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BC Hydro losses, from today to tomorrow ~ Patrick Brown

Creative 'rate-regulated' accounting strategies approved by the provincial government since 2003 have enabled BC Hydro to 'defer' some $1.7 billion in costs and to contribute an apparent net profit for 2010 to help reduce the apparent provincial deficit.

Over the past few years, the BC Utilities Commission (BCUC), acting under 'Special Directions' from the cabinet, have approved the creation of a variety of 'regulatory deferral' accounts intended to spread one-time or unanticipated costs over a number of years so as to stabilize electricity rates charged to consumers.

Since the creation of the Heritage Deferral Account (HDA) and the Non-Heritage Deferral Account (NHDA), BC Hydro has the accounting means to defer operating losses in its core business—the sale of electricity to British Columbians.

Why Losses Into Profits?

As a creature of the provincial government, BCHydro's financial results are rolled into the overall provincial budget. But before this is done, transfers of significant amounts are being made from actual cost accounts to the specialized deferral accounts.

For example, in fiscal year 2010 (F2010), the operating loss was actually some $249 million; but the total transfers amounted to some $696 million, changing this into a profit of $447 million. It is this latter amount that was included in calculating the province's budget deficit.

One interpretation of this might be that BCHydro has borrowed $696 million against its future income; $249 million on its own behalf, and $447 million as a contribution to the provincial government's balance sheet.

BCHydro had, in fact, recorded annual operating profits until fiscal 2009, when an operating loss of $73 million was turned into net income of $365 million through a deferral of $438 million. So 2010 is the second year running that this has occurred.

The total amount of all deferred costs and losses is now $1,713 million.

What's Deferrable?

Deferral accounts are nothing new in accounting. In principle, it is generally thought legitimate to defer costs to future years if they appear to belong to a project which will be carried out or come to fruition in future years, following the concept that project costs and the revenue or capital funds to cover them should appear in the same fiscal period.

It is somewhat less acceptable, but still common, to spread losses resulting from one-time events, which may have been beyond the control of the corporation, over a number of years, to be paid off (or 'amortized') from the revenues to be earned in the future.

It is generally unacceptable to defer losses to future years if there is no assurance that they will be paid back by future profits.

According to the government, and BCHydro, the use of deferral accounts is justified:

1. To better match costs and benefits for different generations of customers;
2. To smooth out the rate impact of a large non-recurring cost; and
3. To defer, to a future period, differences between forecast and actual costs or revenues.

BCHydro, for many years, maintained a 'Rate Stabilization Account', which was intended to smooth out the rate of increase in electricity prices, for the first two reasons above.

Deferral Accounts

The idea of a 'regulatory' deferral account, drawing on the third justification above, appears to have originated in 2003, with the 'Heritage Contract Proposal', which committed BCHydro's Generation facilities to produce, and BCHydro's Distribution organization to use, a

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maximum of 49,000 gigawatt-hours (GWh) per year, thought to be the reliable capacity of BCHydro's 'heritage' assets. (For context, recent annual power sales to customers in BC have ranged from 50,000–53,000 GWh, for a total of a little over $3 billion.)

The 'Heritage Deferral Account' (HDA) was the first of the 'regulatory' accounts. Since the amount of power produced by the heritage assets (the large hydroelectric dams) and used to fulfill the province's power needs was relatively constant and predictable, and the cost-per-unit over the long term well established, the HDA, and its function of reconciling forecast and actual financial performance, was not a big issue. At the end of 2008, its cumulative total was $78 million.

However, over the past few years, the BCUC, acting under 'Special Directives' from the provincial cabinet, have authorized BCHydro to establish a dozen or more additional 'regulatory' deferral accounts. These fall into two categories: cost variance deferral accounts, which enable BC Hydro to carry over actual shortfalls against anticipated future profits, and cost deferral accounts, which permit BC Hydro to spread one-time costs over a number of future years. (All these accounts are described in the BOX to the left, along with their impacts on the 2010 losses.)

The 'First Four' Accounts

The first four are 'profit and loss' accounts showing variances carried over and accumulated from year to year. Accumulated losses for 'First Four' totaled $584 million at the end of 2010.

Both the Heritage Deferral Account (HDA) and Non-Heritage Deferral Account (NHDA) are referred to as 'cost of energy deferral accounts', since they record variance between the planned and actual cost of energy for sale to customers in BC.

BCTC Deferral Account (BCTCDA) and Trade Income Deferral Account (TIDA) record variances from the planned financial results of the transmission and energy trading operations of BC Hydro.

In 'Special Direction HC2', the cabinet has ordered that the actual losses in these four accounts should not be counted against BC Hydro's published current year results. In future years, should BC Hydro exceed annual RRA targets, the amounts carried over in these 'profit and loss' accounts would be reduced. (However, as these accounts represent actual losses or gains, it is misleading to excluded them from current year results.)

The Remaining Accounts

The costs in the other deferral accounts (also listed in the BOX on page 13) are each, in some way, investments in the future, and their deferral, or partial deferral, is more normal accounting practise.

Recovering Losses From the 'First Four' Accounts

Despite the shuffling of figures, losses in the First Four must be recovered from consumers. This is being done in two ways: increasing electricity prices, and by a stopgap—the rate rider.

Electricity prices went up 6.11% in April, as allowed by BCUC following a 'revenue requirements' application (RRA) by BC Hydro. However, looking at your Hydro bill you will see, in the Rate Rider line, an additional percentage on your bill. It went up 3% in April—it's now 4%—which means your power rates actually went up by 9.29% this year.

Given the size of the accumulating deficits in the 'First Four', it is clear that customer electricity rates will have to continue to increase.

GAAP Does Not Help

The provincial government has made much of the 'transparency' that would result from its adoption of Generally Accepted Accounting Principles (GAAP) accounting standards. (The explanations in BC Hydro's 2010 Annual Report are, in fact, reasonably transparent.)

However this does not compensate for a fundamental flaw in the equation; the provincial policy that assumes that BC Hydro's revenue projections, made for its application to BCUC, are completely accurate (when in fact they can be hundreds of millions of dollars astray) and then, through 'Special Directives', ensures that the final accounts—and thus revenue to the government—reflect these original assumptions.

All well and good if BC Hydro is in the black. However, it looks increasingly unlikely that BCHydro will be able to pay off its deferred costs from future profits. And, if it can't, sooner or later, British Columbians will have to foot the bill; either through increased electricity rates, or, when BC Hydro fails to be able to produce its 'dividend' to the provincial government, through taxes, or both. (Note that the 'equity', and the dividend return on equity are all

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determined by the government, not by BC Hydro.)

BC Hydro Losses Not Likely to Turn Around Anytime Soon

The economic downturn has resulted in lower demand for electricity in BC, and lower prices in both electricity and gas trading; both hurt BC Hydro's 2010 bottom line severely.

The provincial government's special directives now have the effect of concealing the resultant losses. That's not just 'creative accounting'; that's tantamount to fraud. ✐

The Regulatory Accounts

1. Heritage Deferral Account (the full text from BC Hydro's 2010 Annual Report): 'Under a Special Directive issued by the Province, BCUC was directed to authorize BC Hydro to establish the HDA. This account is intended to mitigate the impact of certain variances between the forecasted costs in a revenue requirements application and actual costs of service associated with the Heritage Resources by adjustment of net income. In the absence of rate regulation, GAAP would require the inclusion of these cost variances in operating results in the year in which they are incurred, which would have resulted in a $4 million increase in net income.' (Note that the $4 million increase in net income arises from the combination of an actual net income $25 million less than forecast, and an 'amortization' allocation of $29 million from the 'rate rider' surcharge on electricity bills.)

2. Non-Heritage Deferral Account (full text again): 'Under a Special Directive issued by the Province, BCUC approved the establishment of the NHDA, which is intended to mitigate the impact of certain cost variances between the forecasted costs in a revenue requirements application and actual costs related to energy acquisition and maintenance of BC Hydro's distribution assets by adjustment of net income. In the absence of rate regulation, GAAP would require the inclusion of the cost variances deferred in the NHDA in operating results in the year in which they are incurred, which would have resulted in a $45 million decrease in net income.'

Basically, the difference between what BC Hydro forecast in their 'Revenue Requirements' application and what actually happened—costs were $52 million higher than forecast, but $7 million was made up from the 'rate rider', so this accounts for another $45 million of BC Hydro's loss.

3. BCTC Deferral Account: another 'Special Directive'; another $9 million of the loss.

4. Trade Income Deferral Account: this is the big one, since trading income was down by about half in fiscal 2010: another $202 million profit that didn't happen. Clearly, this account has been established (by 'Special Directive') in the hope that future good trading years will cover the losses of this bad one.

5. Demand-side Management Programs: on the basis that the benefits of these 2010 expenditures will occur in the future (we hope) Hydro will either defer the costs or record them as capital assets. This puts off another $78 million of the loss. (Does this include smart meters?)

6. First Nation Negotiations, Litigation and Settlement Costs: mostly reclassified, to be amortized over ten years; another $10 million of the loss accounted for.

7. Non-Current Pension Costs: like everyone else, BC Hydro has had to revalue the investment portfolio of its pension plan. This would have resulted in a further $86 million loss in 2010, so it is now kept in a regulatory account – maybe the value of these investments will come back?

8. Site-C Regulatory Account: another $25 million in costs that weren't provided for. May be rolled into Site-C capital cost later.

9. Environmental Compliance: BC Hydro may have to establish a liability provision for compliance and remediation costs to comply with new PCB regulations under the Canadian Environmental Protection Act. This Regulatory Account has not yet been established or approved, but if and when it is, that will be another $321 million in costs to be provided for – it's not clear when they might be incurred.

10. Future Removal and Site Restoration Costs: this account was established in 2006 and $251 million was reserved from retained earnings for the future costs of dismantling and disposal of property, plant, and equipment. Rate regulation requires recognition of $13 million in current year amortization costs.

11. Foreign Exchange Gains and Losses: BC Hydro made money on foreign exchange, since the company held US dollar assets, which appreciated $44 million in fiscal year 2010. But it's all deferred, so it isn't counted in current income.

12. Finance Charges: the BCUC approved a regulatory account for finance charges, which in fiscal year 2010 were a lot less than expected, due to low interest rates. This resulted in deferral of another $104 million gains from costs avoided.

13. Other Regulatory Accounts: another ten miscellaneous regulatory accounts made a difference to the reported net income; in 2010, $101 million in costs have been deferred; $42 million have been paid ahead.

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