

McCULLOUGH RESEARCH

ROBERT F. MCCULLOUGH, JR.
PRINCIPAL

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To: McCullough Research Clients
From: Robert McCullough
Subject: ASC 980 and the Decision to Complete Site C

While British Columbia has had a regulatory commission, the British Columbia Utilities Commission, since 1980, the government of British Columbia has frequently intervened in the process of regulatory review.

Projects of doubtful economics, like Site C, have been routinely removed from BCUC jurisdiction. As the Auditor General of British Columbia wrote last month:

However, there is a risk that exempting the commission from reviewing large projects can undermine public confidence in those projects and in the regulator itself. As noted by both the 2013 and 2014 task forces, regulators are set up in part to provide a transparent and evidence-based process for regulation.

The Site C dam—exempted from the commission’s review in 2010—demonstrates this. Our office has received many requests to examine government’s decision to build the Site C dam, which government initially excluded from the review process.

Government’s decisions to exclude the commission from overseeing certain BC Hydro projects is inconsistent with one of the original purposes of the commission—to fully regulate BC Hydro. In the past, government has stated an intention to involve the commission more in reviewing future BC Hydro decisions, but to not necessarily defer to the commission on what are essentially policy matters.¹

¹ Observations on the BC Utilities Commission, British Columbia auditor General Carol Bellringer, March 15, 2018, pages 14 and 15.

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Oddly enough, the restrictions on the BCUC preventing review of Site C have been cited by Deputy Minister Lori Wannamaker as why it is impossible for the BCUC to perform its regulatory role under the appropriate accounting standards.²

For those new to the debate, the provincial government of British Columbia removed the Site C dam from regulatory review. An Order in Council on August 2, 2017 directed the BCUC to prepare a report on Site C evaluating whether alternatives exist to the project. The BCUC prepared a highly detailed review on November 1, 2017 providing evidence that there were, in fact, alternatives.

The provincial government determined that it would go ahead with the project in spite of the BCUC report, based in large part on “unambiguous advice” concerning accounting issues and the reaction of debt rating agencies. The two agencies of the British Columbia government with the expertise on the accounting issues – the Auditor General and the British Columbia Utilities Commission – were apparently not the source of the opinion. The actual opinion itself can only be construed from secondary sources.

In December, British Columbia’s Attorney General posted a personal letter explain why completing Site C was an accounting and bond rating necessity:

Devastatingly, at this stage we received unambiguous advice that while the net cost of the termination and continuation scenarios were broadly similar in the BCUC’s initial analysis, the accounting treatment of the two models was dramatically different. In particular, we were told that if we abandoned the Site C project, \$3-4bn would have to be recovered from today’s BC Hydro ratepayers or government would incur an immediate write down of 3-4bn.

In contrast, we were advised that if we continued the project, even if it went significantly over budget, the accounting treatment of the completed project as a “revenue producing asset” would enable it to be repaid over 70 years by ratepayers with a significantly different impact on rates and on the public accounts of BC Hydro and the government.³

Later in his letter he adduces a second reason why bond raters prefer following a risky path rather than a more conservative fiscal path:

² Response to Robert Botterell, Deputy Minister Lori Wanamaker, January 2, 2018, pages 4 and 5.

³ <http://davidbymla.ca/news/site-c-dam-a-personal-explanation-from-david-ebly-about-the-financial-issues-driving-this-decision/>

Leaving the \$4bn charge and debt with Hydro so ratepayers could finance it, with no matching asset, was no better. This approach would result in an acute risk that all of Hydro's debt would no longer be considered "commercial" by bond raters. If BC Hydro's overall \$20bn in debt was suddenly reclassified as taxpayer-supported debt, it would be catastrophic for any hope of building the kind of province we need to build.⁴

For anyone with a background in regulatory finance, both arguments are, to say the least, surprising.

On January 2, 2018, Robert Botterell, counsel to the Peace Valley Landowners Association, received a clarification of Attorney General Eby's comments. The letter attempted to clarify the Attorney General's letter.

The first point about the unambiguous advice is surprisingly ambiguous.

The standards in Canadian and U.S. regulatory accounting have traditionally been closely aligned. This is not by chance. The utility industry in the U.S. and Canada shares customers, assets, operations, and ownership. British Columbia Hydro follows the rules of ASC 980 for regulatory accounting.⁵

ASC 980 and specifically subsection 340 specify the use of regulatory accounts in certain circumstances:

Generally, the criteria in ASC 980-340-25-1 provide that rate-regulated enterprises shall capitalize certain costs that would otherwise be expensed if the rate actions of a regulator provide reasonable assurance that such costs are recoverable (referred to as "regulatory assets"). A regulatory asset shall be written off as a charge to earnings if and when that asset no longer meets the requirements established by ASC 980-340-25-1. Additionally, ASC 980 requires that when a regulator excludes all or a part of a cost from allowable costs (i.e., reduces or eliminates a regulatory asset), the carrying amount of any asset recognized by ASC 980-340-25-1 should be reduced to the extent

⁴ Ibid.

⁵ "The Company applies accounting standards as prescribed by the Province of British Columbia (the Province) which combines the accounting principles of International Financial Reporting Standards (IFRS) with regulatory accounting in accordance with Financial Accounting Standards Board Accounting Standards Codification 980, Regulated Operations (ASC 980) (collectively the Prescribed Standards)."

2016/17 ANNUAL SERVICE PLAN REPORT, British Columbia Hydro and Power Authority, June 14, 2016, page 21.

of the excluded cost, even if the regulator allows the enterprise to earn a rate of return on the remaining regulatory assets.⁶

In normal practice, British Columbia Hydro would have terminated the troubled Site C project and submitted the existing and forecasted expenses to the British Columbia Utilities Commission. The BCUC would then determine which amounts would be expensed and which should be capitalized.

If such a course had been followed, the Site C costs would have been recovered over time – as modelled in the BCUC’s final report.

Deputy Minister Wanamaker disagrees:

It is highly likely that the concerns and qualifications of the Auditor General would continue and indeed be amplified should the government proceed to give Order in Council directions to the BCUC to accept Site C costs as recoverable and/or to choose amortization periods other than what the independent utility regulator would determine as appropriate.

In various reports, the Auditor General has also expressed interest about the fiscal health and financial stability of various provincial public sector entities. It is government’s belief that allowing BC Hydro to continue to carry almost \$4 billion of debt (plus accumulating interest) with an uncertain prospect of recovery or for unreasonable lengths of time without benefit of a revenue producing asset, would risk bringing into question the commercial viability of BC Hydro, especially if it is the result of a government direction through Order in Council.⁷

This is not terribly unambiguous, but the thread of the argument can be reconstructed after a careful reading:

Since the Auditor General has expressed concerns over the lack of independence of the BCUC, the General might intervene to prevent the decision on this matter by the BCUC – especially if the BCUC was ordered to select a specific amortization period.

This is a fairly torturous argument. First, the appropriate ASC 980 process is simply to allow the BCUC to make its own determination. Such determinations are underway in a variety of jurisdictions that operate under ASC 980.

⁶ Impairment or disposal of long-lived assets, Ernst and Young, December 2017, Page 81.

⁷ Response to Robert Botterell, Deputy Minister Lori Wanamaker, January 2, 2018, page 4.

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Alternatively, the government of British Columbia could order the BCUC to make a specific determination by law or edict. As it happens, this has been the case in some jurisdictions as well without the unravelling of the outcome.

However, none of this is actually required. Allowing the BCUC to make its regulatory determination is what an independent regulator is intended to do by British Columbia policy and normal regulatory practice.

It is important to realize that there are many cases where ASC 980 recognizes that laws passed to direct specific outcomes for terminated plant.

For example, South Carolina is facing a similar set of issues with the troubled V.C. Summers nuclear station. Cost recovery of the asset is covered by the Base Load Recovery Act, entered into law in 2007.⁸ In this case, the regulatory commission operates under a strict requirement to allow recovery of the costs of the nuclear plant – even though the construction of the plant has been terminated.

In sum, the unknown author of the unambiguous advice has contradicted the actual application of ASC 980 in other jurisdictions.

Attorney General Eby's second point is no more certain than his first point. He argues that rating agencies are more comfortable with continuing a risky project than a less expensive termination.

This betrays a deep misunderstanding about the role of rating agencies. Rating agencies review overall corporate and governmental debt levels and estimate the risk of default by a series of ratings ranging, in the case of Moody's, from AAA to C.

Sub-sovereign ratings reflect a very disciplined approach. Attorney General's Eby's concerns that British Columbia Hydro would be considered "non-commercial" is not actually a part of the rating process – specifically since the rating agencies do not rate British Columbia Hydro.

It is useful to review the published methodology. The following table is taken from an academic study of Moody's rating methodology:

⁸ https://www.scstatehouse.gov/sess117_2007-2008/bills/431.htm

Table 3: S&P's Sub-sovereign Rating Methodology, 2005

Sovereign factors	
Economy	Demographics Economic structure Growth prospects
System structure and management	Intergovernmental system stability and predictability Management capacity and institutional legitimacy
Fiscal flexibility and performance	Revenue sources and flexibility Expenditure trends and flexibility Budgetary performance and financing requirements
Financial position	Liquidity and debt management Debt burden Off-balance-sheet liabilities

Source: S&P (2005).

Table 4: Moody's Sub-sovereign Rating Methodology, 2005

Institutional quality	Political Dynamics, Government Structure, and Institutional and Public Policy Frameworks
Economic structure and performance	Population Gross Domestic Product GDP per capita GDP per capita as a % of National Average Real GDP (% change) Unemployment Rate (%)
Debt profile	Gross Direct and Guaranteed Debt Net Direct and Guaranteed Debt Net Direct and Guaranteed Debt per capita Net Direct and Guaranteed Debt/GDP (%) Net Direct and Guaranteed Debt/Operating Revenue (%) Net Direct and Guaranteed Debt/Total Revenue (%) Foreign Currency Gross Direct Debt (after swaps)/Gross Direct Debt (%) Short-term Gross Direct Debt/Gross Direct Debt (%) Short-term and Variable Rate Long-term Gross Direct Debt/Gross Direct Debt (%) Weighted Average Maturity of Gross Direct Debt (years)
Financial performance	Discretionary Own Source Revenue/Operating Revenue (%) Intergovernmental Transfers/Operating Revenue (%) Earmarked Revenue/Operating Revenue (%) Interest Payments/Operating Revenue (%) Debt Service/Total Revenue (%) Accrual Financing Surplus (Requirement)/Total Revenue (%) Cash Financing Surplus (Requirement)/Total Revenue (%) Gross Borrowing Need/Total Revenue (%) Total Expenditures per capita (US\$) Total Expenditures/GDP (%) Primary Operating Balance/Operating Revenue (%) Gross Operating Balance/Operating Revenue (%) Net Operating Balance/Operating Revenue (%) Self-financing Ratio (%) Capital Spending/Total Expenditures (%) 5-year Total Revenue CAGR less: 5-year Total Expenditure CAGR (%) Net Working Capital/Total Expenditures (%)

Source: Moody's (2005).

⁹ The Determinants of Moody's Sub-Sovereign Ratings, Norbert Gaillard, International Research Journal of Finance and Economics, 2009, page 201.

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Since British Columbia Hydro does not issue its own bonds, it is not separately rated by the three major rating firms: Moody's, Standard and Poors, and Fitch. Site C's rapidly increasing costs – increasing by \$2 billion since last August – affect the ratings of British Columbia. The “commerciality” of British Columbia Hydro is immaterial since this does not affect the fundamentals that constitute the focus of the rating agencies.

Moody's and Fitch have expressed significant concerns about Site C in recent months:

Further, BC Hydro's debt is expected to continue to rise over the next several years as the utility moves forward with the construction of the Site C hydroelectric dam with a recently revised cost estimate in excess of CAD10 billion (revised from the previous CAD8.3 billion). With the provincial government's recent decision to move ahead with the construction of the project, the anticipated increase in debt continues to pressure the province's rating since it increases the Province's contingent liability.¹⁰

Fitch views currently forecast debt ratios, and the likely higher total provincial debt ratios to account for recent increases in BC Hydro's self-supporting Site C project, as consistent with the province's 'AAA' rating given other notable credit strengths. To maintain the rating, British Columbia will need to continue its practice of carefully managing the risk of more rapid growth in debt levels. Material project cost overruns for Site C, or other project issues, that lead to general government support could erode the province's credit standing.¹¹

Depute Minister Wanamaker rebuts concerns about the rapidly rising debt levels with a quote from the relatively less significant rating agency, the Dominion Bond Rating Service.¹²

The key is that there are no British Columbia Hydro bonds. Since financings for Site C are made by the province, increasing costs of Site C are a significant concern to lenders, and, of course, to the bond rating firms. This is especially true in an environment where British Columbia Hydro stated that the project was on time and on budget this fall, immediately before a C\$2.0 billion cost increase and the announcement of a major delay.

In sum, Attorney General's unambiguous advice has turned out to be quite ambiguous in the context of regulatory accounting.

¹⁰ Province of British Columbia (Canada), Moody's, January 18, 2018, page 4

¹¹ Fitch Affirms Province of British Columbia, Canada's Rating at 'AAA'; Outlook Stable, Reuters, December 20, 2017.

¹² Response to Robert Botterell, Deputy Minister Lori Wanamaker, January 2, 2018, page 4.