

## BC Hydro: The Effects of Rate-Regulated Accounting

Released: [October 2011](#)

First Follow-up: [March 2012](#)

Discussed by the Public Accounts Committee: [November 25, 2011](#)

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### WHAT WE DID IN 2011

Our report<sup>1</sup> in 2011 considered BC Hydro's accounting practices, particularly those related to rate-regulated accounting, and the effects of these practices on the reported financial health of BC Hydro and its ability to match costs and benefits with different generations of customers.

### WHAT WE FOUND IN 2011

At the time of our report, BC Hydro had a net regulatory asset of approximately \$2.2 billion (fiscal 2010/11), that is to say \$2.2 billion in expenses had to be recovered from customers in future years. We found that although BC Hydro had some plans to recover these amounts, it lacked a comprehensive plan defining how these amounts would be recovered, and over what period. Thus in our report, *we recommended that government determine, at the earliest opportunity, how BC Hydro will recover the net deferred costs in its regulatory accounts.*

Leading up to our report, Canadian accounting standards changed significantly. These changes required BC Hydro, as a government business enterprise,<sup>2</sup> to adopt International Financial Reporting Standards (IFRS) from fiscal year 2011/12 onwards. At the time, IFRS did not allow for the use of rate-regulated accounting. This meant BC Hydro would no longer be able to defer expenses and revenues to future years to "smooth out" the effects of unexpected costs or profits for its customers, an accounting practice that BC Hydro and government did not want to lose. As such, government directed BC Hydro through BC Regulation 257/2010 to adopt a U.S. accounting standard<sup>3</sup> which permits the use of rate-regulated accounting rather than the related IFRS regulation. At the time of our report, we were concerned that BC Hydro would continue to apply rate-regulated accounting, which may not be permitted in future years under Canadian generally accepted accounting principles (GAAP). Therefore, in our report *we recommended that government prescribe that the annual financial statements for BC Hydro be prepared fully in accordance with Canadian generally accepted accounting principles.*

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1 Our 2011 report, *BC Hydro: The Effects of Rate-Regulated Accounting*, can be found at [www.bcauditor.com](http://www.bcauditor.com).

2 A government business enterprise is an organization that should, in the normal course of its operations, be able to maintain its operations and meet its liabilities from revenues received from sources outside of the government reporting entity.

3 *United States Financial Accounting Standards Board Accounting Standards Codification 980*

## GOVERNMENT'S PROGRESS TO DATE

### Government's 2012 self-assessed progress in implementing our recommendations

**IN MARCH 2012** government provided us with a self-assessment of its progress in implementing the two recommendations our Office made in 2011. Government said that it had “partially implemented” our first recommendation, as BC Hydro had filed a plan for the recovery of regulatory account balances from fiscal years 2012/13 to 2013/14 with the BC Utilities Commission (BCUC), as part of its Amended fiscal 2012 to 2014 Revenue Requirement Application (the application).<sup>4</sup>

The application provided<sup>5</sup>

- ◆ a definition of each existing regulatory account;
- ◆ the policy framework that defines situations when a regulatory account could be appropriate;
- ◆ the interest rate applied to regulatory accounts;
- ◆ the planned recovery period of each regulatory account; and
- ◆ an explanation of future regulatory accounts.

Although we were encouraged by BC Hydro taking action to implement our recommendation, and the similar recommendation made by government in its review<sup>6</sup> of BC Hydro, more detail could have been provided in the application to explain, and demonstrate, how BC Hydro would recover regulatory account balances from customers in future years. For example, the application provides the extent of recovery for each of the existing account balances for fiscal years 2012 to 2014, but it does not provide a detailed explanation of the rationale for these decisions, nor provide an extrapolation of these planned recoveries beyond fiscal 2014. Many of these regulatory accounts are planned to have balances beyond fiscal 2014.

Furthermore, we noted that the application does not explain that BC Hydro cannot control some of the risks related to the recovery plans. For example, variances in seasonal weather and interest rates can impact regulatory account balances. We expected that these risks would be explained in the application, including clearly indicating that the forecasted regulatory accounts balances and recovery plans are not absolute, and subject to uncertainty; therefore, account balances in future years could be significantly lower or higher than indicated in the application.

<sup>4</sup> Amended application filed with the BCUC on November 24, 2011. More details can be found at [www.bcuc.com](http://www.bcuc.com) or [www.bchydro.com](http://www.bchydro.com)

<sup>5</sup> See Chapters 2 and 7 of the application.

<sup>6</sup> J Dyble, P Milburn, C Wenezenki-Yolland, *Review of BC Hydro* (June 2011)

As for our second recommendation, government said that it had not yet taken action due to the ongoing review of rate-regulated accounting guidance in International Financial Reporting Standards.

## Our follow-up project starting in Fall of 2013

In September 2013, when we initiated this follow-up project, we started by examining what progress BC Hydro had made in implementing our recommendations, and then determined what aspects of the recommendations we still considered incomplete.

We found that in mid-2012, management at BC Hydro started developing the *Regulatory Accounts Report: Fiscal F2013 to F2024* (the BC Hydro report) to explain how BC Hydro would recover its regulatory account balances from customers in future years, and describe in detail its existing regulatory accounts. On March 7, 2014 BC Hydro filed<sup>7</sup> this report with the BCUC.

We examined BC Hydro's report, and made enquiries about it, but did not audit the report. We did not audit the data or assumptions used by BC Hydro to determine the forecasted balances and basis for recovery of the regulatory account balances.

## BC Hydro's Regulatory Accounts Report

“Public reporting is the practical expression of an open and accountable government. It is key to demonstrating transparency in government activities, and is a pragmatic step towards improving the performance of the public sector.”<sup>8</sup>

BC Hydro's report provides for improved transparency in the mechanics of BC Hydro's use of rate-regulated accounting, and it allows for greater scrutiny by the Legislative Assembly, customers of BC Hydro, and the wider public. For example, the report includes a year by year forecast of all existing regulatory account balances up to year 2024 and discloses that in year 2024, 84% of the outstanding regulatory account balances are forecast to be found in only five accounts that either match costs with benefits or relate to the transition to IFRS. As at March 31, 2014, 19 of the 27 regulatory accounts, which represent approximately 80% of the total regulatory account balance, are being recovered in current rates (see Exhibit 1).

Forecasts can (and often) change for several reasons, but nevertheless this forecast of regulatory account balances provides readers with a benchmark to measure the actual performance of the regulatory accounts and their management by BC Hydro.

<sup>7</sup> BC Hydro's *Regulatory Accounts Report: F2013 to F2024* can be found at [www.bcuc.com](http://www.bcuc.com) or [www.bchydro.com](http://www.bchydro.com)

<sup>8</sup> Office of the Auditor General of BC, *Towards a More Accountable Government: Putting Ideas Into Practice*, (February 2000)

**Exhibit 1:** BC Hydro - Actual and forecast regulatory account balances (\$ Million)



Compiled from: Figure 1, *Regulatory Accounts Report: Fiscal 2013 to Fiscal 2024*, BC Hydro (March 2014)

The BC Hydro report provides readers with:

- ◆ a history and description of regulatory accounts;
- ◆ the categories of regulatory accounts;
- ◆ how each regulatory account balance will be recovered;
- ◆ the application of interest to regulatory accounts;
- ◆ actual regulatory account balances for fiscal years 2005 to 2013 and forecast balances for fiscal years 2014 to 2024; and
- ◆ the effect of earnings sensitivities on regulatory account balances.

Although some of the information contained in BC Hydro’s report had previously been made public in filings with the BCUC, collating this information into a specific document provides for easier accessibility and understandability by readers. For example, BC Hydro’s amended revenue requirement for fiscal years 2012 to 2014 provided descriptions of the regulatory accounts in existence at the time, but this BCUC required filing was nearly 3000 pages. BC Hydro’s audited financial statements also provide details and balances of BC Hydro’s regulatory accounts; however, this information is historical and does not provide details about future regulatory accounts, nor forecasted balances of existing regulatory accounts.

## STATUS OF OUR RECOMMENDATIONS

**WE ARE ENCOURAGED** by BC Hydro's progress in implementing our recommendation related to the recovery plans for regulatory accounts balances. However, risk remains as to the certainty of the forecasted balances of the regulatory accounts. The actual balance for each regulatory account could be significantly higher, or lower, in future years, thereby causing BC Hydro's planned revenue requirements to change, and ultimately impact customers' rates.

For example, BC Hydro identified that a 1% change in the discount rate used to calculate its pension obligations for staff would result in an accounting cost increase or savings of approximately \$300 million. This variance would need to be recovered from, or returned to customers in future years (BC Hydro's report proposes that these variances be recovered from or returned to customers over the estimated average remaining service years of employees, which is currently 13 years). Changes to the discount rate for pension obligations are common. In fact, BC Hydro's discount rate for pension obligations changed by nearly 1% between fiscal years 2012 and 2013.

Management at BC Hydro believe that the planned recovery methods and timelines are achievable. As stated before, we have not audited this plan. Ultimately though, time will validate BC Hydro's plans and forecasts for its regulatory accounts for we will easily see if they are achieving their goals.

Recent changes in accounting standards mean that the Canadian Accounting Standards Board (CASB) have allowed rate-regulated entities such as BC Hydro to continue to use rate-regulated accounting beyond 2015. In January 2014, the International Accounting Standards Board (IASB) published an interim accounting standard<sup>9</sup> for rate-regulated entities. This standard allows entities that currently recognize regulatory deferral account balances in accordance with their previous GAAP, to continue to do so when making the transition to IFRS. In April 2014 the CASB adopted this standard, thereby permitting Canadian entities to continue to use rate-regulated accounting beyond 2015. We expect this standard to remain in place for many years while the IASB completes its comprehensive rate-regulation project.

The effect of recent changes to the accounting standards mean that, at least at this point in time, and with respect to rate-regulated accounting, BC Hydro is preparing its financial statements in accordance with Canadian GAAP, thereby making our recommendation that BC Hydro prescribe to Canadian GAAP no longer applicable.

<sup>9</sup> International Financial Reporting Standard 14: Regulatory deferral accounts (January 2014)

## LOOKING AHEAD

**WE WILL CONTINUE** to monitor BC Hydro's use of rate-regulated accounting, including actual performance and management of regulatory account balances. The regulatory account report published by BC Hydro provides our Office with a good benchmark to perform further follow-up work in future years.