OCCASIONAL PAPER No. 45a BC HYDRO

FURTHER OBSERVATIONS ON THE BC HYDRO RATE FREEZE

USING DEBT TO SUBSIDIZE ELECTRICITY RATES

On 8 November 2017, the government announced that it will not proceed with the planned 3% increase to BC Hydro electricity rates planned for 1 April 2018.[1] The planned 3% increase was part of the 2014 Liberal government's 10-year financing plan, which relied on recording future unbilled revenue, and a variety of other cost deferrals, to keep the increases in electricity prices price below the level required to cover the corporation's rising costs, and achieve the cabinet-mandated net income targets .

These accounting maneuvers were condemned by the NDP when it was in opposition, and were recently judged by the auditor general as unacceptable, as the 'prescribed' accounting at BC Hydro did not conforming to public sector accounting standards.[2]

Despite finance minister Carole James statement that the government intends to fix the accounting practices at BC Hydro,[3] the government decided to use the Liberal's dubious revenue deferral account to pretend that the foregone revenue will be received during 2018/19. The government stated that the $150 million, instead of being billed to ratepayers, will now be added to BC Hydro's rate smoothing deferral account, increasing the 2018/19 addition to this account to $450 million (the equivalent of a 9.6% rate increase).[4]

Michelle Mungall, the minister responsible for BC Hydro, said freezing the rates at the 2017 level for one year fulfills the NDP election promise, and suggested that a planned review of BC Hydro's finances might recommend offsetting savings.[5] She also said that the freeze would assist in meeting the government's goal of improving affordability.

IMPACT ON BC HYDRO DEBT

Maintaining the 2017 rates for 2018/19 is subject to the approval of the BC Utilities Commission (BCUC). The BCUC must adhere to the prescriptive requirements of Direction 7, which requires the BCUC to follow the cost of service (COS) method for

[1] http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_45_9_nov_2017/pdf
[2] http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_44_26_october_2017/pdf
[3] https://thetyee.ca/News/2017/10/25/Fixing-BC-Hydro-Accounting/?utm_source=daily&utm_medium=email&utm_campaign=251017
[4] The 10-year financing plan assumed that the 3% rate increase would generate about $150 million in new revenue, while an additional $300 million would be added to the rate smoothing deferral asset and recorded as revenue in 2018/19.
[5] The fact that the government is now relying on the revenue deferral account to forego the planned 3% rate increase may signal that the proposed financial review should not question BC Hydro's unique accounting methods.

setting rates, and not increase the rates by more than 3%. It must also ensure that the 2018/19 return on deemed equity is at least $712 million.[6] The BCUC may find that the government's request is unfair to future ratepayers.

The government could have reduced the cabinet mandated $712 million return on deemed equity for 2018/2019 by the amount of the foregone revenue. This would have avoided placing the BCUC in the position of agreeing to increase BC Hydro's already high debt level; debt which must eventually be recovered in the rates charged to future electricity customers.

The 10-year financing plan showed the balance in the rate smoothing deferral account peaking at $1.59 billion (now $1.74 million) by 31 March 2021, and then decreasing to zero during the next three years.[7] BC Hydro has not indicated how this feat will be achieved within the assumed 2.6% average annual rate increase during these years.

AFFORDABILITY FOR WHOM?

The government justified the rate freeze, which is a subsidy to current ratepayers funded by increasing the debt burden facing future ratepayers, by suggesting it would help meet keep costs affordable for British Columbians.[8]

An analysis of BC Hydro's domestic sales revenue shows that residential customers paid some $2.0 billion (40%) of the total domestic revenue in 2016/17, Commercial customers paid $1.8 billion (36%), while Large Industrial customers paid $770 million (15.4%).[9]

As shown in Appendix 1, the 3% cost avoidance will save approximately $37 per year for each residential customer, approximately $280 per year for each Commercial customer and approximately $132,000 per year for each Large Industrial customer.

Within the Large Industrial category, the six electricity-intensive mechanical pulp and paper mills will benefit the most from the rate freeze. I estimate that the rate freeze will save mechanical pulp and paper mills some $7.0 million (of the $24 million saved for the Large Industrial sector) in additional payments to BC Hydro. In a period of depressed commodity prices this further subsidy will be welcome.[10]

It is probable that avoiding higher input costs, and thereby helping to preserve some 5,600 direct and indirect jobs in the pulp and paper sector, meets the government's criteria of preserving affordability for British Columbians. But assisting these resource

[6] OIC 590/16 of 28 July 2016; http://www.bclaws.ca/civix/document/id/oic/oic_cur/0590_2016
[7] http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_25_12_march_2017/pdf
[8] https://news.gov.bc.ca/releases/2017EMPR0021-001875
[9] https://www.bchydro.com/content/dam/BCHydro/customer-portal/documents/corporate/accountability-reports/financial-reports/annual-reports/bchydro-2016-17-annual-service-plan-report.pdf p. 105.
[10] In its' September budget update the NDP government had confirmed the previous government's commitment to eliminate the 7% sales tax on electricity purchases by businesses, see Appendix 3.

processors by increasing BC Hydro's debt appears to be counter-productive, as the subsidy must eventually be repaid through future rate increases.

ICBC'S INSURANCE RATES RISE EIGHT PERCENT

The government's concern with improving affordability for British Columbians did not apply to the cost of insuring private and commercial vehicles through ICBC.

In recent years the public auto insurer has been losing hundreds of millions of dollars resulting from a rapid increase in claims costs, and the previous government's policy of suppressing premium increases. The operating losses have led to a rapid decline in ICBC's capital reserves.[11]

On 5 September 2017, the government announced that it would seek the BCUC's approval for a 6.4% increase in the compulsory Basic insurance rates commencing in November 2017.[12] The Optional rates, which are set by cabinet order, would increase by four stages, reaching a 9.6% increase on an annualized basis. The average annual increase was estimated at 8%, which would cost an average ICBC policyholder about $130 more for both Basic and Optional coverage.[13]

Assuming each household insures an average of 1.4 vehicles with both Basic and Optional coverage purchased from ICBC, the 8% rate increase results in an additional cost of $180 per year. This is far higher than the average $37 cost of the spiked 3% increase in residential electricity rates planned for April 2018.

Why the apparent double standard in applying the affordability test? The explanation would appear to centre on the weak finances of the wood manufacturers, especially the pulp and paper producers.

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

[11] See http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_42_11_october_2017/pdf

[12] ICBC estimated that a 20% increase in Basic rates would be necessary to maintain the minimum capital reserve required by the government; the shortfall of $470 million is being transferred from the Optional capital reserve, which is already below the government's minimum level.

[13] https://news.gov.bc.ca/releases/2017AG0018-001534

APPENDIX A -- IMPACT ANALYSIS

By dividing the estimated 2017/18 revenue by the number of accounts in each of the customer groups it is possible to calculate the value of the deferred 3% rate increase for 2018/19.

TABLE -- ESTIMATED OF 3 PERCENT COST AVOIDANCE BY MAJOR GROUP ACCOUNT

Major Customer Group	Revenue ($Mil) 2017/18*	Accounts	$/Yr. Per Account	Add 3%	Saved/Account
Residential	2,193	1,777,000	1,234	1,271	37
Commercial	1,962	210,000	9.345	9,625	280
Large Industrial	839	191	4,395,000	4,527,000	132,000

Source: Derived from BC Hydro 201617 annual report.

Notes: * 2016/17 revenue increased by 9% as per F17 to F19 rate request (3.5% on rates and 5.5% to RSRA.

APPENDIX 2 -- EMPLOYMENT TRENDS IN WOOD MANUFACTURING

BC Statistics reports that from 2016 to 2016 the paper and wood product manufacturing sectors lost approximately 22,000 jobs.

TABLE – EMPLOYMENT LOSS IN PAPER AND WOOD MANUFACTURING

	2006	2016	Reduction	Per Cent
Paper Manufacturing	14,700	8,500	6,200	(42.2)
Wood Products Manufacturing	47,400	32,000	15,400	(32.5)
TOTAL	62,100	40,500	21,600	(39.6)

Source: http://www.bcstats.gov.bc.ca/Files/9cc67f6b-a827-4c2b-86ab-ceb97586c792/EmploymentbyIndustry.xls

Joe Nemeth, president and CEO of Catalyst Paper, *Vancouver Sun*, 4 May 2016.

Together, B.C.'s 15 pulp mills and six paper mills directly employ about 12,000 workers and support an additional 12,500 indirect jobs — about 20 per cent of all forest sector jobs in B.C. The sector pays among the highest wages and salaries in the province. While many rural families depend on these jobs, the sector also supports many professional services jobs in the Metro Vancouver area.

But it's not just working men and women and their families who benefit from pulp and paper production in our province. The sector generates significant tax revenues for the provincial government which help pay for public services such as education, health care and transportation.

B.C.'s thermo-mechanical mills alone (which account for just five of the 21 pulp and paper operations in the province), provide government with about $250 million in tax revenues each year. That's about half of the Vancouver School Board's budget.

http://vancouversun.com/opinion/opinion-pulp-and-paper-remains-a-key-contributor-to-b-c-s-economic-future

APPENDIX 3 -- PHASE-OUT OF THE SALES TAX ON ELECTRICITY

3.1 Finance Minister Carole James explains reasons for eliminating the provincial tax on electricity for businesses; BC Hansard, September 11, 2017.

This budget update also takes steps to make businesses more competitive. Starting this fall, we're moving forward to phase out the provincial sales tax on electricity — a move that businesses across B.C. have long asked for as a way to increase their competitiveness as they invest in new technologies and create more jobs. These savings will support businesses in every corner of the province from forestry to construction, mining to agriculture. Not only is this a competitive move to help B.C.'s businesses; it's also going to encourage a transition to low-carbon energy sources like electricity, helping to lower B.C.'s carbon footprint.

3.2 Annualized Savings Resulting from Elimination of PST On Electricity

For 2019/20, the total tax revenue lost by eliminating the PST on electricity purchased by Commercial and Large Industrial consumers is estimated at $164 million (BC government 2017/18 budget update). Assuming 70% is for Commercial and 30% for Large Industrial (estimated based on BC Hydro revenue), the Commercial savings of $115 million equates to about $550 per account, while the $49 million for Large Industrial equates to about $256,000 per account.

3.3 Catalyst Pulp Congratulates

Catalyst Applauds Government's Decision to Cut PST on Electricity in 2017 Budget Update

Release Date: **Tuesday, September 12, 2017**

Richmond, (BC) – Catalyst applauds the government's commitment to eliminate the Provincial Sales Tax (PST) on electricity for commercial and industrial users in its 2017 budget update, which will assist in protecting jobs in British Columbia's pulp and paper sector, says Len Posyniak, Senior Vice President, Human Resources & Corporate Services.

Effective this fall, the PST on electricity for commercial and industrial users will be reduced from 7% to 3.5%. On April 1, 2019, electricity for commercial and industrial users will be fully exempt from the PST.

British Columbia's thermo-mechanical pulp and paper sector supports 5,600 direct and indirect jobs across the province, generating about $250 million in annual revenue for governments. In B.C., Catalyst owns and operates pulp and paper mills in Powell River, Port Alberni and Crofton, a distribution centre in Surrey, and is headquartered in Richmond.

"Catalyst wants to thank the government for recognizing the importance of the pulp and paper sector to B.C.'s economy," says Mr. Posyniak. "The elimination of this tax will help industry in B.C. improve its competitiveness