OCCASIONAL PAPER No. 62 B.C. HYDRO

SENIOR OFFICIALS REVIEW B.C. HYDRO FINANCES: WILL THE NEW APPROACH OF INTEGRITY IN PUBLIC FINANCE PREVAIL?

Introduction

The government is again wrestling with the issue of financial integrity versus political expediency with respect to the finances of B.C. Hydro. It professes to respect the independence of the B.C. Utilities Commission (BCUC), yet it may be unwilling to restore its regulatory discretion.[1]

The lack of an independent third-party regulator was the reason cited by auditor general Carol Bellringer when she determined that B.C. Hydro's regulatory/deferral accounts did not conform to generally accepted accounting principles and qualified the province's financial statements for 2016/17 and 2017/18.

The government agreed with the auditor general and set aside $950 million of the 207/18 surplus to begin to address the problem.[2]

We now await the results of a senior officials' financial review of B.C. Hydro, launched in June 2018, to identify cost savings and other changes to keep electricity rates low and predictable over the long-term.[3]

Will this review, which was first mentioned in conjunction with the proposed elimination of the 3% rate increase planned for April 2018, produce some new solution to the dilemma of affordability versus responsible financial management? Or will it be used to try to convince the BCUC to agree to a new multi-year rates plan that sacrifices the interests of future generations of ratepayers to engineer lower-than-required rates for current ratepayers?

I -- SENIOR OFFICIALS REVIEW 2.0

The objective of the first stage review is to identify cost savings, efficiencies and possible new revenue streams to keep rates low over the long-term, and to justify a new multi-year rates plan.[4] This rates plan will probably be the focus of the next rate application which will be filed with the BCUC in February 2019. The government promised that a

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[1] It has not repealed the 2014 Special Direction 7, not the 2010 cabinet order exempting B.C. Hydro from the need for an independent regulator to approve and oversee deferral accounts.

[2] http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_deferral_reversal_31_august_2018/pdf/commentary_deferral_reversal_31_august_2018.pdf and http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_cleaning_up_bc_hydro_s_prescribed_10_sept_18/pdf/commentary_cleaning_up_bc_hydro_s_prescribed_10_sept_18.pdf

[3] https://news.gov.bc.ca/releases/2018EMPR0041-001156

[4] https://www2.gov.bc.ca/assets/gov/farming-natural-resources-and-industry/electricity-alternative-energy/electricity/bc-hydro-review/terms_of_reference_bc_hydro_review_public_final_may25_901am_2018_mmm_mcj_additions_lm.pdf

report on the first phase of the review, and government's response, will be released in the fall of 2018.

The process and membership appear very similar to the 2013 joint government/B.C. Hydro review,[5] which reviewed funding options following the government's rejection of B.C. Hydro's proposed two-year 26% rate increase.[6] The outcome of the 2013 review was a 10-year financing plan (featuring lower than required rate increases from 2015 to 2019), and a cabinet-directed Rate Smoothing deferral account.

The creation of the Rate Smoothing deferral made overt what had been the covert practice of booking unbilled and unreceived revenue. The new account allows B.C. Hydro to end the sham of over-forecasting sales revenue to achieve a pre-determined net income target, then deferring the subsequent year-end revenue shortfall as a "cost of energy" variance to the Non-Heritage deferral account.[7] Instead, by recording ethereal revenue contrary to basic accounting principles, the Rate Smoothing account suppresses rate increases at the expense of future customers who face a larger debt liability.[8]

New Government Adopts Old Thinking

The review of the finances of B.C. Hydro -- first mentioned in the NDP's 2017 election platform -- conformed to the party's previous criticism of the Liberal government's manipulation of the public utility's finances. But on 8 November 2017, energy minister Mungall used the financial review to partly justify further manipulation through a proposed roll-back of the 3% rate increase planned for 1 April 2018.

Judging from the November 2017 media briefing information, the government also contemplated that the review would recommend a revised multi-year financing plan, including an extension of the time to pay down the Rate Smoothing account, thereby again reducing B.C. Hydro's short-term rate increases while adding further debt liability for future generations of ratepayers.[9]

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[5] The review is being managed by a steering committee composed of the deputy ministers of energy and finance, the chair of the B.C. Hydro board and the president of the utility. The outline released in June also states that there will be consultations with the BCUC staff during the process. All the senior officials are new, but two key ADMs from the 2013 review remain in key advisory positions.

[6] The Liberal government had set the 2013 election year rate increase at only 1.4%, resulting in a significant shortfall. Part of the 26% increase was to properly reflect sales forecasts, increasing costs, and to keep the net deferrals under control.

[7] By 2015/16 almost $1.0 billion in deferred revenue was recorded in the Non-Heritage account.

[8] The current 10-year financing plan has the Rate Smoothing balance growing to $1.6 billion by 2020/21.

[9] http://docs.openinfo.gov.bc.ca/Response_Package_GCP-2017-74006.pdf pdf p. 13/49. The potential adjustment to the 10-year financing plan ("a refreshed plan for rates") was also part of B.C. Hydro's justification for the rate freeze in its argument to the BCUC; see http://www.bcuc.com/Documents/Arguments/2017/DOC_50481_12-21-2017_BCHydro-Final-Argument.pdf p. 13.

This cynical manipulation of the finances of B.C. Hydro reflected the former government's thinking that the corporation's unique accounting practice allowed it to completely disregard normal accounting standards.

The New Thinking

Two new considerations resulted in a change from the old thinking to a new understanding that recognizes that the abuse of regulatory accounting must end. The first consideration was the government's desire to restore the BCUC's independence, as evidenced by allowing the Commission to reject the rate freeze proposal (and review the financing of the Site C project). The second consideration was the 2017 opinion from the auditor general that the accounting practices at B.C. Hydro, and by extension those of the government, did not conform to generally accepted accounting principles.[10]

In carving-out a $950 million fund from the 2017/18 surplus finance minister Carole James has agreed that the gaming of B.C. Hydro's finances must end. But it appears that the decision to fix the public utility's accounting practices was made about two months after the terms of reference of the B.C. Hydro review were announced; a review that focuses on producing low rate increases rather than restoring integrity to the corportation's accounting practices.

The fact that the government's first quarter financial update of September continues to incorporate B.C. Hydro's deferral-laden net income forecast of $712 million from the February budget suggests that the government has yet to decide on how to reduce or eliminate the deferrals.[11] Nor is it forecasting a reduction in current year revenue to recognize such a reduction.

Are the two objectives compatible? Can the finances be re-jigged to produce lower rates without resorting to more "financial engineering," such as continuing to record non-existing revenue, underfunding the pension plan and extending the time to pay down the deferral accounts?

II -- OPTIONS for RATES

B.C. Hydro's Finances Threaten the Province's Credit Rating

The latest analysis from Moody's Investor Services says the large increase in B.C. Hydro's debt continues to threaten the province's high credit rating as it increases the government's contingent liability. It also states that "some of the utility's financial

[10] http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_44_26_october_2017/pdf/occasional_paper_no_44_26_october_2017.pdf

[11] https://www2.gov.bc.ca/assets/gov/british-columbians-our-governments/government-finances/quarterly-reports/2018-19-q1-report.pdf

metrics are among the weakest of Canadian provincial utilities and the use of largely debt financed regulatory asset accounts puts pressure on the balance sheet."[12]

What exactly are the "metrics" and what can be done to improve them? Credit rating agencies review a corporation's credit-worthiness, meaning the risk of defaulting on repaying the principal and interest on a loan. The level of equity and the cash flow are key determinants in evaluating a company's risk.

The Status Quo

While the NDP government appears to agree with Auditor General Bellringer's opinion that the BCUC is not independent, and therefore the regulatory accounting at B.C. Hydro does not conform to public sector accounting standards, it has yet to rescind the prescriptive Liberal cabinet orders.

The current (2016) 10-year financing plan projects a rate increase of approximately 11% for 1 April 2019, of which about 8.3% (approximately $400 million) will be funded via the Rate Smoothing revenue deferral account. The 2016 deferral accounts plan also shows an improbable forecast of $1.6 billion in the Rate Smoothing account being eliminated in the three-year (2021/22 to 2023/24) period with only an average 2.6% annual rate increase, which would generate approximately $130 million in new revenue per year to cover all cost increases.

The corporation's February 2018 forecast shows the net debt increasing by $4.7 billion (22.8%) from 2017/18 to 2020/21 as more of the Site C costs are incurred (no additional revenue from Site C can be expected until late 2024 or 2025).[13]

Reduce the Capitalization Target?

The capitalization target is a standard indicator used to measure a utility's ability to self-finance capital projects.[14] Hydro Quebec reported a 69.5/30.5 ratio as of 31 December 2017, while Manitoba Hydro's ratio dropped to 85/15 by 31 March 2018. The deferral-assisted ratio for B.C. Hydro improved to 79/21 as of 31 March 2018 from the 80/20 ratio recorded in recent years.

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[12] https://www2.gov.bc.ca/assets/gov/british-columbians-our-governments/government-finances/debt-management/bc-credit-rating-moodys.pdf p. 4.

[13] https://www.bchydro.com/content/dam/BCHydro/customer-portal/documents/corporate/regulatory-planning-documents/service-plans/bchydro-2018-2019-service-plan-february-2018.pdf

[14] "The debt-to-equity ratio is a measure of the portion of assets that are financed by Manitoba Hydro's internally generated funds, rather than debt. The measurement evaluates the relationship of debt (comprised of long-term debt, sinking fund investment, short-term debt, and short-term investments) to equity (comprised of Retained Earnings, customer contributions, Accumulated Other Comprehensive Income, and Non-Controlling Interest) through a comparison of Manitoba Hydro's net debt to total capital. The debt-to-equity ratio identifies the capital structure of the Utility." http://www.pubmanitoba.ca/v1/proceedings-decisions/orders/pubs/2018%20orders/59-18.pdf p.48.

The adjusted net debt to equity ratio is subject to manipulation by the amount of net deferral assets on the balance sheet. At B.C. Hydro, for example, the net deferral balance equates to 100% of the equity, while it is only 23% of the equity at Hydro Quebec.

The previous government set a 60/40 ratio as the capitalization target, but to achieve the target would require either a major reduction in debt or a major increase in rates. Manitoba Hydro management believe that a 75/25 capitalization ratio provides an appropriate equity cushion to protect the taxpayer from incurring payment for Hydro Manitoba costs. But its' regulator did not agree, stating that carrying a large amount of equity is a cost to ratepayers. "The Board accepts [the] evidence that debt-to-equity is a questionable metric for a vertically integrated monopoly Crown utility with a debt guarantee from the provincial government.... The Board agrees with the evidence that there is a cost associated with equity as equity is provided by ratepayers who could otherwise use those funds."[15]

Should the government adopt the attitude of the Manitoba regulator and reduce the capitalization ratio?

Reduce or Eliminate Net Income?

In recent years B.C. Hydro's net income has been inflated by deferring large cost and revenue variances. In fact, by manipulating the deferrals the previous government was able to set the corporation's net income by cabinet order. B.C. Hydro's net income ($712 million for 2018/19 and the next two years) forms part of the government's total revenue, (even though only a fraction of the amount is actually transferred to the government as cash, and no dividend will be paid starting in 2019/20).

Lowering the net income was suggested in the background material announcing the financial review. This will occur if the government abandons the recording of unearned revenue by repealing the Rate Smoothing directive. Less net income will lower government's fiscal plan revenue forecasts.

Manitoba Hydro does not operate to produce a profit for the government. If the government fundamentally changed the financial structure of B.C. Hydro to adopt a non-profit approach it would no longer be considered a self-supporting Crown. This could mean that the $20 billion in debt would be reclassified as taxpayer-supported, in the same manner that the $3.5 billion in the Port Mann Bridge debt was reclassified when the government removed the tolls and the self-financing status.[16]

Lengthening Deferral Repayment Periods

Lengthening the time to pay-down the deferrals has been suggested as a way to lower the pressure on B.C. Hydro rates. This is another form of financial engineering because

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[15] http://www.pubmanitoba.ca/v1/proceedings-decisions/orders/pubs/2018%20orders/59-18.pdf p. 63-4.
[16] https://www2.gov.bc.ca/assets/gov/british-columbians-our-governments/government-finances/public-accounts/2017-18/public-accounts-2017-18.pdf p. 21.

the amortization periods on most of the deferrals are already at the maximum reasonable repayment periods.

The 10-year financing plan of 2016 showed that by 2020/21 the balance in the Rate Smoothing revenue deferral account would be $1.6 billion. It also showed that with only an average 2.6% yearly rate increase (about $125 million annually) the $1.6 billion would be eliminated within three years. B.C. Hydro has yet to explain this magical thinking.

Increase Taxpayer Debt?

If the government retains the prescriptive Direction 7 and continues to circumscribe the BCUC's independence it must wind-up the regulatory deferrals. This is the logic of the auditor general's opinion. This would have required a transfer of a further $4.5 billion as of year-end 2017/18 ($5.46 billion reported less the $950 million prospective allocation).

In this scenario the government would need to increase the 2019/20 rates by approximately 11% because the Rate Smoothing deferral account would not be available to transfer a lower rate increase to future customers through higher debt (see the status quo option).

If the government rescinds the prescriptive cabinet directions and restores the BCUC's independence many of the regulatory accounts could be retained. This would satisfy most of the auditor general's concerns regarding the accounting treatment. I would also reduce the likely size of the debt transfer. However, the BCUC would probably review a number of the deferral accounts to determine whether they are justified or contravene accounting principles (such as the Rate Smoothing account).[17]

Use New Carbon Tax Revenue to Moderate Rate Increases?

The government should consider using some portion of the new carbon tax revenue to moderate the projected growth in electricity rates. I had previously suggested this option to fund the probable net operating losses resulting from the construction of the Site C dam.[18]

The government forecasts that by 2020/21 the carbon tax revenues will increase by approximately $0.5 billion compared to the current year.[19]

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17 http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_cleaning_up_bc_hydro_s_prescribed_10_sept_18/pdf/commentary_cleaning_up_bc_hydro_s_prescribed_10_sept_18.pdf

18 http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_33_cost_estimates_of_site_c_24_june_2017/pdf/occasional_paper_no_33_cost_estimates_of_site_c_24_june_2017.pdf

19 http://bcbudget.gov.bc.ca/2018/bfp/2018_Budget_and_Fiscal_Plan.pdf p. 18.

The Manitoba regulator also suggested that the Manitoba government direct a portion of the carbon tax to help Manitoba Hydro's increased cash flow requirements resulting from the Keeyask dam ($8.7 billion) and the Bipole III ($5.0 billion) capital projects.[20]

III -- COMPARISON with QUEBEC HYDRO and HYDRO MANITOBA

Moody's Financial Services stated that some of B.C. Hydro's financial metrics were among the weakest of Canadian provincial utilities. Is there an integrated provincial utility that could serve at the benchmark to guide policies for B.C. Hydro?

Only Hydro Quebec and Manitoba Hydro would seem to qualify as possible benchmarks. The following table presents comparisons of key information and financial indicators for the three utilities.

Hydro Quebec is an important component in that province's economic development, returning over $2.2 billion in dividends to the government. It's electricity is almost 100% hydropower, and the export market in an important source of revenue. Hydro Quebec's rates are amongst the lowest in North America and its net income is high; primarily because of the extremely favourable price paid for power from the Upper Churchill dam (which is then sold for many multiples of that price).

Manitoba Hydro derives most of its electricity from hydropower, although natural gas sales are an important source of revenue. Manitoba Hydro entered into large capital projects in the expectation of large and profitable sales to the United States market, but the drop in natural gas prices has meant the American demand is now much less than when the new projects were approved. The large increase in debt has dropped the capitalization ratio, and the regulator is unwilling to support a 75/25 ratio because of the size of the resulting rate increases required to reduce the debt.

This comparative information in Table 1 was obtained from the corporations 'most recent annual reports. Manitoba Hydro is not expected to be a profit centre and proves no dividend to the Manitoba government.

Note that the abundance of deferral accounts distorts certain measures at B.C. Hydro, such as revenue, equity and debt. Most information is from the most recent annual report, and the deferral information for B.C. Hydro is prior to the $950 million prospective adjustment.

[20] http://www.pubmanitoba.ca/v1/proceedings-decisions/orders/pubs/2018%20orders/59-18.pdf p. 31.

TABLE 1 – COMPARISON of CERTAIN INDICATORS of B.C. HYDRO, HYDRO QUEBEC and MANITOBA HYDRO

	B.C. HYDRO	HYDRO QUEBEC	MANITOBA HYDRO
GDP Growth	3.4%	3.0%	2.9%
Independent Regulator?	No. Prescriptive cabinet directives	Yes	Yes, but no authority to approve capital.
Profit Centre?	Yes	Yes	No
Net Income	$684 mil 2017/18	$2.85 b in 2017	$29 mil 2017/18
5-YEAR TRENDS			
Cumulative Rate Change	24.3%	8.8%	18% incl. pre-payment for Bipole III
Change in Revenue (%)			
Residential	30.1	18.7	6.2
Comm& Small Ind.	29.5	14.9%	4.3
Large Industrial	26.3	(1.3)	4.1
Total Domestic	**29.7**	**12.7**	**6.1**
Total Trade	(17.4)	38.3	23.2
TOTAL	**21.4**	**15.3**	**13.0**
Change in GWh Sold (%)			
Residential	2.5	6.7	4.1
Comm& Small Ind.	2.7	4.7	2.4
Large Industrial	(0.5)	(10.3)	7.7
Total Domestic	**0.3**	**1.4**	**5.6**
Total Trade	(42.3)	24.4	4.0
TOTAL	**(23.5)**	**4.7**	**4.5**
Revenue/GWh ($)	**2017/18**	**2017**	**2017/18**
Residential	115.54	79.94	80.67
Comm& Small Ind.	98.55	84.53	72.15
Large Industrial	60.34	42.61	43.43
Trade	20.52	47.25	46.25
Residential Accounts	1,804 million	3,958 million	509,465

	Commercial	210,673	316,430	70,409
	Revenue ($) *Domestic *Trade	 $5.527 billion (88.6%) $ .710 billion (11.4%)	 $11.763 billion (87.7%) $ 1.651 billion (12.3%)	 $1.893 billion (81.2%) $ .437 billion (18.8%)
	Revenue from Deferral (latest year)	$522 million This inflates net income, equity and debt.	none	none
	Equity ($)	$5.46 billion	$19.76 billion	$2.45 billion
	Net Deferrals ($) % of Equity	$5.45 billion 100 %	$4.84 billion 22.7%	$.97 billion 39.5%--but only 28% excluding capital project cancellation deferral.
	ST & LT Debt	$20.1 billion	$45.3 billion	$19.2 billion
	Debt/Equity Ratio Outlook	79/21 Steady until Site C	69.5/30.5 Steady	85/15 Worsening
	LT & ST Debt to Revenue	3.23X Major distortion due to deferrals	3.98X	10.10X
	Pension Solvency Ratio Deferred?	75.1% Yes	93.6% Yes	65.6% No

 September 23, 2018. 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 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.