OCCASIONAL PAPER No. 11 – BC HYDRO

IS BC HYDRO OPERATING MORE LIKE A COMMERCIAL POWER UTILITY?

In June 2013 Bill Bennett, the newly-appointed minister responsible for BC Hydro, said his goal was to have the major[1] electrical public utility "operate like a commercial corporation."[2] The Liberal government had just been re-elected, and Bennett seemed to indicate that he wanted to change the recent practice of the government controlling BC Hydro's finances.[3] In 2012, cabinet had stripped the BC Utilities Commission of its regulatory authority over BC Hydro's operations, and set low rate increases for 2012 and 2013, thereby ensuring that BC Hydro's finances would not become an election issue.

In the summer of 2013 the government rejected the corporation's proposed cumulative 26% rate increase for 2014 and 2015. In November, the government announced a 10-year financing plan for BC Hydro, which was detailed by cabinet orders in March of 2014.

The plan set rate increases of 9%, 6% and 4% for 2014 to 2016, which were below the forecasted growth in expenditures, resulting from higher energy costs and a major growth in capital expenditures. Premier Clark defended the plan as balancing the need for renewing BC Hydro's aging assets[4] and "keeping rates as low as possible."[5]

RECENT PERFORMANCE AND DIRECTION 7

The 10-year financing plan relies on the extensive use of deferring cost over-runs (from the rate-suppressed annual budgets) to meet the net income (profit) targets. Only independently regulated power utilities are permitted to use deferral, or regulatory, accounting to help cushion or smooth rate changes resulting from the volatility in the cost of energy. Following the 2008 financial crisis and the economic recession, BC Hydro was able to appear profitable by resorting to a much greater use of deferral accounts to defer cost variances, as the amounts deferred both increase the net income and are treated as assets on the balance sheet. By 2012/13, the net balance in the deferral accounts was 126% of BC Hydro's equity, far greater than other power utilities.[6]

The 10-year financing plan relied on a new deferral account which appears to be in violation of accepted accounting rules – the recording of non-approved future revenue. The new government-mandated 'rate smoothing' account requires BC Hydro to inflate its true revenue and net income (which also allows a dividend to be paid to the government). The higher net income, in turn, adds to the government's

[1] BC Hydro is the fifth largest corporation headquartered in BC ranked by revenue.
[2] *Globe and Mail*, 30 June 2013.
[3]
[4] Although a significant percentage of the capex was for new generation and transmission lines.
[5] *Hansard*, 28 May 2014, p 4399.
[6] For example, FortisBC's ratio was 39%, and Hydro Quebec's ratio was approximately 25% in 2014.

revenue and improves its operating surplus. The cash dividend helps lower the government's borrowing requirements.

Table 1, developed from the information in BC Hydro's annual reports, shows that the actual revenue from sales was being inflated before the new rate smoothing mechanism was imposed. The cost of energy was also adjusted by the transfer of the difference between the budgeted and the actual amounts.

TABLE 1 ACTUAL AND REPORTED AMOUNTS ($=millions)

	2013/14	2014/15	2015/16
REVENUE Actual	5,187	5,256	5,358
-Add Deferrals	205	326	178
-Add Rate Smooth	--	166	121
Reported	5,392	5,747	5,657
EXPENDITURES Actual	4,862	5,169	5,231
-Less Deferrals	(19)	(2)	219
Reported	4,843	5,167	5,002
NET INCOME Actual	324	87	127
-Deferral Adjust.	225	494	528
Reported	549	581	655

Source: BC Hydro, annual reports.

The use of deferral accounting, and the recording of future unapproved revenue allows BC Hydro to record greater retained earnings, pay a dividend to the government and increase the equity on the balance sheet. Table 2 shows the reported change in equity by year compared to the actual without the net increase in deferrals. The actual equity is after the dividend, but the dividend paid would have been much lower or zero in the absence of the deferred assets.

TABLE 2 CHANGE IN EQUITY ($=MILLIONS)

	2013/14	2014/15	2015/16
REPORTED	532	569	656
-LESS DIVIDEND	(167)	(264)	(326)
-LESS DEFERRAL	(256)	(734)	(474)
ACTUAL	109	(429)	(144)

Source: BC Hydro, annual reports.

The experience after some two years into the plan would suggest that instead of lessening the controls on BC Hydro's finances, and allowing the BC Utilities Commission to regulate in the public interest,[7] the government has tightened its controls. This is summarized below where the pre and post 10-year plan practice shows:

1) Rates Set by Independent process? No change, cabinet sets rates.
2) Rates Reflect Cost of Service Model? No, growth in rates less than growth in costs.
3) Eliminate 'Deemed' Equity? No, net income target still set on inflated equity plus CPI.
4) Net Income Target Based on Benchmark ROE? No, continue to use cabinet-ordered ROE ratio.
5) Net Income Based on Performance? No, now minimum profit set by OIC 590/16 (28 July 2016).
6) Dividends Paid from Earnings? No, dividends paid by borrowing.
7) Dividend Based on Performance? No, now dividend amount fixed by OIC 589/16 (28 July 2016).
8) Pension Solvency Ratio close to 100%? No, approximately 72%, same as 2012/13.
9) Less Reliance on Deferrals? No, net deferral to equity ratio at 131% in 2015/16, compared to 126.7% in 2012/13.

Direction 7 of March 2014 is more prescriptive as to rate-setting and the manipulation of BC Hydro's finances than any previous cabinet order. It requires that any revenue shortfall between that generated by the capped rate increase and the forecast requirement (the baseline forecast) must be recorded as received and deferred to the new rate smoothing deferral account.[8]

In its F17 to F19 rate request, BC Hydro states that Directive 7 also implies that any revenue shortfall (not offset by a cost reduction) between the baseline forecast and the year-end actual will also be deferred. While apparently contrary to accounting principles, this seems to have been the practice during the last three years as shown in Table 1, where over $700 million of future unapproved revenue has been recorded and deferred in addition to the $287 million in the rate smoothing account.

Why defer a revenue variance rather than increase the cost variance deferral? The answer seems to be that, where sales are less than forecast, BC Hydro cannot achieve the net income target required by the government solely from the variance in costs. Rather than report a lower net income, as one would expect from a power utility using generally accepted accounting principles, the government has determined that the forecast net income will be fixed and the revenue deferral will vary depending on the circumstances.

CREDIT RATING AND CONDERN ABOUT BC HYDRO'S FINANCES

[7] As recommended by the Independent Review Panel in their 2014 report.

[8] Officially the three cost of energy accounts are called deferral accounts, while the remainder are called regulatory accounts, but for simplicity they are all referred to as deferral accounts. In its 28 July 2016 rate requirements request BC Hydro says that the energy deferral accounts are intended for revenue and cost variances, see http://www.bcuc.com/Documents/Proceedings/2016/DOC_46852_B-1-1_BCH_RevenueRequirements-App.pdf, Chapter 7, page 10. There was no mention of revenue being deferred in the F2012 to F2014 review.

In a recent report on the province's finances Moody's Investor Services expressed concern about the recent and planned growth in BC Hydro's debt, noting that the utilities financial health indicators were among the weakest of Canadian provincial utilities. It noted, however, that BC Hydro "has flexibility to increase utility rates to ensure that its own revenues will continue to support its operations and debt payments."[9] Apparently the Moody's analyst had not been briefed on the government's decision to suppress the required rate increases[10] yet demand a high profit margin by the use of deferred expenditures and recording future unapproved revenues. These measures have accelerated the growth in the utility's debt liability faced by future customers.

The joint federal/provincial Site C review panel was more insightful when they commented that the finances of BC Hydro and the provincial government were "intertwined by the latter at the expense of the former." The effect has been the government forcing BC Hydro to increase its debt and maintaining that the corporation's debt was self-sustaining through "rates it did not allow BC Hydro to charge."[11]

One is left to conclude that BC Hydro is not operating more like a commercial corporation, in fact the rate setting is no longer based on the reasonable cost of service model, but has been altered to what appears politically expedient. As the net income is now pre-determined, the difference between actual revenue and the baseline forecast revenue will be deferred and future ratepayers will face a larger debt liability.

The writer is a retired senior BC government public servant who's paper on the 40-year financial history of ICBC was published by *BC Studies* in 2013. The same academic journal will be publishing his paper describing the BC government's manipulation of the finances of BC Hydro from 2008 to 2014 in the fall. He has been an intervener in the BC Utilities Commission's 2014 and 2015 reviews of ICBC's rate requests.

[9] http://vancouversun.com/opinion/columnists/vaughn-palmer-credit-report-sounds-alarm-over-bc-hydro-debt

[10] The 4% rate increase for 2016/17 is 4.9% less than what BC Hydro estimates is required, while the 3.5% for 207/18 is (using the corporation's optimistic forecast) 1.5% less than required.

[11] Government of Canada, "Report of the Joint Review Panel – Site C Clean Energy Project," May 2014, p 280 and 281.In April, during questioning about BC Hydro's finances, minister Bennett admitted that the current and future dividends are paid using borrowed funds, see *Hansard*, April 7, 2016, p 11987.