decline in the discount rate results in a $500 million to $600 million increase in the pension obligation.[12] It is highly likely that for 31 March 2020, the combination of a significant decline in the discount rate, combined with a loss of value in the pension assets, would have increased the pension shortfall to approximately $2.2 billion (from $1.47 billion in the prior year), resulting in a solvency ratio of only 60%. The shortfall to the new solvency ratio target of 85% would be approximately $1.5 billion, rather than $2.2 billion.[13]

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10 http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_hydro_hedging_8_october_2019_2/pdf/commentary_hydro_hedging_8_october_2019_2.pdf

11 BC Hydro, F2020 to F2021 RRA, Exhibit B-11 Evidentiary Update, Appendix D, pp. 2-3; https://www.bcuc.com/Documents/Proceedings/2019/DOC_55184_B-11-BCH-Evidentiary-Update-Public.pdf Pdf 40-41.

12 Ibid. p. 2. Pdf 40.

13 Following the lead of Quebec and Ontario, the BC government amended the defined benefit pension legislation to lower the required solvency ratio to 85% from 100%; see https://www.burnabynow.com/les-leyne-pension-change-heightens-risk-in-private-sector-1.24106283

The pension shortfall is deferred to the pension regulatory account, which offsets the increase in the liability on the balance sheet, thereby protecting the net income and equity targets. The balance in the pension deferral account is added to customer rates over a 13-year period.

The net balance in the regulatory accounts for 31 March 2020 could rise to $5.8 billion (compared to $4.2 billion for the previous year[14]), and significantly exceed the reported equity.

Summary

The COVID-19 related drop in the equity markets, and the related monetary stimulus provided by much lower interest rates have had negative consequences for the finances of ICBC and BC Hydro. The 2019/20 impacts at ICBC, which uses standard accounting, will likely result in a significant operating loss, and negative equity. With BC Hydro, the extensive use of regulatory accounting allows the losses in electricity sales, the losses in the pension funds and the interest rate hedges to be deferred. These deferrals protect the net income and the equity targets, but increases the balance sheet liabilities (and eventually the actual debt).

The poor state of the financial health of these two vital Crown corporations resulting from the effects of combatting the pandemic raises some key questions for the next two to three years.

Can the government proceed with a 20% drop in ICBC rates in May 2021 if continuing low interest rates results in negative equity at the public auto insurer? Should the government be continuing to press for more affordable electricity rates at BC Hydro without addressing the growing debt and the net balance in the deferral accounts?[15] Can BC Hydro's balance sheet carry the burden of more costs resulting from potential CleanBC initiatives, especially when it faces higher debt and major operating losses once the Site C dam becomes operational?

 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

[14] https://www.bcuc.com/Documents/Proceedings/2019/DOC_55184_B-11-BCH-Evidentiary-Update-Public.pdf Pdf 42.

[15] The 26 March 2020, interim report on the Phase 2 report on BC Hydro includes broad suggestions of lowering the price of electricity, particularly for the Industrial users; https://www2.gov.bc.ca/assets/gov/farming-natural-resources-and-industry/electricity-alternative-energy/electricity/bc-hydro-review/bc_hydro_cr_ph2_ir_mar06_2020_f.pdf

2016. *BC Studies* published his paper on the 40-year financial history of ICBC in 2013. He has been an intervener in the BC Utilities Commission's recent reviews of both ICBC's and BC Hydro's rate requests.