

A CLOSER LOOK AT THE GOVERNMENT'S FINANCIAL PLAN FOR B.C. HYDRO

The NDP government has announced a cumulative 2.5% increase in B.C. Hydro rates for 2019 and 2020. The increase is less than the cumulative 5.2% suggested by the previous government in its 2016 update to the 10-year financing plan. Using B.C. Hydro's February 2019 three-year service plan¹ and its recent two-year rate request filing,² Part I of this paper will review some of the key features of the public utility's financial outlook for the next three years.

From 2012 to 2018, the cabinet effectively established B. C. Hydro's annual rate increases. The 2019 and 2020 rate increases are now subject to a constrained approval of the B.C. Utilities Commission (BCUC). In response to a negative opinion by Auditor General Bellringer, and using the recommendations of a review of senior government and B.C. Hydro management,³ the government has eliminated the rate smoothing account (Part II) and loosened the restrictions on the rate-setting discretion of the B.C. Utilities Commission (BCUC). But the government is not prepared to fully restore all the regulator's discretion immediately. This will be discussed in Part III.

PART I THE 2019/20 to 2021/22 FINANCIAL PLAN

I-1 The Three-Year Financial Plan

The February 2019 service plan financial summary for the current year forecast and the budget for 2019/20 to 2021/22 is shown in Table 1.⁴

Table 1 – B.C. HYDRO FINANCIAL SUMMARY (\$=MILLION)

	F2018/19	B2019/20	B2020/21	B2021/22	Percent Δ
RATE CHANGE %	3.0	1.8	0.7	2.2	4.75
REVENUE	6,095	6,304	6,390	6,600	8.3
EXPENDITURE	5,255	5,619	5,704	5,741	9.2
NET INCOME ⁵	(424)	712	712	712	N/A

¹ <https://www.bchydro.com/content/dam/BCHydro/customer-portal/documents/corporate/regulatory-planning-documents/service-plans/bchydro-service-plan-2019-201902.pdf>

² <https://www.bchydro.com/ex/rr/pdfs/BCHF20F21RRA.pdf>

³ https://www2.gov.bc.ca/assets/gov/farming-natural-resources-and-industry/electricity-alternative-energy/electricity/bc-hydro-review/final_report_desktop_bc_hydro_review_v04_feb12_237pm-r2.pdf

⁴ See <https://www.bchydro.com/content/dam/BCHydro/customer-portal/documents/corporate/regulatory-planning-documents/service-plans/bchydro-service-plan-2019-201902.pdf>

⁵ The net loss of \$424 million is before the addition of \$950 million of taxpayer funding from FY2017/18; see https://www.bcbudget.gov.bc.ca/2019/pdf/2019_budget_and_fiscal_plan.pdf p. 28. The revised net income of \$526

DIVIDEND	59	---	---	---	N/A
NET DEBT	22,233	23,419	24,654	25,857	16.3
EQUITY	4,973	5,684	6,396	7,108	42.9

Source: B.C. Hydro Service Plan 2019/20 to 2021/22, p. 17.

Highlights:

- B.C. Hydro has reduced its Domestic sales forecast to better reflect actual sales.
- Approximately half of the revenue increase results from increased rates and half from increased sales, primarily from the sale of surplus power (see Appendix).
- The cost of energy is forecast to increase by \$406 million (19.4%) over the three years, mostly from increases in the cost of IPP purchases.
- Amortization and finance charges are forecast to rise by a modest \$79 million (5.0%) which reflects the lower net balance in the regulatory accounts and continuing low interest rates.
- The net debt rises by approximately \$3.6 billion (16.3%) over the three years as B.C. Hydro continues to incur about \$1.5 billion in Non-Site C capital expenditures per year, and a further \$1.46 billion average for Site C for the three years.⁶
- Equity is forecast to increase by about 43% over the three years as the corporation now keeps all its net income as retained earnings.
- The Net Income target of \$712 million for 2019/20 and 2020/21 is required by the government to meet its three-year fiscal plan.

I-2 Coping Without the Rate Smoothing Deferral

The Rate Smoothing Regulatory Account (RSRA) recorded the difference between the required (budgeted) revenue, and the revenue generated by the allowed rate increase. In 2018/19, for example, the increase in the required revenue was 9%, but only 3% was generated through higher rates; the balance of the unearned revenue was recorded and added to the RSRA. In effect, it allowed B.C. Hydro to record future potential revenue as an asset which was then used to record sufficient revenue to achieve the net income target.

The previous rate plan suggested that the corporation required an increase in rates of 2.6% in 2019 and 2020, but this increase assumed that the RSRA would be used to increase revenue by approximately 8% in 2019/20 and about 2% more for 2020/21.

million is \$186 million less than the \$712 million budgeted for 2018/19, meaning that the government is contributing a two-year combined total of \$1.136 billion to B.C. Hydro to eliminate the Rate Smoothing Regulatory Account in 2018/19 (the \$950 million from 2017/18 and the foregone \$186 million for 2018/19).

⁶ <https://www.bchydro.com/content/dam/BCHydro/customer-portal/documents/corporate/regulatory-planning-documents/service-plans/bchydro-service-plan-2019-201902.pdf> p. 20.

The two-year rate plan filed with the BCUC requests only a 1.8% rate increase for 2019 and a 0.7% increase for 2020. The new plan redirects the 5% surcharge (the Deferral Account Rate Rider or DARR) currently in the rate base (approximately \$250 million) to fund ongoing operational requirements. It had been used to pay down the balance in the cost of energy deferral accounts. Also, the government has allowed B.C. Hydro to use a one-time positive accounting adjustment of approximately \$350 million in the Heritage deferral account to reduce the rate requirement for 2019 and 2020.⁷ These two adjustments allow the new plan to require a smaller rate increase for the next two years, while eliminating the RSRA.

A comparison of the marginal increase in revenue of the two plans is shown below, where a 1% increase results in approximately \$50 million in revenue.

The 2016 Plan (\$=million)	<u>FY2019/20</u>	<u>FY2020/21</u>
Rate Increase 2.6%/year	\$130	\$130
Rate Smoothing Deferral	<u>408</u>	<u>98</u>
Total	\$538	\$228
The Current Plan		
Rate Increase (1.8% + 0.7%)	\$90	\$40
Re-purpose DARR 5%	250	
Use Heritage Surplus	<u>165</u>	
Total	\$505	\$40

Using this simple summary, the new plan generates the equivalent revenue as the previous plan for 2019/20, but potentially leaves B.C. Hydro \$190 million short for 2020/21. This will be explored in the 2019 and 2020 rate filing with the BCUC.

PART II WHY WAS ONLY THE RATE SMOOTHING ACCOUNT CLOSED?

The elimination of the RSRA (using \$1.1 billion in taxpayer funding) is certainly welcome, as this government-imposed scheme embodied the worst excess of the previous government's manipulation of B.C. Hydro's books by ignoring established regulatory accounting principles.

One might legitimately ask why only the RSRA was deemed as being beyond the public sector accounting pale. The senior officials justified closing this illegitimate account because the BCUC was ordered to approve it.⁸ If this was the reason why did the

⁷ A new IFRS accounting interpretation required B.C. Hydro to record payments

⁸ In fact, reading the B.C. Hydro F20 to F21 rate request one gets the impression that there was nothing wrong with recording future revenue as an asset. The corporation said that recording unearned revenue in a rate smoothing deferral account can be appropriate; see

government not wind-up other regulatory accounts, such as Site C and the Smart Meter program, which the BCUC was directed to approve?

It is probable that the unstated reason that the RSRA was closed was because it clearly violated fundamental public sector accounting principles. As Ontario Auditor General Bonnie Lysyk said regarding a revenue deferral scheme in that province; “A promise or commitment to raise revenue in the future is not an asset today.” And that “future revenue raised to pay off the debt should be recorded when it is earned—that is, when electricity is consumed by ratepayers.”⁹

With Auditor General Carol Bellringer about to assume the role of B.C. Hydro’s external auditor¹⁰ it is likely that she would have objected to the recording of unearned revenue through the RSRA as not conforming to public sector accounting standards.

Ms. Bellringer may also wish to review B.C. Hydro’s intention to continue to record any variance in the budgeted revenue compared to the actual revenue in the Non-Heritage deferral account. This account was intended to defer cost variances, but B.C. Hydro has expanded the definition of a cost variance to record revenue shortfalls (load variances) which it now calls the “Domestic Revenue Variance.”¹¹ Recording this unearned revenue as an asset inflates the net income and equity, but also increases the debt. The effect of the Domestic Revenue Variance is practically the same as the RSRA.¹²

The BCUC commented on the growth of the unearned revenue in the Non-Heritage account in its decision on the F17 to F19 rate request:

Because BC Hydro’s actual load has been less than its forecast since F2009, there have been significant additions to the Non Heritage Deferral Account (NHDA) every year. The annual variance related to domestic revenues has steadily increased from \$20 million in F2009 to \$269 million in F2016 for total additions of \$998 million in 8 years. On average the variance has been \$125 million per year over the fiscal 2009 to fiscal 2016 period and the average annual addition has been \$171 million over the last five-year (i.e., fiscal 2012 to fiscal 2016) period.¹³

The auditor general qualified the provincial financial statements partly because the province could not create an accounting standard distinct from the national public

⁹ http://www.auditor.on.ca/en/content/specialreports/specialreports/FairHydroPlan_en.pdf p. 15; see also http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_43_22_october_2017/pdf/occasional_paper_no_43_22_october_2017.pdf

¹⁰ <https://vancouver.sun.com/opinion/columnists/vaughn-palmer-bellringer-anxious-to-plug-into-b-c-hydros-accounts>

¹¹ https://www.bcuc.com/Documents/Proceedings/2019/DOC_53488_B-1-BCH-F20-F21-RR-Application.pdf p. 7-25, or pdf 915/3006.

¹² For a general overview see

http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_63_1_october_2018/pdf/occasional_paper_no_63_1_october_2018.pdf

¹³ https://www.bcuc.com/Documents/Proceedings/2018/DOC_50971_03-01-2018_BCH_F17-19_RRA_Decision_WEB.pdf p. ii.

sector accounting standard. In fact, in her February 2019 report on regulatory accounting, the auditor cited the “premature” recognition of revenue in the RSRA as an example of how this deferral account did not conform to standard accounting principles.¹⁴ Will she now allow the BCUC to accept B.C. Hydro’s assertion that it can continue use the Non-Heritage deferral account to record unearned revenue? Is agreeing to the B.C. Hydro position of using the Non-Heritage deferral account to record unearned revenue agreeing to another unique accounting standard?

PART III RESTORING REGULATORY INDEPENDENCE (In Time)

The government has taken a large step to addressing Auditor General Bellringer’s qualification of the province’s financial statements for 2017/18 and 2018/19 as B.C. Hydro adopted the IFRS accounting standard as of 1 April 2018.¹⁵

But despite the significant lessening of the shackles the NDP government has not fully restored the rate-setting freedom to the BCUC, perhaps reflecting what Thomas Jefferson said of slavery -- it was like holding a wolf by the ears: you didn't like it, but you didn't dare let it go.¹⁶ The government withheld the BCUC complete discretion because it still requires the Commission to set rates to ensure that B.C. Hydro generates \$712 million in net income for 2019/20 and 2020/21 to protect the government’s fiscal plan revenue forecast.¹⁷

By fixing the net income the government has left the BCUC very little discretion to vary the rate proposal as most costs are fixed for the next two fiscal years. Also, non-rate revenues, such as the Powerex profit, cannot be adjusted by a BCUC order. The government has also decided that the BCUC’s will not be allowed to change other components, such as rebalancing the rates and requiring a longer-term load forecast.

¹⁴ http://www.bcauditor.com/sites/default/files/publications/reports/OAGBC_RRA_RPT.pdf p. 23.

¹⁵ This was the only recommendation of the auditor general’s February 2019 report on regulated accounting at B.C. Hydro;

http://www.bcpolicyperspectives.com/media/attachments/view/doc/commentary_ndp_five_year_hc_hydro_plan_15_february_2019/pdf/commentary_ndp_five_year_hc_hydro_plan_15_february_2019.pdf. A 2010 cabinet order created a unique accounting system for B. C. Hydro. This order was repealed in November 2018.

¹⁶ https://www.google.ca/search?source=hp&ei=kYt9XO3KMNHy-gS7naG4Cw&q=thomas+jefferson+it+like+holding+a+wolf+by+the+ears&oq=thomas+jefferson+%22it%27s+like+holding+a+wolf+&gs_l=psy-ab.1.0.33i22i29i30.10824.31008..33772...0.0..0.152.3758.35j8.....0....1..gws-wiz.....0..0i131j0i3j0i22i30.DL71FL19T24

¹⁷ Although none of B. C. Hydro’s net income is actually transferred to the government, see http://www.bcpolicyperspectives.com/media/attachments/view/doc/occasional_paper_no_10_21_september_2016/pdf/occasional_paper_no_10_21_september_2016.pdf

This is not regulatory independence as suggested by the IFRS accounting principles.¹⁸ The question is whether the auditor general will withdraw her qualification of the government's financial statements on the basis of a promise to reform at a later date?

SUMMARY

The government has recommended a relatively minor increase in B.C. Hydro's rates over the next two years. The modest increase has been accomplished through a one-time accounting redefinition windfall and the redirection of the 5% surcharge originally intended to pay down the cost of energy deferral balance.

It has not restored the BCUC's full authority to regulate the public power utility because it will withhold the Commission's authority to alter the \$712 million net income requirement.¹⁹

The BCUC uses the cost of service model to set annual rates for electricity where revenues cover the cost of service, including the opportunity to earn a return on equity (ROE or net income). It does not guarantee the net income (as the current government intends). The BCUC will also have to determine an appropriate ROE target for B.C. Hydro. The ROE includes a provision to recognize risk, but since the shareholder is protected from most risk by the array of deferral accounts, one would expect the BCUC to set a very low ROE target.

While the government has indicated that it intends to respect the independence of the BCUC in overseeing the finances of B.C. Hydro the good intentions may change if it adopts a rate setting philosophy that is markedly different than one favoured by the government. We may then see this government revert to issuing much more prescriptive directives to the Commission to ensure that the operation of our public power utility conforms to the government's priorities.

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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. *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.

¹⁸ The government is also prohibiting the BCUC from rebalancing the rates between residential, commercial and large industrial consumers, and placing other restrictions on the regulator, see http://www.bcpolicy Perspectives.com/media/attachments/view/doc/commentary_ndp_five_year_hc_hydro_plan_15_february_2019/pdf/commentary_ndp_five_year_hc_hydro_plan_15_february_2019.pdf

¹⁹ The government's willingness to direct the BCUC is discussed by Les Leyne in <https://www.timescolonist.com/opinion/columnists/les-leyne-ndp-uses-escape-clause-after-two-weeks-1.23653989>

APPENDIX

Net Debt and Capital Expenditure

B.C. Hydro forecasts that its net debt will increase by \$5.7 billion (28.4%) from 2017/18 to 2021/22, despite the wind-up of the RSRA. In 2017/18 this account had a balance of \$815 million, which is included in the net debt for that year. Excluding the RSRA from the base figure results in a true increase of \$6.5 billion, or approximately 33.9%, in three years.

In this period the corporation no longer has to increase borrowing to pay a dividend to the government.

**Table 1 -- B.C. HYDRO NET DEBT AND CAPITAL EXPENDITURE
2014/14 to 2021/22 (\$=billion)**

	2014/15	2015/16	2016/17	2017/18	f2018/19	b2019/20	b2020/21	b2021/22
NET DEBT	16.68	18.00	19.80	20.14	22.23	23.42	24.65	25.86
CAPITAL EXP.								
SITE C	25	489	663	705	1.187	1.530	1.535	1.318
NON-SITE C	2.144	1.817	1.781	1.768	2.589	1.311	1.432	1.685
TOTAL	2.169	2.306	2.444	2.473	3.776	2.841	2.967	3.003

Source: B.C. Hydro annual reports and Service Plan 2019/20 to 2021/22.

The average annual capital expenditure planned for the coming three years (\$2.94 billion) is the same as the annual average for the previous three years. When Site C is excluded the average capital expenditure for the last three years of the plan (\$1.48 billion) will be significantly less than for the prior three years (\$2.05 billion).

Electricity Sales

Table 2 shows that from 2017/18 to 2021/23, Domestic sales are forecast to be relatively flat. Sales of surplus power are forecast to drop in the current year then climb again.

Table 2 – NON-TRADE ELECTRICITY SALES (GWh)

	2014/15	2015/16	2016/17	2017/18	f2018/19	b2019/20	b2020/21	b2021/22
DOMESTIC	51,199	51,023	51,863	52,114	52,604	53,567	53,253	53,093
Ratio of Total	91.9	81.0	82.9	83.2	87.7	87.1	86.0	84.2
SURPLUS	14	6,277	5,789	5,059	2,230	2,409	3,087	4,402
LINE LOSS	4,486	5,713	4,927	5,454	5,173	5,554	5,553	5,538
TOTAL	55,699	63,013	62,579	62,627	60,007	61,530	61,893	63,033

Source: B.C. Hydro annual reports and Service Plan 2019/20 to 2021/22.

Notes: For 2016/17 and 2017/18 the split between Domestic and Surplus Sales is estimated .

B.C. Hydro explained surplus sales in its 2014/15 annual report (p. 19):

Surplus energy sales were required to reduce spill risk, as a result of higher reservoir levels at the start of the fiscal year resulting from increased storage through the fall and winter of the prior year due to low market prices. In addition, increased generation at Mica was required in the current year to maintain downstream Arrow reservoir levels and to meet Columbia River Treaty obligations which contributed to increased surplus energy sales. Surplus sales vary year to year based on level and timing of inflows, risk of spill, and market conditions.

<https://www.bchydro.com/content/dam/BCHydro/customer-portal/documents/corporate/accountability-reports/financial-reports/annual-reports/bchydro-2015-17-annual-service-plan-report.pdf>