

OBSURE GOVERNMENT ORDER ENSURES BC HYDRO CAN APPLY REGULATORY (DEFERRAL) ACCOUNTING EVEN WITHOUT AN INDEPENDENT REGULATOR

THE GREAT BC HYDRO PAN OUT – FINDING GOLD NUGGETS IN THE DROSS

In 1896 gold was discovered in the Klondike, and by the spring of 1897 thousands of gold seekers went north hoping to make their fortune. After securing their small claim area the fortune-seekers spent the long winter days melting the frozen ground to shovel out the dirt. When the warmer weather finally came, the miners washed the accumulated dirt in sluice boxes to separate the heavier gold nuggets and flakes. The final cleaning of the sluice boxes was done with a gold pan to ensure all the gold was found.¹

In some ways, the BC Utilities Commission's review of BC Hydro's rate request for fiscal years 2016/17 to 2018/19 is like the great pan-out of the early years in the Klondike. Between the initial application in July 2016, and the two rounds of information requests from the Commission and the interveners, BC Hydro filed over 13,000 pages of text, tables, graphs and related reports.²

What makes this more remarkable is that the government had capped the potential rate increase for these three years at 4, 3.5 and 4 percent.³

The BC Hydro pan-out really began with in late November 2016 when BC Hydro filed over 7,200 pages of responses to the first round of information requests, followed in late January 2017 with about 3,000 pages responding to questions posed in the second round. The questions ranged from broad issues respecting policy and forecast trends, down to asking for the cost differential between concrete and wood power poles.

Finding the gold nuggets makes all the work of digging and separation worthwhile. Several examples can be sited, but this paper will concentrate on the fact that the government has created an accounting system that is unique to BC Hydro. One that does not conform to Canadian or American generally accepted accounting principles (GAAP).

This nugget came to light in BC Hydro's January 23, 2017 response to my question about the need for an independent regulator as part of the accounting standard used by the public utility.⁴

¹ Kathryn Winslow, *The Big Pan-Out: The Klondike Story*, Phoenix House 1952, p. 170. My grandfather Henry McCandless was in Dawson City in 1899 as the owner of an outfitting store.

² The staff of BC Hydro deserves to be complimented for all their effort in responding to the hundreds of questions; the cost, both for BC Hydro and that of the Commission and the interveners who file claims, eventually is included in the electricity rates.

³ The fact that there had not been a full review since 2012 may explain part of the eagerness for information from the public utility. In May 2012 (OIC 314/12) the cabinet ordered the BC Utilities Commission to approve rate increases for 8, 3.91 and 1.44 % for 2011, 2012 and 2013 respectively. In March 2014, through cabinet order, the rates for 2014 (9%) and 2015 (6%) were also set by government fiat.

⁴ See BCUC, BC Hydro RRA F17 to F19, IR 2, RM 4.5.2, http://www.bcuc.com/Documents/Proceedings/2017/DOC_48632_B-15_BCH-Response-Intervener-IR-No2.pdf, p.1278/1815.

A SHORT HISTORY

The BC government requires that all accounting policies and practices for the government, including Crown corporations, conform to the GAAP for senior governments in Canada.⁵ In the late 2000s the national Public Sector Accounting Standards Board ordered that the International Financial Reporting Standards (IFRS) would be adopted as the Canadian standard.

At that time the IFRS did not contain a provision for rate regulated accounting, consequently its adoption would end BC Hydro's ability smooth annual electricity rates over several years using deferral accounts.⁶ The IFRS also required entities to include on the balance sheet pension shortfalls as liabilities, and it would have ended BC Hydro's practice of deferring a portion of its overhead to capital projects.

To avoid these problems, in July 2011 the treasury board sub-committee of cabinet adopted a regulation under the Budget Transparency and Accountability Act (BTAA) to allow BC Hydro to use the American accounting standard, which does recognize deferral, or regulatory, accounting.⁷ In this way, BC Hydro's deferral accounts, a vital component of the government's rate suppression policy, would be preserved.

In 2012/13, BC Hydro adopted the IFRS accounting rules and the American standard (ASC 980) for the deferred accounts, and this was now termed the "prescribed standard" in the annual report and other documents.

BC HYDRO EXEMPTED FROM NEED FOR INDEPENDENT REGULATOR

The American ASC 980 regulated accounting standard has as its foundation the need for an independent, third-party regulator to ensure that regulated utilities do not abuse the use of deferral accounting. If a regulated utility is reducing the risk of loss to its shareholders by expanding the use of cost or revenue deferrals, the regulator can either not approve the deferral, or it can reduce the utility's allowed net income (return on equity).

Section 5 (3), however, of the July 2011 treasury board regulation (146/2011) states: "The part of the United States Financial Accounting Standards Board Accounting Standards Codification 980 that requires rates to be established by or subject to approval by an independent, third-party regulator is not adopted."

This means that **BC Hydro does not need an independent, third-party regulator to use regulatory accounting.** The role of the protector of ratepayers' interests is eliminated.

The exclusion clause was not mentioned in BC Hydro's annual reports or service plans. In fact, BC Hydro implies that in using the combined "prescribed" standard it follows the ASC 980 principles.

This exemption provides a convenient trump card if the assumed independence of the BC Utilities Commission, and thereby the adherence to accepted accounting principles, was ever questioned.⁸

⁵ BC Budget Transparency and Accountability Act (BTAA), Section 23.1.

⁶ See p. 2 in <http://www.bcpolicyperspectives.com/blog/posts/bc-hydro-rate-suppression-and-debt>

⁷ See BC Regulation 146/2011 of July 5, 2011. The US standard assumes an independent, third-party regulator; see Appendix 1.

⁸ For example; <http://www.bcpolicyperspectives.com/blog/posts/is-the-bc-utilities-commission-independent-27-octo>

IMPLICATIONS

The exemption clause allowed the government to strip the BC Utilities Commission's independence in May 2012, when it ordered the Commission to approve BC Hydro's rate increases for 2011 through 2013. If the deferral/regulatory accounting regime, resting as it did on an independent regulator, was questioned as not conforming to the US GAAP the government had an answer. It never was.

The net balance in the deferral accounts has continued to grow, reaching \$5.9 billion in 2015/16.⁹ In 2014, cabinet ordered the Commission to approve a new "rate smoothing" account¹⁰ as part of the detailed financial requirements in cabinet directions 6 and 7 of March 2014. This account defers the shortfall between the required revenue to that generated by the government-imposed rates included in the new 10-year rate plan.

Based on the responses from the current rate review, BC Hydro has been deferring "load" revenue variances (between that allowed in the rates and the actual revenue received) since 2008/09.¹¹ The revenue deferral allows BC Hydro to appear to operate with moderate rate increases, while the actual year-end shortfall is recorded as revenue (and an asset on its books). The shortfall adds to BC Hydro's debt.

Since 2011, the government has used the form of rate regulated accounting to artificially suppress the true cost of BC Hydro's electricity, while ensuring a high net income (which counts as government revenue) and to take an annual dividend to reduce the government's borrowing requirements.

The broader implication is that the government has manipulated BC Hydro's finances to the detriment of future ratepayers who must eventually pay the debt.¹² The public utility now operates in accordance with neither the IFRS accounting standard, nor the American ASC 980 standard. BC Hydro's accounting standard appears to be unique in North America.

Is this practice what finance minister de Jong means by prudent financial management? Is this sound public administration?

Some other nuggets have emerged from the pan-out, and they will be discussed in later papers.

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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. He has been an intervener in the BC Utilities Commission's recent reviews of ICBC's rate requests, and is currently an intervener in the Commission's current reviews of ICBC and BC Hydro rate requests.

⁹ The net deferral balance was 131% of BC Hydro's equity. This partly explains Moody's Financial concern with BC Hydro's finances; see <http://vancouversun.com/opinion/columnists/vaughn-palmer-moodys-dampens-mood-of-hydros-court-celebration>

¹⁰ Given that the purpose of all the deferrals is to smooth rates, it seems the terminology is redundant.

¹¹ See BCUC, BC Hydro RRA F17 to F19, IR 1, BCUC 126.1.

¹² For more detail see; <http://www.bcpolicyperspectives.com/blog/posts/bc-hydro-rate-suppression-and-debt>

ATTACHMENT 1

The following is an extract from the US Financial Accounting Standards Board standard for regulated accounting. Note that to use regulatory accounting all the criteria in the Scope section must be met, and the first is that there is an independent, third-party regulator.

Statement of Financial Accounting Standards No. 71

Accounting for the Effects of Certain Types of
Regulation

Financial Accounting Standards Board

ORIGINAL PRONOUNCEMENTS

AS AMENDED

Issued: December 1982

Effective Date: For fiscal years beginning after December 15, 1983

Scope

5. This Statement applies to general-purpose external financial statements of an enterprise that has regulated operations that meet all of the following criteria:

- a. The enterprise's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.³
- b. The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products.
- c. In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.

6. If some of an enterprise's operations are regulated and meet the criteria of paragraph 5, this Statement shall be applied to only that portion of the enterprise's operations.

7. Authoritative accounting pronouncements that apply to enterprises in general also apply to regulated enterprises. However, enterprises subject to this Statement shall apply it instead of any conflicting provisions of standards in other authoritative pronouncements.⁴

8. This Statement does not apply to accounting for price controls that are imposed by governmental action in times of emergency, high inflation, or other unusual conditions. Nor does it cover accounting for contracts in general. However, if the terms of a contract between an enterprise and its customer are subject to regulation and the criteria of paragraph 5 are met with respect to that contract, this Statement shall apply.

²*Capitalize* is used in this Statement to indicate that the cost would be recorded as the cost of an asset. That procedure is often referred to as "deferring a cost," and the resulting asset is sometimes described as a "deferred cost."

³GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, paragraph 9, provides that state and local proprietary activities that meet the criteria of paragraph 5 may apply this FASB Statement and related pronouncements (including FASB Statements No. 90, *Regulated Enterprises—Accounting for Abandonments and Disallowances of Plant Costs*, No. 92, *Regulated Enterprises—Accounting for Phase-in Plans*, and No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71*) that were issued on or before November 30, 1989. Amendments of FASB pronouncements related to regulated operations issued after that date are subject to the provisions of GASB Statement 20, paragraph 7.

⁴For example, a regulator might authorize a regulated enterprise to incur a major research and development cost because the cost is expected to benefit future customers. The regulator might also direct that cost to be capitalized and amortized as an allowable cost over the period of expected benefit. If the criteria of paragraph 9 of this Statement were met, the enterprise would capitalize that cost even though FASB Statement No. 2,

ATTACHMENT 2

The following are three questions from the writer, and responses from BC Hydro, from the second round of information requests. The responses were filed on January 23, 2017. See

http://www.bcuc.com/Documents/Proceedings/2017/DOC_48632_B-15_BCH-Response-Intervener-IR-No2.pdf, RM 2.4.5.1 and 2.4.5.2, pages 1277 and 1278.

4.0 Future Revenue Reporting and Deferral

2.4.5 In response to BCUC 1.159.5 BC Hydro provided reasons why it believes that the recording of future revenue, and the transfer of such revenue to the Rate Smoothing Regulatory Account conforms to the US ASC 980.

2.4.5.1 Does BC Hydro agree that the US ASC 980 presupposes the existence of an independent regulator?

RESPONSE:

BC Hydro does not agree that the United States Financial Accounting Standards Board Accounting Standards Codification 980 presupposes the existence of an independent regulator.

Accounting Standards Codification 980, in paragraph 15-2, provides the criteria that entities must meet to be included in the scope of Accounting Standards

Codification 980. Criterion (a) of paragraph 15-2 states the following regarding the regulator:

“The entity’s rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers”.

BC Hydro says they do not agree, but since the BC Hydro governing board does not have the statutory authority to set rates, the only remaining option is an independent, third-party regulator.

4.0 Future Revenue Reporting and Deferral

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2.4.5.2 Does BC Hydro agree that as a result of prescriptive cabinet directives, especially Direction 7 and OIC 590/16, the BC Utilities Commission would not qualify as an independent regulator as required by US ASC 980?

RESPONSE:

The scope criteria regarding an independent regulator is not applicable to BC Hydro under the Prescribed Standards (further described in section 8.12 of the Application). *Treasury Board Regulation 146/2011* (dated July 5, 2011, which was effective for fiscal 2012) paragraph 5(3) specifically excludes the requirement for an independent regulator from the accounting policies adopted by BC Hydro. Paragraph 5(3) states:

“The part of the United States Financial Accounting Standards Board Accounting Codification 980 that requires rates to be established by or subject to approval by an independent, third-party regulator is not adopted”.

Notwithstanding the above, BC Hydro considers that the British Columbia Utilities Commission is an independent, third-party regulator under paragraph 15-2 of Accounting Standards Codification 980 referenced in BC Hydro’s response to McCandless IR 2.4.5.1.

BC Hydro does not give reasons for its belief that the Commission is independent, despite the clear evidence to the contrary.

5.0 Is the BC Utilities Commission Independent?

Rowland Harrison QC, an authority on energy regulation in Canada, wrote “Independence and the British Columbia Utilities Commission.” which was Appendix 4 to the 2014 Task Force report on the BC Utilities Commission, see http://www2.gov.bc.ca/assets/gov/farming-natural-resources-and-industry/electricity-alternative-energy/electricity/bcuc_review_final_report_nov_14_final.pdf In his paper, Mr. Harrison concluded that because of the provincial cabinet’s prescriptive directions the BC Utilities Commission is not independent with respect to the regulation of BC Hydro. He stated that the use of special directions “directly contradicts the independence of the Commission, which, rather than making independent decisions in such circumstances, is merely implementing decisions made by cabinet.” (p. 82).

On 28 October, 2016, the writer posted “Is the BC Utilities Commission Independent?” on http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_15_bcuc_independence_27_october_2016/pdf.

2.5.1 Would BC Hydro agree with Mr. Rowland Harrison’s assessment that on matters concerning the regulation of BC Hydro the BC Utilities Commission is an agent implementing decisions of the provincial cabinet?

RESPONSE:

BC Hydro does not agree with the characterization of Mr. Harrison’s assessment in the question. The British Columbia Utilities Commission is an independent regulatory agency that makes its decisions based on the evidence before it. As discussed by Mr. Harrison in his report, in some circumstances the British Columbia Utilities Commission is required to follow Special Directions issued by Government under section 3 of the *Utilities Commission Act*. However, the use of Special Directions is limited to specific circumstances and does not apply to the British Columbia Utilities Commission regulation of BC Hydro generally.

In the current Application, the British Columbia Utilities Commission has a significant role in evaluating BC Hydro’s revenue requirements. As evidence of this fact, there have been over 1,700 information requests on the Application asked by the British Columbia Utilities Commission covering a wide range of matters.

Rate changes from 2012 to 2015 were set by cabinet order, while the rate increases from 2016 to 2018 cannot exceed the cabinet-ordered caps. Direction 7 is highly prescriptive and was part of the reason why Mr. Rowland Harrison concluded that the BC Utilities Commission is not independent. Evaluating information is no substitute for having the authority and discretion to act independently to set rates, or approve major capital projects.