

RATE SUPPRESSION AND DEBT TRANSFORMATION:

The Political Use of BC Hydro, 2008 to 2014

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With actions gamed for their effect, rather than the harder accountability that comes with transparency, the tough-minded decisiveness at the center of both good government and sound business gets subtly corrupted.

– Ron Suskind, *Confidence Men*

THE FINANCIAL CRISIS OF 2007-08, and the economic recession and unsteady recovery that followed, caused most governments to run operating deficits and incur higher debt. From F2010 to F2013 the BC government recorded successive operating deficits totalling \$5.1 billion.¹ The improving economy, together with the government's expenditure restraint and revenue enhancement measures, combined to produce a small operating surplus in F2014. During his F2015 budget address, Finance Minister Michael de Jong stated that the government's sound fiscal management had enabled it to come through "the worst economic recession of our time." An aversion to higher taxes and prolonged deficit financing was a key aspect of the government's fiscal management strategy: "British Columbia," he averred, "rejects the notion of asking future generations to assume responsibility for budget deficits that result from a lack of fiscal discipline."² A year earlier, echoing the same theme, de Jong stated that the government "would not spend money that [it didn't] have."³

¹ Fiscal years will be shown as the year ending the reporting period (e.g., the government fiscal year of 2013-14 is shown as F2014).

² British Columbia, Debates of the Legislative Assembly (hereafter *Hansard*), 18 February 2014, 1377.

³ *Ibid.*, 19 February 2013, 12913.

At the outset of the recession, the Liberal government imposed significant financial restraint measures within government departments and across the broader public sector. Many non-income tax revenues were increased to moderate the loss of personal, corporate, and resource revenues. The self-financing Crown corporations were expected to contribute to the balanced budget strategy. Through changes to legislation, regulations, and other cabinet orders, the government generated increased revenue from BC Hydro and the British Columbia Insurance Corporation (ICBC), in effect transferring some of the fiscal burden of rebalancing the provincial accounts from taxpayers to the customers of these corporations. In the case of BC Hydro, the government exploited its unique rate-regulated accounting system to actually increase the electrical utility's profits during the recession and, thereby, to ensure a growing source of revenue for the provincial accounts.

The manipulation of BC Hydro's finances was accomplished primarily by a series of cabinet orders and directives, culminating in the removal of the BC Utilities Commission (BCUC) from its oversight role. Under the government's direction, electricity rates and revenues remained lower than what was required to match BC Hydro's expenditures. During the same period, the growth in both the number and the total value of deferred expenditures assured a high annual net income and continuing dividend payments to the government. Rate suppression and the exploitation of deferral accounts distorted the true picture of BC Hydro's finances as well as those of the provincial government. By overstating profits and dividends, the government lowered its direct borrowing costs and helped make possible a balanced budget in F2014. The cost burden was shifted to future BC Hydro customers in the form of greater debt.⁴

THE FINANCIAL CRISIS AND RECESSION

The global financial crisis of 2007–08 led to a high degree of uncertainty regarding the stability of the financial system, as evidenced by a restriction in the liquidity of bond markets and a severe decline in equity markets. The massive injection of liquidity by the US Federal Reserve into the American banking system helped stabilize the balance sheets of the major financial institutions and restored a measure of confidence to lenders and investors. By 2011, the equity markets had regained most of the 2008 losses, aided by very low interest rates and the additional

⁴ Political opportunism had played a role in BC Hydro's finances before, including the 1959 "debt free" claim of the W.A.C. Bennett Social Credit government and the rate freeze imposed by the Glen Clark NDP government prior to the 1996 provincial election.

liquidity available through “monetary easing.” General economic recovery was slow, however, and unemployment rates remained high during the following two years.

The economic crisis caused a sharp reduction in American housing prices and in consumer spending and manufacturing on a worldwide basis, which, in turn, lowered commodity prices. The BC economy had always been reliant on resource extraction and processing, especially in forestry, mining, and natural gas. The provincial GDP, which had grown by 3.6 percent in 2006, grew by 3.1 percent in 2007, then contracted by 2.6 percent during the next two years.⁵

The Liberal government, first elected in 2001, prided itself on being a prudent and responsible manager of the public’s finances. During the mid-2000s, the government revenues benefited from strong demand for commodities and steady economic growth. Following a record \$4 billion surplus in F2007, the government’s February 2008 budget, while noting the decline in the US housing market in the growing financial turmoil, still predicted a GDP growth of 2.4 percent. With the aid of a 1 percent contingency and a \$750 million forecast allowance, the government planned on a balanced budget for F2009.⁶

The economic situation continued to deteriorate during 2008. The provincial government began to forecast major reductions in its revenue as the economy contracted. In late October, Premier Gordon Campbell, in a prime-time television address, unveiled a ten-point \$0.5 billion stimulus program designed to encourage consumer confidence and spending. Premier Campbell assured the audience that there was “every reason to be confident about the future ... We have faced tough times before and came through with flying colours. This time will be no different.”⁷ The premier needed to adopt a positive tone since a provincial election was planned for May 2009.

The February 2009 budget for the coming year also emphasized the theme of stability and confidence. The government forecast a 0.9 percent decline in GDP for F2010, followed by growth of 2.4 percent and 2.6 percent, respectively, for the next two years. A deficit of some \$495 million was anticipated, reflecting lower revenue forecasts, but the finance minister promised expenditure reductions of \$1.9 billion over

⁵ Government of British Columbia, Public Accounts, 2006-07 and 2008-09. Available at http://www.fin.gov.bc.ca/OCG/pa/06_07/PublicAccounts.pdf and http://www.fin.gov.bc.ca/ocg/pa/07_08/CRF_Supplementary_Sched.pdf.

⁶ Government of British Columbia, Budget Fiscal Year 2008-09. In fact, the Public Accounts recorded a razor-thin surplus of \$80 million after the contingency and forecast allowance were consumed.

⁷ *Vancouver Sun*, 23 October 2008.

the next three years to help restore a balanced budget.⁸ The return to a balanced budget became the government's top priority.

The Liberal government was re-elected in May and almost immediately announced the adoption of the federal value-added tax, known as the harmonized sales tax (HST), primarily to claim the \$1.6 billion federal transition inducement. Such an infusion of new funding was most welcome to the government, which was desperate to stem the revenue loss in the budget. The post-election adoption of the HST sparked a political furor over whether or not the premier had misled the electorate during the election campaign by denying that British Columbia would adopt the HST. Some criticized the regressive nature of consumption taxes and the government's drive to increase other sources of revenue: "Raising existing sales, income, and corporate taxes were considered not only counterproductive in recessionary times but also inconsistent with the government's oft-repeated mantra about the benefits of lower taxes."⁹ In addition to cutting expenditures and changing the basis of the sales tax, the government also looked to the self-supporting Crown corporations to assist in achieving the three-year balanced budget target.

CROWN CORPORATION NET INCOME AND PAYMENTS

Under Canadian national public-sector accounting rules, the net income of profit-orientated Crown corporations is included in the government accounts as revenue, and the equity is treated as a government asset. In British Columbia there are a number of self-supporting Crown corporations that generate significant net earnings; the largest are the BC Lotteries Corporation, the Liquor Distribution Branch, BC Hydro, and the Insurance Corporation of British Columbia (ICBC).

For F2008, the total net income of the self-supporting Crown corporations was approximately \$3 billion, which exceeded the revenue collected by the corporate income tax and approached 60 percent of the total provincial sales tax revenue.¹⁰ The Canadian public-sector accounting standard assumes that all of the net income from these entities count as revenue to the government's consolidated revenue fund, while any dividend or other cash payments help reduce the government's borrowing

⁸ *Hansard*, 17 February 2009, 13767.

⁹ George Malcolm Abbott, "The Precarious Politics of Shifting Direction: The Introduction of a Harmonized Sales Tax in British Columbia and Ontario," *BC Studies* 186 (Summer 2015): 133.

¹⁰ Government of British Columbia, *Public Accounts 2007-08*, 40. Available at http://www.fin.gov.bc.ca/ocg/pa/07_08/CRF_Supplementary_Sched.pdf.

requirements. Most of the net income generated by the lottery and liquor distribution operations is transferred as a cash payment. For BC Hydro and ICBC, however, only a portion of the net income in any year is actually transferred. Following legislative changes in 2010, ICBC was required to transfer excess optional insurance capital to the government rather than reduce rates.¹¹ BC Hydro must have a certain equity level to support its debt. The government requires BC Hydro to transfer up to 85 percent of its net income as a form of dividend payment as long as the debt to total debt and equity ratio does not exceed 80/20.¹² During the period of this study, BC Hydro has never achieved the 85 percent transfer target as the growth of the debt required ever increasing equity to maintain the required ratio.

The distinction between the accounting recognition of the net income from self-supporting Crowns as government revenue and the actual cash transfer would become important in the coming years as the government sought to achieve its three-year balanced budget target. Between F2009 and F2014, the government recorded approximately \$5.2 billion in net income from BC Hydro and ICBC, while the actual cash transfer was \$2.1 billion.

BC HYDRO AND THE ECONOMIC RECESSION

Created in 1964, BC Hydro is one of the largest integrated electrical energy utilities in Canada. In 2008, it provided electricity to some 1.8 million residential, commercial, and industrial customers; reported net income of \$369 million on revenue of approximately \$4.8 billion; and had assets of \$13.6 billion.¹³ The export of energy totalled approximately 50 percent of the gigawatt hours sold in F2009 and \$1.4 billion (34 percent) of BC Hydro's total revenue.

In addition to its fundamental mandate of providing low-cost and reliable power, BC Hydro has been used by successive governments to

¹¹ ICBC transferred approximately \$575 million in F2011, followed by \$348 million from F2012 to F2014. See Richard C. McCandless, "Politics and Public Automobile Insurance in British Columbia, 1970-2010," *BC Studies* 178 (Summer 2013): 97-119.

¹² Prior to F2009 the debt to equity ratio was 70/30, but this was changed to 80/20 by cabinet Order-in-Council (hereafter OIC) 27/08 of January 2008. The government also ordered a new calculation of "deemed equity" for the calculation of the allowed ROE (OIC 28/08). In F2009, BC Hydro recorded net income of \$366 million, but no payment was made to the province because the debt to equity ratio was 81/19. See BC Hydro, *Annual Report 2009*, available at https://www.bchydro.com/content/dam/hydro/medialib/internet/documents/annual_report/2009_annual_report.pdf, 59.

¹³ BC Hydro, *Annual Report 2008*, available at https://www.bchydro.com/content/dam/hydro/medialib/internet/documents/info/pdf/info_annual_report_2008.pdf.

achieve economic development objectives, such as extending the power grid to areas of potential development as well as limiting power purchases from carbon-based generation while promoting private investment in power generation. The Liberal government adopted a “green” agenda during its second term in office, with the enactment of the Clean Energy Act in 2007 and the announcement of the first carbon tax in Canada as the centrepiece of the February 2008 budget. The Clean Energy Act required BC Hydro to meet most of its electricity growth forecast through conservation, and it encouraged the growth of independent power producers by restricting the locations for future BC Hydro dam projects and requiring the utility to meet a high energy self-sufficiency target. The corporation was forced to sign long-term power purchase contracts with private producers to ensure an adequate return on investment for private investors.¹⁴ The government also directed the BCUC to recognize the role of private power producers when establishing BC Hydro’s annual rates. Apparently, the government assumed that the additional cost of the new sources of clean hydro power would be covered by increasing profits from sales to the power-hungry California market.¹⁵ However, the economic recession, combined with technological advances in the extraction of oil and gas, lowered demand for electricity and lowered the cost of natural gas for heating. This slowed BC Hydro’s revenue growth and reduced the profits from exports.

Provincial legislation required the BCUC to set rates using the cost-of-service method, which was designed to produce sufficient revenue to cover the utility’s costs and to provide a reasonable profit, or return on equity (ROE), to the shareholders based on the level of risk. The ability of the regulated utility to cover costs and to achieve the ROE depends on its achieving the forecasts of revenue and expenditure established in the rate-setting process. The ROE for BC Hydro was set by government regulation as equivalent to the ROE approved by the BCUC for Terasen Gas (later FortisBC Energy Inc.), which was the benchmark.¹⁶ In January 2008, the amount of potential profit that BC Hydro could earn was substantially increased when the cabinet ordered that BC Hydro’s ROE for rate setting be calculated on “deemed” equity calculation, which

¹⁴ These included cost-of-living escalator clauses. See Marjorie Griffin Cohen and John Calvert, “Assessing BC Electric Policy since 2002 and the Government’s 2011 Review of BC Hydro,” *BC Studies* 174 (Summer 2012): 15–16.

¹⁵ Ibid.

¹⁶ The equivalent level was generous as BC Hydro’s debt was borrowed through the government’s lower rates.

resulted in a net income target approximately 30 percent greater than that produced by using the accepted accounting definition of equity.¹⁷

BC Hydro filed its F2009 and F2010 rate request with the BCUC in February 2008, but the deteriorating economy forced a number of revisions to the budget forecasts during the next eight months. The oral hearings portion of the review occurred in October, just as the financial markets were in significant decline and forecasts for economic activity were increasingly negative.¹⁸ BC Hydro initially requested a 6.56 percent increase for F2009 and an 8.2 percent increase for the following year. Including the requested 1.5 percent reduction in the debt reduction surcharge, the increase in requested revenue in the coming year was approximately 8.1 percent, with a further 9.7 percent for F2010.¹⁹

The proposed 15.9 percent cumulative increase, together with a forecast 15 percent rise in the following two years, caused shock and concern among the intervenors representing business and consumer groups.²⁰ Commercial and industrial representatives advised that such a rate of increase during the recession might result in the closing of some of their operations. While the government needed a healthy net income from the electricity utility to avoid a larger provincial deficit (and the annual dividends that reduced provincial borrowing requirements), the cabinet was concerned about a possible negative political reaction to a rapid rise in electricity rates. BC Hydro president Bob Elton, in his 2008 testimony before the BCUC, stated: “There is a surprising amount of discussion about the amount and timing of rate increases [at the treasury board committee of cabinet].” The government, he said, was “vitaly interested in that because the shareholder [government] is elected by the customers of this company.”²¹

To find a balance between the requirement to set rates to reflect costs and to mitigate the steep rise in costs to consumers, the BCUC agreed to expand the use of deferral accounts. The deferral of some \$400 million

¹⁷ OIC 27/08 and OIC 28/08 of 17 January 2008. This was when the 80/20 total debt to Generally Accepted Accounting Principles (GAAP) equity standard was implemented.

¹⁸ For example, on 6 October 2008, Jim Quail, representing certain consumer groups, began his remarks by commenting that the Toronto Stock Exchange had dropped by 720 points that day. See British Columbia Utilities Commission, BC Hydro Rate Request F2009 to F2010, *Oral Hearings*, vol. 3, 251. Available at http://www.bcuc.com/Documents/Proceedings/2008/DOC_19875_Transcript-Vol3-BCH_F09-10RR_OralHrg_Oct-7-08.pdf, 251.

¹⁹ British Columbia Utilities Commission, *Decision*, 13 March 2009, available at http://www.bcuc.com/Documents/Proceedings/2009/DOC_21286_BCH-2009RR_WEB.pdf. The application and the resulting review were lengthy and complex, as reflected in the 288-page decision.

²⁰ The cumulative rate increase for F2005 to 2007 was 1.6 percent.

²¹ British Columbia Utilities Commission, BC Hydro Revenue Requirements Request F2009 to F2010, *Oral Hearings*, vol. 3, 407.

allowed the BCUC to approve rate increases of 2.34 percent for F2009 and 8.74 percent for the following year.²² Faced with the uncertain economic outlook most intervenors supported the greater use of deferral accounts to lower the indicated rate increase. The BCUC noted that the difficulty in accurately forecasting demand, the effect of changing interest rates on debt servicing, and the fluctuations in pension assets presented a difficult problem for rate-setters. It justified the expansion in the scope and number of deferral accounts as a “short term transient measure” to restrain the rise in electricity rates “during the prevailing uncertainty and volatility in the economy.”²³ To ensure a high net income for BC Hydro, a February 2009 cabinet directive set the ROE at the benchmark level plus 1.63 percent for F2009 and the next two years.²⁴ The cabinet order significantly increased BC Hydro’s net income – and the government revenue – during this period.

DEFERRAL ACCOUNTING

Among regulated energy utilities in North America it is common to use deferral accounting to moderate or smooth indicated rate changes over a longer period. For hydroelectric utilities in particular, annual changes in water flows can cause significant variances between budgeted and actual revenues and expenditures. By deferring the actual expenditure variance to future rate adjustments, the utility’s net income remains higher than would have been possible had the cost been expensed. A deferred expenditure adds to a utility’s balance sheet assets because it is considered a loan to ratepayers, while a deferred obligation to ratepayers (such as a refund) is shown as a balance sheet liability. Deferring expenditure variances has a short-term benefit to the utility as it lowers the risk of not achieving the planned ROE, and it increases assets and equity. However, if a utility overuses the deferrals it is likely that an independent regulator would reduce the allowed ROE to reflect the lower risk exposure. Continued growth in the net amounts deferred will usually require an increase in debt and may result in cash flow difficulties. For an investor-owned utility, the growth in debt would increase the investment risk and may result in a lower share price and higher borrowing costs.

When the BCUC was given the authority to regulate BC Hydro, the government mandated deferral accounts for variances in the cost of energy and in the net income from energy trading. The BCUC added

²² BC Hydro, *Annual Report 2009*, 55.

²³ British Columbia Utilities Commission, *Decision*, 13 March 2009, 2.

²⁴ OIC 74/09 of 17 February 2009.

deferral accounts for a number of new cost variances, including the cost of conservation programs (demand-side management), for First Nations negotiation costs, and for site restoration costs. Prior to F2008, the government directed that the costs for other initiatives, such as the smart metre program and the Site C dam planning, be deferred.

The BCUC accepted three situations in which a deferral account would be appropriate: (1) to better match costs and benefits for future generations of customers (such as planning and pre-commissioning costs of a major capital project), (2) to smooth the impact of a large non-recurring cost (such as a generator failure), and (3) to record annual differences between budgeted and actual costs or revenues. For the last situation BC Hydro made a distinction between controllable and non-controllable risks to the budget forecast. Due to the uncertain economic and financial outlook following the financial crisis, BC Hydro argued that most of the risk factors in its financial forecasts had become uncontrollable. Transferring more expenditure variances to deferral accounts transferred the risk from the shareholder to the ratepayer in some future period.²⁵

Deferring more variances between actual and budgeted expenditures will ensure smoother rates, but the increase in the scope and number of possible variances subject to deferral may encourage less attention to setting financial priorities as “there is a real danger of BC Hydro becoming a cost plus utility with little responsibility or incentive left to manage or control costs.”²⁶ The Joint Industry Electricity Steering Committee, an intervenor in the hearings, asked the BCUC to develop a consistent philosophy regarding the use of deferral accounts beyond BC Hydro’s interest in protecting the return to the provincial government.²⁷ To address concerns of ever-growing deferral account balances the BCUC accepted a proposed formula to increase or decrease a debt repayment rate surcharge designed to reduce the balance in the cost of energy deferral accounts (but not all the accounts).

²⁵ British Columbia Utilities Commission, *Decision*, 13 March 2009, 163.

²⁶ British Columbia Utilities Commission, Joint Industry Electricity Steering Committee Argument, 5 December 2008, 26.

²⁷ By the use of deferral accounts BC Hydro reported cumulative F2009 and F2010 net income of \$812 million, compared to a loss of \$322 million had the deferral accounts not been available. The long-term debt climbed from \$3.1 billion to approximately \$10.7 billion. See BC Hydro, *Annual Report 2010*, 56 and 112, available at https://www.bchydro.com/content/dam/hydro/medialib/internet/documents/annual_report/2010_annual_report.pdf.

GROWTH IN COSTS, DEBT, AND RATES

During the 2010 to 2012 period, with a return to some stability in the financial markets, the BCUC sought to restrain the forecast growth in the costs of electricity. In early 2010, it rejected BC Hydro's long-term plan for electricity supply, believing that the planned phase-out of the Burrard Thermal generating capacity in favour of more expensive private power was not in the public interest. The government response came through the 2010 Clean Energy Act, which mandated the Burrard Thermal exclusion as well as removing the commission's authority to review and approve some \$10.6 billion in planned capital projects, including the new Site C dam, new transmission projects, and the \$1 billion expenditure on new smart metre technology. The legislation also limited the location of BC Hydro's future development of major power projects, effectively leaving potential smaller-scale hydro sites to be developed by the private sector. To encourage this private investment, the government shortened the time frame for BC Hydro to obtain all of its power from provincial sources rather than have to purchase its variable supply from the wholesale (or spot) market.

The restriction of the authority of the independent regulator sparked strong criticism from the opposition New Democratic Party (NDP), which accused the government of driving up electricity rates to provide a guaranteed source of income for private power producers. NDP member Adrian Dix charged that the limitation on the authority of the BCUC was a "shocking and arrogant indictment of a government out of control."²⁸ Energy Minister Rich Coleman justified the action as being designed to streamline the planning and approval process and to encourage new private-sector investment in the province. The government, he asserted, should be responsible for energy planning and "not subject to an unnecessary, lengthy and costly process before the BC Utilities Commission."²⁹ In its F2011 rate request of 6.1 percent, filed in March 2010, BC Hydro forecast declining consumption for large industrial users and acknowledged that the continuing economic uncertainty made the pace of economic activity difficult to predict. The rate request included an increase of \$157 million in additional net income, increased transfers to the deferral accounts, and an increase in the debt repayment surcharge to 4 percent.³⁰ The increase in the net income reflected another cabinet

²⁸ *Hansard*, 3 June 2010, 6201.

²⁹ *Ibid.*, 25 March 2010, 5789.

³⁰ British Columbia Utilities Commission, BC Hydro F2011 Revenue Requirements Application, 1-6, available at http://www.bcuc.com/Documents/Proceedings/2010/DOC_24719_B-1_BCHydro-F11RR-Application.pdf.

directive that changed the definition of net income by excluding financing charges from the calculation.³¹ In approving the request, the BCUC required BC Hydro to develop a fixed repayment schedule for the cost of energy deferral accounts, and it ordered the utility to propose policy changes to the government that would reduce its costs and lower the projected future rate increases.³²

Within three months of the BCUC F₂₀₁₁ rate approval, BC Hydro filed its rate proposal for the F₂₀₁₂ to F₂₀₁₄ years, which amounted to a cumulative increase of approximately 32 percent; if approved, the cumulative rate increase for the five years to F₂₀₁₄ would be over 50 percent.³³ Two days later the auditor general announced a review of the growth and management of BC Hydro's deferral accounts.

The rapid escalation in electricity rates in BC Hydro's submission caused a great deal of media attention, reflecting public and industry concern. Interest rates were low and unemployment remained at elevated levels, but the government's focus on financial restraint seemed not to apply to its electrical utility. Christy Clark, the new premier, soon announced that a panel of senior officials, including the deputy to the premier and the deputy finance minister, would review the corporation's operations and provide options and recommendations for minimizing the planned rate increases.

While the government's panel of senior officials and their accountants were reviewing BC Hydro's budget assumptions, the media continued to question government policies that were driving up the cost of electricity.³⁴ The *Vancouver Sun's* editorial of 21 June 2011 was highly critical of the government's taking BC Hydro's net income to fund provincial

³¹ OIC 21/11, see BC Hydro, *Annual Report 2012*, 44, available at https://www.bchydro.com/content/dam/hydro/medialib/internet/documents/annual_report/2012_BCH_AnnualReport.pdf. In May 2013, the BCUC announced that the benchmark ROE would be reduced by seventy-five basis points to reflect the lower cost of borrowing resulting from lower interest rates. The government directed BC Hydro to ignore this reduction and to retain the existing ROE (some two hundred basis points higher) "to contribute to ongoing balanced budgets." See BC Hydro, *Annual Report 2013*, 54, available at <https://www.bchydro.com/content/dam/BCHydro/customer-portal/documents/corporate/accountability-reports/financial-reports/annual-reports/bc-hydro-annual-report-2013.pdf>.

³² British Columbia Utilities Commission, *Decision*, 2 December 2010, Appendix A, 5, available at http://www.bcuc.com/Documents/Proceedings/2010/DOC_26531_G-180-10_BCH-F2011-Revenue-Requirements-Reasons-WEB.pdf.

³³ A summary of events can be found in the BCUC's decision of 12 June 2012. It appeared that the size of the increase caught the government off guard as the cabinet was absorbed in a leadership campaign during this period, the result of which was the selection of Christy Clark as the Liberal leader and premier in late February 2011.

³⁴ "Rates Need Sweeping Review," editorial, *Times Colonist* (Victoria), 5 March 2011; and Justine Hunter, *Globe and Mail*, 19 May 2011.

programs, even though including the annual profit in the government revenue account was a national accounting requirement.³⁵ It said that the costly energy policies, such as the self-sufficiency requirement, were not driven by sound reasons and should be abandoned.

The report of the senior officials was released in early August. While most of the media attention focused on recommendations concerning the growth in BC Hydro's management numbers and compensation practices, the panel did provide a useful review of government policy that was contributing to the pressure on rates. Costs were being driven by the government's financial needs for a high net income from BC Hydro, the rapid capital construction program either planned or under way, and the directive that BC Hydro was to encourage more expensive private power generation. The panel noted that the government's directive on "deemed" equity for rate setting produced a larger net income requirement when compared to actual equity. The large net income requirement helped bolster government revenues and increased the cash transfer, but it put pressure on BC Hydro's rates. "If a model of reduced dividends is used, the province would be required to supplement the dividend shortfall ... by reducing its own operating or capital requirements, or by taking on its own debt."³⁶ The panel noted, however, that the prospects for debt moderation at BC Hydro were unlikely as its three-year capital plan called for over \$7 billion in new spending. It cautioned that the province's credit rating could be downgraded if the debt levels continued to grow at planned rates.³⁷

The growth in both the number and the size of the deferral accounts was also discussed in the report. The panel noted that BC Hydro planned to limit the net amount deferred at some \$4.9 million by F2017, but the plan made the bold assumption that no further additions would be made to the cost of energy deferral accounts. The deferral of annual cost variances preserves the level of profits to the government's accounts, but it increases the liability of future BC Hydro ratepayers and, potentially, of provincial taxpayers as well.

³⁵ The distinction between the net income and the dividend was often confused by commentators and the politicians. Perhaps the editorial was suggesting that the government forego the net income, but only a portion of this amount was actually transferred to the government as a dividend. Neither the government nor the external auditor has sought to clearly explain this distinction.

³⁶ British Columbia Government, *Review of BC Hydro* (Victoria: June 2011), 97.

³⁷ *Ibid.*, 100. The recession was affecting most government balance sheets, and Ontario's credit rating was downgraded in 2015 over concern about its debt level.

The company and its external auditor have not made any allowance with respect to the ability of BC Hydro to recover the regulatory assets through future rates, but this could be a potential future concern given the projected future size of these accounts and the desire to keep rates competitive. If BC Hydro is unable to recover any of the deferred amounts, the costs would be passed on to the province (as sole shareholder) and covered by taxpayers.³⁸

The panel of senior officials, being mindful of the government's balanced budget commitment, suggested that, as the economy improves, the province should reduce its reliance on BC Hydro's net income and annual dividends.

The Auditor General's Report on deferral accounting, released at the end of October 2011, provided more ammunition for attacks on the government's management of electricity rates. The linking of BC Hydro management bonuses to the achievement of the Crown's net profit target – a target only achieved by deferring expenditure variances – caught the public's attention and caused significant embarrassment to the government. The report focused on the growing balance in deferral accounts and was concerned that BC Hydro did not seem to have a plan to reduce the resulting debt. It showed that the rate-regulated accounting technique was being used far more extensively by BC Hydro than it was by other public and private power corporations.³⁹ In his testimony to the public accounts committee, Auditor General John Doyle was more blunt than was the carefully worded public report, stating that the sole purpose of the whole exercise was to generate revenue for the government: "So what I see is a conversion of cash being transferred over [to the government] and a replacement of what would normally be the province's taxpayer supported debt by self-supporting debt in a different entity."⁴⁰ Charles Reid, BC Hydro's acting president, in justifying the deferrals, said that the practice protected BC Hydro's customers from larger annual rate fluctuations and also ensured "a consistent stream of net income" to the provincial budget. He notes: "it's very difficult for us to lose money in a given year."⁴¹

³⁸ Ibid., 112.

³⁹ British Columbia Office of the Auditor General, "BC Hydro: The Effects of Rate-Regulated Accounting," October 2011, available at https://www.bcauditor.com/sites/default/files/publications/2011/report_8/report/OAGBC-BC-Hydro-rate-regulated-accounting.pdf.

⁴⁰ *Hansard*, Select Committee on Public Accounts, 25 November 2011, 556.

⁴¹ *Times Colonist* (Victoria), 3 November 2011.

THE GOVERNMENT TAKES FULL CONTROL

On 24 November 2011, BC Hydro filed a revised three-year budget forecast that requested rate increases of 8 percent in F2012 and of 3.91 percent in each of the two following years, along with a reduction in the debt repayment surcharge to 2.5 percent. A \$490 million reduction in the previous expenditure forecast was achieved by a lower forecast for interest rates, reduced operating costs, and a greater use of deferral accounts, despite a \$276 million increase in the cost of independent power.⁴² In February 2012, the BCUC approved an interim 3.91 percent rate increase for 1 April 2012 but increased the debt repayment surcharge to 5 percent, citing concern that the deferral account balances were continuing to grow “without any opportunity in sight to clear them,” as required by government regulation.⁴³

Some six weeks later, the BCUC announced that the F2013 rate request would be reviewed in an open hearing process, and it rejected the arguments of BC Hydro and the majority of the intervenors that a negotiated settlement process (where non-disclosure rules apply) was preferred. The BCUC said that the rate determination involved important policy issues, including the continuing deferral of significant expenditures, the rate of debt recovery, the impact of the transition to new accounting standards, the size and accounting treatment of energy conservation expenditures, as well as the cost and timing of capital projects. The BCUC believed that many of the costs involved “public policy and/or public interest related-issues, and as such, in the Panel’s view, require[d] an open and transparent review.”⁴⁴

Another public airing of the reasons for the rapid rise in electricity rates, coming just months before an anticipated provincial election, was not acceptable to the Liberal government. In May 2012, the cabinet ordered the BCUC to approve the November rate proposal and even lowered the April 2014 increase from 3.91 percent to 1.44 percent.⁴⁵ Energy Minister Rich Coleman justified the action by claiming that the BCUC

⁴² British Columbia Utilities Commission, BC Hydro Amended Revenue Requirements Request F2012 to F2014, 24 November 2011, available at http://www.bcuc.com/Documents/Proceedings/2011/DOC_29146_B-1-3_BCH-Amended-F12_F14-RRA.pdf. The 8 percent for F2012 had previously received interim BCUC approval.

⁴³ British Columbia Utilities Commission, *Decision*, 15 February 2012, 6, available at http://www.bcuc.com/Documents/Proceedings/2012/DOC_29841_A-27_Interim-Rates-Approved.pdf. The Utilities Commission also considered a higher interim rate for F2013 but decided against such a move.

⁴⁴ British Columbia Utilities Commission, *Decision*, 30 March 2012, 5, available at http://www.bcuc.com/Documents/Proceedings/2012/DOC_30246_A-31_BCH_NSP-Application.pdf.

⁴⁵ oic 314/12 of 30 May 2012. The debt repayment surcharge remained at 5 percent.

was planning a 7 percent rate increase, which was much higher than what the government wanted, and he denied that political considerations concerning a possible election influenced the cabinet's decision.⁴⁶ Vaughn Palmer, a respected political commentator, called the action a cover-up: "Defending the decision to emasculate the independent regulator, a badly briefed Premier Christy Clark (she garbled the numbers) claimed ... to have scored a famous victory for lower rates. More like a coverup [*sic*]. By rendering the public hearings moot, the Liberals prevented the public from discovering the full cost implications of their ambitions for Hydro and thereby postponed the rate-setting reckoning until after the election."⁴⁷

Defying many opinion polls, the Liberals gained another majority in the May 2013 general election. Between F2012 and F2014, BC Hydro reported \$1.62 billion in net income, added \$2.53 billion to the net deferral balance, and increased the long-term debt by \$3.9 billion. The large increase in deferrals was due to some \$1.3 billion in new accounts to smooth the impact of the transfer to the new International Financial Reporting System (IFRS) accounting standard.⁴⁸ The new IFRS standard required the expensing of certain BC Hydro overhead expenses relating to capital project planning. To maintain continuity in reporting (and to maintain the net income target) approximately \$220 million in these ongoing operational costs were deferred commencing in F2012.⁴⁹

The IFRS standards required that the actuarial gains and losses of the employee pension fund be recognized immediately in the financial statements. Previously, any surplus or deficiency in the pension fund was recorded as a note to the financial statements and did not affect the balance sheet. Provincial pension legislation requires corporations to make up any solvency deficiency within a reasonable period of time. The financial crisis significantly decreased the value of assets in all public and private corporate pension plans; however, most of the losses had been recovered by 2013. This was not the case for BC Hydro, which reported a decline in the solvency ratio from 97 percent in F2007 to 78.9 percent in F2014. Hydro-Québec, in contrast, injected almost \$2.2 billion from its equity into its pension plan between F2008 and F2013 to keep the solvency

⁴⁶ *Times Colonist* (Victoria), 23 May 2012.

⁴⁷ *Vancouver Sun*, 24 May 2012.

⁴⁸ BC Hydro retained the American standard for the deferral accounting and referred to the mix of accounting standards as the "prescribed standard."

⁴⁹ Details on the deferral accounts can be found in British Columbia Utilities Commission, BC Hydro Revenue Requirements Request F2013 to F2014, app. H, available at http://www.bcuc.com/Documents/Proceedings/2011/DOC_27065_B-1_BCHydro_F12_F14-RR-application.pdf.

ratio within a comfortable range.⁵⁰ Elsewhere within the government the pension solvency ratios declined between 2009 and 2010; but, through a combination of improving financial markets, higher employer and employee contributions, and reductions in some benefits, the solvency ratios had returned to near 100 percent by 2014.⁵¹ Rather than reducing its equity, BC Hydro deferred \$723 million in pension liability in F2013 and stretched the attainment of pension solvency to twenty years instead of the five-year range outlined by Charles Reid in his testimony to the BCUC during the oral review of the F2009/F2010 rates.⁵² The availability of the deferral option appears to have lessened any pressure on BC Hydro management to use equity, or to reduce benefits, to reduce the pension solvency gap.

A NEW FINANCING PLAN FOR BC HYDRO

The small rate increase in April 2013 may have calmed public concern about rising electricity costs, but within months Bill Bennett, the new energy minister, was warning that the planned growth in capital expenditures would require rate hikes, and he publicly lobbied for a reduction in the government's expected revenue from BC Hydro: "Governments – the NDP and us – have become too reliant on BC Hydro's annual dividend" which would result in "a situation where we have less leverage to force important changes to make the corporation operate like a commercial corporation – which is what my overall goal is."⁵³

In the summer of 2013, BC Hydro approached the government with a cumulative 26.4 percent (\$1 billion) rate increase for F2015 and F2016, primarily because of higher debt service costs and higher costs for private power commitments. The government rejected the proposal and formed a joint working group to develop a lower-cost alternative. The importance of the rate issue to the government was evidenced by the attendance of the deputy minister to the premier, the deputy minister of finance, and the president of BC Hydro at the planning sessions held through August

⁵⁰ See Hydro-Québec annual reports. The solvency ratio dropped to 85.6 percent in F2012, reached 100 percent in F2013, and declined to 93.3 percent in F2014.

⁵¹ By 2014, the government employee pension solvency ratio was almost 110 percent, while the ICBC plan ratio was close to 96 percent. For the BC Hydro pension plan, it would appear that the employer and employee contribution, as a percentage of pay, did not change during these years. The solvency ratio for FortisBC also declined to the low 70 percent range in F2011 and F2012 but rose to 82.5 percent by F2014.

⁵² British Columbia Utilities Commission, BC Hydro Final Argument, 21 November 2008, 72, available at http://www.bcuc.com/Documents/Arguments/2008/DOC_20376_11-21_BCH-Final_Argument.pdf.

⁵³ *Globe and Mail*, 30 June 2013.

and September. During the review, BC Hydro warned that the BCUC review process was a risk to any rate proposal and to the government's fiscal plan as the regulator was likely to disallow some of the proposals to moderate the rate increases.⁵⁴ BC Hydro advised the working group that over \$1.3 billion of the \$4.8 billion in proposed F2016 revenue would assist the government's budget through net income (\$780 million), water rental fees (\$400 million), and taxes (\$200 million).⁵⁵

In late November, Energy Minister Bennett unveiled the government's comprehensive ten-year financing plan, which had been developed by the working group. The plan included cabinet-ordered rate increases of 9 percent for F2014, 6 percent for F2015, and retained the high 11.84 percent ROE target.⁵⁶ The Utilities Commission would be allowed to review proposed rate changes commencing in April 2016, but its independence was curtailed as potential rate increases would be capped by government order at 4, 3.5, and 3 percent, respectively, for the next three years. The plan included the gradual phase-out of the annual dividend payment to the government, setting the debt to equity ratio at 60/40, fixing the net income at the current excessive level plus inflation, and holding the debt repayment surcharge at 5 percent.⁵⁷ It was clear that the minister of finance had insisted that the net income stream be maintained, but Bennett did succeed in breaking the link between growing debt levels and the resulting increase in net income.⁵⁸ In mid-December, the government followed up on the ten-year financing plan by announcing approval of the \$8.8 billion Site C dam project, which would significantly increase BC Hydro's long-term debt.⁵⁹ By no longer linking future net income

⁵⁴ A number of background documents prepared by BC Hydro for the working group are found in the freedom of information response package: Government of British Columbia, Open Government Website, FOI Request EGM-2014-000216, released on 9 April 2014, available at http://docs.openinfo.gov.bc.ca/d21976014a_response_package_egm-2014-00216.pdf. This information can be found on page 58 of the package.

⁵⁵ *Ibid.*, 49.

⁵⁶ *Vancouver Sun*, 26 November 2013.

⁵⁷ The government also reduced its annual \$400 million water rental charge, which, at \$7.80/MWh, was approximately 130 percent higher than the fee paid by Hydro-Québec and Manitoba Hydro. See EGM-2014-000216, 34, available at http://docs.openinfo.gov.bc.ca/d21976014a_response_package_egm-2014-00216.pdf.

⁵⁸ Under the existing model, as debt grew the 80/20 debt to equity standard forced the equity to rise in lockstep with the increase in debt, which was accomplished through rate increases and additional expenditure deferrals.

⁵⁹ In addition to the capital cost, BC Hydro estimated that it would lose approximately \$800 million in the initial four years of operation since rates would be below the cost of the new power. The difference would likely be deferred. See Vaughn Palmer, *Vancouver Sun*, 9 May 2014.

to the growing debt, the actual debt to equity ratio would deteriorate as the Site C and other capital expenditures were incurred.

More details of the plan became public in March 2014 when BC Hydro filed its F2015 to F2016 rate application. While the government was now directing the BCUC decisions, a formal approval of the package of changes was still required by the regulator. The filing came one day after the cabinet approved two directives to the BCUC containing specific details on the financial issues announced in November.⁶⁰ The BC Hydro application revealed two key aspects of the plan that were not part of the November announcement. The first was that the 5 percent debt repayment surcharge would, over a period of years, be repurposed to fund normal operations. This redirection effectively added to the announced increase in BC Hydro operating revenue during the first five years of the plan.

Of more concern was the government's creation of a new and unprecedented "rate smoothing" deferral account.⁶¹ Previously, variances in actual expenditures to those approved in the rates had been deferred in anticipation of inclusion in future rates. This new account accelerated unapproved future revenue into the early years of the ten-year plan, thereby allowing BC Hydro to achieve the desired net income without raising electricity rates even higher. The ten-year rate deferral plan included in the BC Hydro submission showed the balance in this rate acceleration account rising to \$785 million by F2021.⁶² Had the government covered the revenue requirement of the early years in a more conventional manner, either higher rates would have been required or the net income would decline. The redirection of the debt repayment surcharge, and the acceleration of hypothetical future revenue, allowed the government to

⁶⁰ oic 96/14 and oic 97/14 of 5 March 2014. The rate request filing included all of the details in the two directives.

⁶¹ British Columbia Utilities Commission, BC Hydro Revenue Requirements Request F2015 to F2016, 7 March 2014, Appendix H, available at http://www.bcuc.com/Documents/Proceedings/2014/DOC_40964_03-07-2014_BCH-F2015-16RevenueRequirementsApplication.pdf.

⁶² *Ibid.*, 32. The Office of the Auditor General did not express concern with this revenue acceleration practice, citing acceptance by BC Hydro's external auditor. The approval of the new account by the BCUC fulfilled the legal requirement for the external auditor, despite the fact that the approval was ordered by the cabinet. See e-mail from Bill Gilhooly, Assistant Auditor General, to the author, 1 December 2015. A useful discussion of the manipulation of revenue can be found in Barry Jay Epstein, *Revenue Recognition: A Whitepaper on Fraud and Financial Reporting Risk* (Chicago: Cendrowski Corporate Advisors, December 2013), available at http://www.epsteinnach.com/wp-content/uploads/2014/11/White_Paper_Revenue_Recognition_Barry_Epstein_Nov2014.pdf.

announce lower than required rates while increasing the net income.⁶³ The BC Hydro ten-year deferral account plan forecast that the net deferral balance would rise to approximately \$5 billion by F2020 and then slowly decline in future years. The forecast was based on the unlikely assumption of no new additions to the cost of energy deferral accounts.

The government's actions were criticized by the NDP during the spring legislative sitting, with opposition leader John Horgan charging that the government was controlling the BCUC and manipulating electricity rates for political purposes. Premier Clark responded that the government was trying to find a balance between renewing BC Hydro's aging assets and keeping rates as low as possible.⁶⁴ Energy Minister Bennett defended the new financing plan by saying that the government could not afford to reduce BC Hydro's dividend sooner and that the creation of the new rate-smoothing account maintained the net income while avoiding the need for higher rates.⁶⁵ The previous year, Bennett said that, without the expenditure deferrals, the necessary rate increase would have a "horrible impact on ratepayers" and that this would result in "blood on the streets, I'm sure."⁶⁶

Two other reports that had a direct bearing on the government's relationship with BC Hydro and the BCUC were made public in 2014. The joint federal-provincial panel established to review the Site C project released its comprehensive report in May 2014. After reviewing a number of options, the panel concluded that the proposed dam was the most economical way of providing the forecast new power requirement. The panel, however, neither supported nor rejected the project and recommended that the matter be referred to the BCUC for further study. The report noted that the finances of BC Hydro and the provincial government "ha[d] been intertwined by the latter at the expense of the former." The panel stated that "BC Hydro's [then] present financial condition, with its immense deferral ('regulatory') accounts and the absence of a real equity base" was a consequence of government policies to extract revenue and to suppress rates: "In effect, the Province has been increasing the total of its direct and indirect debt while classifying BC Hydro's portion

⁶³ The announced cumulative total rate increase for the five years was 28 percent; including the impact of the surcharge redirection and the revenue acceleration, the increase in revenue totalled approximately 50 percent.

⁶⁴ *Hansard*, 28 May 2014, 4399. BC Hydro figures show that, from F2008 to F2014, some 50 percent of \$12.1 billion in capital expenditures was for growth in generation or distribution capacity.

⁶⁵ Shaw Cable, "Voice of BC," 6 March 2014.

⁶⁶ *Hansard*, 17 July 2013, 644.

of it as being supported by rates it did not allow BC Hydro to charge.”⁶⁷ The report noted that the government’s rigid adherence to clean hydro power generation eliminated the investigation of other and potentially cheaper options, such as geothermal or natural gas generated electricity. Energy Minister Bennett denied that politics were involved in the decision to proceed with the Site C project. Vaughn Palmer was not convinced: “As I read the report, political calculations have repeatedly trumped sound energy policy making in this province.”⁶⁸

Some six months later the government received the report of a task force established to review the operation of the BCUC. The task force panel consisted of a former chair of the BCUC, a former deputy minister and chair of BC Hydro, and a respected lawyer well versed in the BCUC process. The recommendations centred on restoring the government’s and key stakeholders’ confidence in the BCUC, which would be accomplished by strengthening its resources and independence. The panel stated that the government should clearly delineate its role in setting energy policy and providing direction on specific matters, “then leave the Commission to act independently within its mandate.”⁶⁹

TRENDS AND COMPARISONS

During the seven years under review, the rising price of electricity did not automatically translate into an equivalent increase in revenue to BC Hydro. During the period total kilowatt hours (KWh) of domestic consumption remained relatively flat as the average residential KWh usage declined by 6.2 percent.⁷⁰ The average cost of electricity purchased from private power producers rose from approximately sixty-two dollars per gigawatt hour in F2008 to \$74.80 per gigawatt hour in F2014, an increase of 20.6 percent. During this period the private power share of the domestic sales rose from 12.9 percent to 21.7 percent, despite total domestic sales rising by only 0.8 percent (five hundred gigawatt hours). The cost of purchasing electricity from the private producers rose from \$481 million in F2008 to \$825 million in F2014, an increase of 71.5 percent.

⁶⁷ Government of Canada, *Report of the Joint Review Panel – Site C Clean Energy Project* (May 2014), 280 and 281.

⁶⁸ *Vancouver Sun*, 9 May 2014.

⁶⁹ Government of British Columbia, *Independent Review of the British Columbia Utilities Commission, Final Report*, 14 November 2014, 1, available at http://www.empr.gov.bc.ca/EPD/Electricity/BCUC_Review/Documents/BCUC%20Review%20Final%20Report%20-%20Nov%2014%20-%20FINAL.PDF.

⁷⁰ From 11,290 KWh in F2008 to 10,571 KWh in F2014. See BC Hydro annual reports.

The increased cost was not fully reflected in electricity rates because part of the growth in the cost of private power was deferred.

Trade income, which was an important source of profits for the public utility in the mid-2000s, declined sharply in the F2010 to F2012 years as the recession took hold in the United States. During the period total trade electricity gigawatt hours dropped by 36.5 percent, offsetting price increases of approximately 33 percent. From F2008 to F2014, net income from trading operations was consistently less than the amount assumed in the rates, and, by F2014, BC Hydro had deferred \$324 million of this variance.

A comparison of certain key elements in the finances of BC Hydro to other Canadian energy utilities provides useful insights into how the government has managed the finances of the public utility. The 2011 report of the government review panel and the Auditor General's Report on deferral accounts referenced how BC Hydro compared to Manitoba Hydro and Hydro-Québec on certain key indicators. FortisBC Inc. (which acquired Terasen Gas) was included as Terasen/FortisBC and was the BCUC benchmark for setting BC Hydro's ROE. All the comparisons were derived from public financial statements.

By regulation, BC Hydro must pay a dividend to the province of up to 85 percent of the annual net income, as long as the debt to equity ratio remains at or below 80/20. The dividend limit at Hydro-Québec is 75 percent of net income, while Manitoba Hydro does not pay a dividend. In the period under review, the government changed the definition of equity twice and required that the net income target be calculated on "deemed" equity, which is approximately 30 percent higher than the national accounting standard definition. On the basis of the national standard definition of equity, from F2008 to F2014, BC Hydro maintained a long-term debt to equity ratio of 75/25. The consistency of the ratio throughout the period is interesting as it suggests that the annual rates (including the net income) were calculated to achieve this ratio. The average ratio for Hydro-Québec is in the 55/45 range for these years,⁷¹ and Manitoba Hydro operated in the 70/30 range. FortisBC grew its equity from F2010 onward, and by F2014 its equity exceeded its long-term debt by 25 percent.

A comparison of the annual (after deferrals) net income to the actual equity ratio shows that, from F2008 to F2012, BC Hydro was in the 17 to 20 percent range, declining to 14.5 and 14.2 percent in F2013 and F2014,

⁷¹ Hydro-Québec is highly profitable as it benefits from extremely low electricity costs from the Churchill Falls contract with Newfoundland and Labrador.

respectively. This high profit level is remarkable in light of the economic recession and is greater than the ratio of the highly profitable Hydro-Québec. From F2010 to F2014, the ratio for BC Hydro was approximately twice that reported by FortisBC, which was the BCUC benchmark for determining the allowed ROE. The difference is partly explained by the government directions to calculate the ROE target on the higher “deemed” equity and to set the ROE higher than the BCUC benchmark.⁷² The high profits recorded during these years also reflect the annual transfer of hundreds of millions to deferral accounts, thereby ensuring a high level of net income.

BC Hydro was able to achieve high profits and grow its equity through a combination of rate increases and an extensive use of deferral accounts. The other utilities surveyed also defer certain expenditure and revenue variances to help smooth annual rate fluctuations, but none exploited the deferral account option to the extent that did BC Hydro. This is demonstrated by comparing the percentage ratio of the corporation’s net asset and liability balance in deferral accounts to the reported equity (Hydro-Québec and FortisBC have fiscal years that run from January to December). The data for Hydro-Québec were not available from F2011 onwards as the presentation in the financial statements changed that year.

TABLE 1
Ratio of Net Deferral to Equity

	F2008	F2009	F2010	F2011	F2012	F2013	F2014
BC Hydro	29.7	46.8	64.0	75.0	83.8	126.6	121.4
Hydro-Qué.	4.7	5.0	4.8	6.0	N/A	N/A	24.4
Man. Hydro	12.7	14.9	11.9	10.4	8.9	9.6	11.7
FortisBC	N/A	N/A	25.1	32.9	37.0	39.0	35.0

Source: Financial Statements.; in 2015 Hydro Quebec adopted the US accounting standards for its regulatory accounts, and the F2014 number reflects this change.

The data show that throughout the period a growing proportion of BC Hydro’s assets and equity was composed of deferred expenditures; in F2014, for example, the net deferrals totalled \$4.70 billion while the reported equity totalled \$3.87 billion. Without the deferral accounts the Crown utility would have not achieved its high net income to equity

⁷² IOC 74/09 of 17 February 2009. In 2013, the government again ordered BC Hydro to maintain the ROE target despite the reduction ordered by the BCUC to the benchmark utility. In March 2014, the cabinet set the ten-year target at 11.84 percent of “deemed” equity.

levels, since the equity would have been greatly reduced. In fact, all else being equal, BC Hydro would have become insolvent during 2013. Yet it is unreasonable to expect BC Hydro to manage annual rate fluctuations in the absence of some degree of expenditure variance deferral.

During the seven years under review, the net balance in the BC Hydro deferral accounts jumped from approximately \$0.5 million to \$4.7 billion.⁷³ On the basis of a more restrictive scenario, where only the cost of energy, trade income, and capital-like deferral accounts are considered – as these were in place before the BCUC liberalization resulting from the economic recession and government directives – the net balance in the deferral accounts would have grown to approximately \$1.7 billion.⁷⁴ The difference between the actual increase in net deferrals and the increase in the more restrictive scenario is approximately \$3.0 billion. Had the more restrictive scenario been used during the seven years, and assuming no change in rates beyond those approved, BC Hydro would have recorded approximately \$3.1 billion less in cumulative net income, and incurred operating deficits in F2010 and 2013.⁷⁵ Under the restricted scenario, by F2014 BC Hydro would have reported a \$3.1 billion lower net balance in the deferral accounts, and an equivalent reduction in assets. The equity reduction would have been less as most of the pension deferral was offset by a liability entry on the balance sheet.⁷⁶ It is also likely that, due to the debt to equity limitation, the \$1.4 billion in total dividend payments to the government during the period would not have been made. A \$3.1 billion reduction in the accumulated net income from BC Hydro would have delayed the government's attainment of a balanced budget.

Would the adoption of a more restrictive approach to the use of deferral accounts have required rate increases resulting in “blood on the streets” as the energy minister suggested? The minister's statement assumed that the government would have insisted that BC Hydro achieve the accumulated net income difference of \$3.4 billion recorded during these

⁷³ During the same period, BC Hydro's long-term debt rose by \$7.9 billion to reach \$15.5 billion by F2014. The government's decision to proceed with the Site C project will add a further \$8 to \$10 billion to the debt, depending on construction costs and the average selling price of the power. See *Vancouver Sun*, 16 December 2014.

⁷⁴ Also excluded is the energy conservation deferral account as this is more properly an annual operating expenditure. Hydro-Québec began to expense these costs in 2012, after its regulator declared that this was an operational expenditure.

⁷⁵ From F2008 to F2014, BC Hydro reported cumulative net income of approximately \$3.4 billion. Based on the restrictive scenario the cumulative net income would have been approximately \$0.3 billion.

⁷⁶ By offsetting the pension liability, mandated by the change to the new IFRS standard, to a deferral account BC Hydro avoided a sharp drop in its equity.

years; profit the government needed in order to achieve its balanced budget target. The restricted deferral option, without further rate increases, would have forced the government to run larger deficits, or raise taxes.⁷⁷ Rather than restricting the use of deferral accounts, the ten-year financing plan of November 2013 continues the same financing policies characterized by lower than required rate increases and a growing net income stream to the province. The new financing plan now incorporates a new revenue acceleration deferral account and the staged redirection of the debt repayment surcharge, to maintain the illusion of profitability at BC Hydro.

In January 2015, energy minister Bennett admitted that most of the dividends paid by BC Hydro had been financed through borrowing,⁷⁸ and one can assume that most of the reported net income was also added to the debt. Nonetheless, when BC Hydro's three-year service plan was released a month later, a further \$2.0 billion in cumulative net income, and approximately \$1.1 billion in cumulative dividend payments, were forecast between F2016 and F2018.⁷⁹

CONCLUSIONS

The 2007-08 financial crisis, and the resulting economic recession, significantly reduced the provincial government's revenues, forcing it to incur budget deficits from F2010 to F2013. The debt for government operations – the taxpayer-supported debt – rose from \$28.5 billion in F2008 to \$41.8 billion in F2014.⁸⁰ The Liberal government prided itself on being disciplined and prudent financial managers, but the worst financial crisis since the Great Depression of the 1930s forced desperate measures in an attempt to retain the public's trust in its management of the provincial finances. Beginning in 2009, the overarching government priority was to restrain government expenditures, and to maintain or enhance non-tax revenues, with the goal being a balanced budget by F2013.

⁷⁷ There are many possible financing options, including returning to the benchmark ROE, rather than freezing it at the 11.84 percent level as ordered by cabinet in the March 2014 directive. All options would result in the government foregoing revenue to moderate the growth in BC Hydro's deferral accounts and its debt.

⁷⁸ The minister stated that the BC Hydro ratepayer had been loaning money to the provincial taxpayer. See Rob Shaw, *Vancouver Sun*, 13 January 2015.

⁷⁹ BC Hydro, 2015-16 to 2017-18 Service Plan, February 2015, 14-15, available at <https://www.bchydro.com/content/dam/BCHydro/customer-portal/documents/corporate/regulatory-planning-documents/service-plans/bchydro-service-plan-2015-16-2017-18.pdf>.

⁸⁰ From F2008 to F2014, the government taxpayer-supported debt to revenue ratio grew by 31 percent, while the long-term debt to revenue ratio at BC Hydro increased by approximately 60 percent.

The adoption of the HST, and the booking of the \$1.6 billion federal inducement, was a highly visible aspect of the revenue strategy which caused a political backlash. The manipulation of the finances of ICBC, and especially BC Hydro, was more incremental and did not garner anywhere near the same degree of public attention or concern. In introducing the government's F2014 budget, Finance Minister de Jong proudly announced that the provincial budget was now balanced, and the growth in taxpayer-supported debt was moderating. He did not discuss how the government had manipulated BC Hydro's finances to suppress rate increases while increasing the public utility's profits and dividends.

BC Hydro was central to the government's clean energy and economic development initiatives, but these policies added to the utility's financial pressures. BC Hydro's net income had been a steady source of revenue to the provincial government, while the dividend reduced borrowing requirements. The rapid increase in capital expenditures, together with the requirement to acquire clean power from private producers, raised costs at a time when the recession flattened demand for electricity. During the recession and slow economic recovery the government raised BC Hydro's net income target, and encouraged the deferral of more expenditure variances, to ensure that its profits and dividends would continue to flow to the provincial budget. The deferring of expenditures also had the benefit of increasing BC Hydro's assets and equity, despite adding to the utility's debt. In effect, debt was recast as equity.

The short-term strategy of low electricity rate increases during 2012 and 2013, and the avoidance of public scrutiny by sidelining the BCUC, helped to keep the government's costly energy policies and the growing BC Hydro debt from becoming issues during the May 2013 election. The new financing plan for BC Hydro, announced in November 2013 and mandated by cabinet orders in March 2014, was designed to provide rate predictability and high net income for at least five years. The introduction of a new and unpredicted revenue acceleration deferral account, suggests that the government was prepared to continue its manipulation of the utility's accounts.⁸¹ Suppressing electricity rates, while transferring the cost of the government's balanced budget, economic development and clean energy policies to BC Hydro, fulfilled the government's short-term financial and political needs. However, the resulting growth in BC Hydro's debt will entail a high cost to future generations of electricity consumers. The distortion of the provincial finances also suggests that the government was just as adept at financial manipulation as financial management.

⁸¹ For a useful summary of trends in accounting manipulation in the United States, see Schumpeter, "The Story and the Numbers," *Economist*, 31 October 2015, 64.