British Columbia Utilities Commission

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ORDER NUMBER
G-42-16

IN THE MATTER OF
the *Utilities Commission Act*, RSBC 1996, Chapter 473

and

British Columbia Hydro and Power Authority
Application for Approval of Debt Management Regulatory Account

BEFORE:
D. M. Morton, Panel Chair/Commissioner

on March 30, 2016

ORDER

WHEREAS:

A. On December 16, 2015, British Columbia Hydro and Power Authority (BC Hydro) submitted an application to the British Columbia Utilities Commission (Commission) for approval of a Debt Management Regulatory Account (DMRA) and for the Commission's endorsement of BC Hydro's debt management strategy (Application);

B. The DMRA is to capture to capture mark-to-market gains and losses of financial contracts that hedge future long-term debt (Future Debt Hedges) to mitigate interest rate risk on future long-term debt that BC Hydro intends to issue;

C. BC Hydro states that it prefers to use the DMRA over Hedge Accounting, as the DMRA will better protect the utility and its ratepayers from the risk of intergenerational inequity in customer rates, rate volatility and increased debt requirements;

D. Using the DMRA, any mark-to-market gains or losses from the Future Debt Hedges would be amortized over the term of the associated long-term debt as a finance charge beginning in the test period subsequent to that in which the associated long-term debt is issued;

E. Amounts amortized to finance charges from the DMRA would also be eligible to be included in the calculation of Interest During Construction, thereby spreading its recovery over the amortization of the capital asset to which the debt is associated;

F. BC Hydro does not propose to apply interest to the balances in the DMRA;

G. BC Hydro proposes a semi-annual report to the Commission setting out key terms of Future Debt Hedges executed, the related debt and associated amortization amounts;

H. By Order G-2-16 dated January 8, 2016, the Commission established a regulatory timetable with a workshop and one round of information requests, and sought written submissions on the review process. By way of letters dated January 20 and 26, 2016, the Commission revised the regulatory timetable;

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I. Four interveners registered for the proceeding and participated in the information request process: BC Sustainable Energy Association and the Sierra Club of BC (BCSEA); British Columbia Old Age Pensioners' Organization *et al*. (BCOAPO); Association of Major Power Customers of BC (AMPC); and Commercial Energy Consumers Association of British Columbia (CEC);

J. On February 26, 2016, interveners filed their written final submissions and BC Hydro filed its reply submission on March 4, 2016;

K. On March 8, 2016, the Commission requested further written submissions regarding the Commission's jurisdictional authority. BC Hydro filed its argument on this issue on March 15, 2016, followed by interveners' arguments on March 18, 2016, and BC Hydro's reply on March 22, 2016;

L. The Commission has considered the Application, evidentiary record and submissions of all parties and considers that certain approvals are warranted.

NOW THEREFORE pursuant to sections 59-60 of the *Utilities Commission Act*, the British Columbia Utilities Commission orders as follows:

1. The Debt Management Regulatory Account (DMRA) as proposed by BC Hydro in its application is approved, effective the date of this order. If BC Hydro does not go forward with its proposed Debt Management Strategy within the next 12 months, this account must be automatically closed.

2. The gains or losses from Future Debt Hedges recorded in the DMRA will be amortized over the remaining term of the associated long-term debt issuances, commencing at the beginning of the test period subsequent to the test period in which the long-term debt to which the Future Debt Hedge is associated is issued.

3. Amounts amortized to finance charges from the DMRA are also eligible to be included in the calculation of Interest During Construction.

4. BC Hydro is directed to work with Commission staff to determine the contents and timing of future reporting of the DMRA.

DATED at the City of Vancouver, in the Province of British Columbia, this 30th day of March 2016.

BY ORDER

Original signed by:

D. M. Morton
Panel Chair/Commissioner

Attachment

British Columbia Utilities Commission

IN THE MATTER OF

British Columbia Hydro and Power Authority
Application for Approval of
Debt Management Regulatory Account

REASONS FOR DECISION

March 30, 2016

Before:
D. M. Morton, Commissioner/Panel Chair

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1.0 INTRODUCTION

On December 16, 2015, British Columbia Hydro and Power Authority (BC Hydro) applied to the British Columbia Utilities Commission (Commission) for approval of a Debt Management Regulatory Account (DMRA) and endorsement of its debt management strategy for future debt (Application).

By Order G-2-16 dated January 8, 2016, the Commission established a regulatory timetable with a technical workshop and one round of information requests, followed by written submissions. By letter dated January 19, 2016, the Commission issued specifications for BC Hydro's workshop presentation. On January 27, 2016, BC Hydro held a workshop to address the technical contents of its Application and allowed interveners the opportunity to ask clarifying questions.

Four interveners registered for the proceeding and participated in the workshop and information request process:

- BC Sustainable Energy Association and the Sierra Club of BC (BCSEA);
- British Columbia Old Age Pensioners' Organization *et al*. (BCOAPO);
- Association of Major Power Customers of BC (AMPC); and
- Commercial Energy Consumers Association of British Columbia (CEC).

On February 26, 2016, three of the four registered interveners filed their written final submissions. BC Hydro submitted its reply on March 4, 2016.

On March 8, 2016, the Panel requested further written submissions regarding the Commission's jurisdictional authority. BC Hydro filed its argument on this issue on March 15, 2016, followed by interveners' arguments on March 18, 2016, and BC Hydro's reply on March 22, 2016.

1.1 Approvals sought

BC Hydro filed its Application pursuant to section 7(j) of Direction No. 7 and in accordance with its guidelines for establishing new regulatory accounts as outlined in BC Hydro's Regulatory Accounts Report filed with the Commission in February 2014.[1] BC Hydro seeks an order for the following:

- Approval of the DMRA, effective the date of the order;
- To record the gains and losses from Future Debt Hedges (FDHs) in the DMRA and amortize amounts in this account over the remaining term of the associated long-term debt, commencing at the beginning of the test period subsequent to the test period in which the long-term debt to which the FDH is associated is issued;
- To amortize amounts from the DMRA to finance charges, such that they are also eligible to be included in the calculation of Interest During Construction (IDC), thereby spreading their recovery over the amortization period of the underlying capital asset to which the debt is associated; and
- To provide a semi-annual report to the Commission in which it will set out the key terms of FDHs, the related debt, and the remaining amortization amounts associated with each FDH.[2]

[1] Exhibit B-1, p. 1.
[2] Exhibit B-1, Appendix A, Draft Order.

Additionally, BC Hydro seeks Commission endorsement of its new debt management strategy for future long-term debt as described in its Application.[3]

2.0 ISSUES ARISING

2.1 The Commission's jurisdiction

BC Hydro requests a non-binding endorsement from the Commission of its debt management strategy for future debt that it intends to issue and argues that the requested relief reflects the Commission's authority for general guidance or direction to utilities under its jurisdiction. According to BC Hydro, the legal basis of such non-binding direction arises from the broad scope of the Commission's authority to regulate utilities. [4]

The Panel considers two jurisdictional issues. The first issue is whether the Commission has the jurisdiction under the *Utilities Commission Act* (UCA), to provide a "non-binding endorsement" of BC Hydro's debt management strategy as requested in the Application.

The second jurisdictional issue relates to whether FDHs could be considered "securities" under the context of section 50(1) of the UCA. If FDHs are considered securities, then section 32(7)(x) of the BC Hydro Power and Authority Act applies to the issuance of FDHs and the Commission has no jurisdiction with respect to their issuance. The issue then is whether the Commission has jurisdiction to provide a non-binding endorsement of a strategy that encompasses the issuance of securities over which the Commission has no jurisdiction. If the Commission has no jurisdiction over the issuance of FDHs, then it would not be permissible for the Panel to provide a non-binding endorsement of the strategy.

2.1.1 Can the Commission provide a "non-binding endorsement"?

BC Hydro states that

> [t]he requested relief reflects the fact that the Commission (and indeed all regulators acting under the authority of statute) regularly in its decisions provides non-binding guidance or direction to utilities under its jurisdiction. The legal basis of such non-binding direction arises from the broad scope of the Commission's authority to regulate utilities and as a matter of necessary implication. Such direction may be in the form of a warning or caution that allows utilities the opportunity to change their course of action; similarly it may be in the nature of an endorsement, as requested in this application, that affords utilities some comfort that the Commission understands and on the basis of information presented is content with a course of action.[5]

Of those parties who have provided submissions, none disagree with BC Hydro's position.

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[3] BC Hydro Final Submission, p. 1.
[4] Exhibit B-3, BCUC IR 1.4.
[5] Ibid.

Commission determination

Given that there is no provision in the UCA for a "non-binding endorsement," the Panel is not able to provide such an endorsement. However, the Panel agrees with BC Hydro that the Commission has provided non-binding guidance or direction to utilities in the past. To the extent that this is what BC Hydro is requesting, the Panel is prepared to do so, provided that the guidance or direction is in respect of an activity that is within the jurisdiction of the Commission.

2.1.2 Are FDHs considered securities?

The British Columbia Hydro and Power Authority Act section 32(7)(x) states that the UCA, except for certain sections[6] applies to BC Hydro. Section 50 (1) of the UCA does not apply to BC Hydro. It refers to the Commission's authority for approval of issues of securities, which are defined as "any share of any class or shares of a public utility or any bond, debenture, note or <u>other obligation</u> of a public utility whether secured or unsecured." [emphasis added]

BC Hydro describes its debt management strategy as utilizing bond locks and interest rate swaps.[7] BC Hydro states that while it "has not conducted legal research on the meaning of 'security' in this context," FDHs are likely included in the expression "security" in section 50(1) of the UCA and when adopting a broad interpretation of the provisions of section 50(1) of the UCA, financial instruments such as bond locks and interest rate swaps (i.e., the Future Debt Hedges proposed in the Application) can be described as securities, since they are "bond[s]" or "other obligation[s] of a public utility."[8]

It further submits that "[l]Looking at sections 50(2) and 50(3) of the *UCA*, it is clear that issuing a security includes assuming obligations vis-à-vis a third-party, which obligations would include key terms such as value, an interest rate, a maturity date and redemption terms", and that when the Future Debt Hedges are executed pursuant to the Debt Management Strategy the contracting party, notional value, interest rate, maturity date and redemption terms will be determined and fixed.[9]

However, BC Hydro also "does not believe that the Debt Management Strategy encompasses the issuance of 'securities' as defined in section 50(1) of the *UCA*. The Debt Management Strategy does not itself constitute a security; it is a proposed course of action relating to securities."[10]

CEC, BCSEA, and BCOAPO agree with BC Hydro's views on this matter.

Commission determination

Given the evidence and the submissions provided, the Panel is not persuaded that FDHs are not securities as that term is defined in 50(1) of the UCA. As a result, the Panel is unable to provide any guidance or direction on any proposed Debt Management Strategy that encompasses the issuance of these FDHs.

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[6] Sections 44.1, 50, 51 (c), 52, 57 (2), 95 and 98 of British Columbia Hydro and Power Authority Act.
[7] Exhibit B-1, pp 1–2.
[8] Exhibit B-4, p. 1.
[9] ibid., pp. 1–2.
[10] Ibid.

The Panel accepts BC Hydro's view that bond locks and interest rate swaps, which constitute the FDHs that BC Hydro proposes to use in its Debt Management Strategy, are "bonds or other obligations of a public utility."

In the Panel's view, given BC Hydro's exemption from section 50(1) of the UCA, it is not appropriate for the Commission to provide guidance or direction with regard to the issuance of securities. The inappropriateness arises because if the Commission has no jurisdiction to approve or deny an issuance of a security, it cannot guide or direct that BC Hydro issue or not issue a security. Therefore to the extent that BC Hydro's Debt Management Strategy involves the issuance of FDHs, it is inappropriate for the Panel to provide any comment on that strategy.

With regard to BC Hydro's argument that its proposed Debt Management Strategy does not encompass the issuance of securities, the Panel will consider this further in the following section.

2.2 Debt management strategy

With the establishment of BC Hydro's Ten Year Capital Forecast and Ten Year Rate Plan, BC Hydro has insight into its borrowing requirements out to F2024. Over this period, BC Hydro's total debt is expected to increase from approximately $17.5 billion today to approximately $24 billion. Coupled with the risk of refinancing at higher interest rates, BC Hydro states that ratepayers are exposed to increases in interest costs due to increased debt levels.

The proposed debt management strategy has the following essential elements:

- To enter into approximately 20 to 30 FDHs of notional size between $100 and $400 million each with discrete maturities of up to 8 years based on changes in long-term interest rates. The size and determination of each FDH will depend on market conditions at the time of execution;
- To hedge approximately 50 percent or up to $5 billion of future debt issuances between F2017 and F2024;
- The hedge is entered into over a six-month period following Commission approval; and
- That hedge is a combination of ten and 30-year forward Interest Rate Swaps and Government of Canada Bond Locks.[11]

Although BC Hydro's proposal is to hedge 50 percent (or $5 billion) of its future long-term debt to be issued during the period of F2017 to F2024, a number of factors might modify that strategy.[12] Factors that might cause BC Hydro to modify its strategy include the timing of FDHs and future debt, market liquidity and volatility, a significant increase in interest rates, changes in forecasted borrowing requirements, and/or significant deterioration in the credit worthiness of a trade counterparty.[13] BC Hydro suggests that it is able to discontinue its hedging activities at any time under any of the three accounting methodologies by unwinding (via early settlement or sale of) its FDHs.[14]

[11] Exhibit B-3, BCUC IR 2.2; Exhibit B-1, p. 5.
[12] Exhibit B-1, p. 4; Exhibit B-3, BCUC IR 6.1.
[13] Exhibit B-3, BCUC IR 2.3.
[14] Exhibit B-3, CEC IR 27.1.

BC Hydro expects that the proposed FDHs will be highly effective in offsetting changes in the future cost of long-term debt. However, BC Hydro has not developed probabilistic models or run Monte Carlo simulations to estimate the probability of and impact from higher interest rates and relie s on that fact that its debt management strategy was developed under the view that interest rates are at historical lows and there is greater risk associated with higher interest rates versus reward from lower interest rates.[15]

Subject to market conditions at the time of execution, BC Hydro proposes to enter into financial contracts over six months beginning in 2016 in order to lock in current low interest rates. BC Hydro believes that in this low interest rate environment, execution of Future Debt Hedges as described in its Application, are part of a prudent debt management strategy to protect ratepayers from the risk of higher interest rates.[16]

BC Hydro considers that endorsement of the debt management strategy would reduce concerns with regard to the prudency of the debt management strategy itself. Even with such an endorsement, the Commission would still be able to rule on the prudency of the individual hedging transactions. Such endorsement would not preclude the Commission from determining that a particular hedging transaction was executed imprudently.[17]

The Commission's endorsement of the Debt Management Strategy is sought to reduce concerns about possible after-the-fact prudency reviews associated with the strategy as a whole (bearing in mind that such an endorsement would not insulate BC Hydro from a review of the execution of specific hedge transactions). BC Hydro suggests that the Commission retains the ability to conduct a prudency review of individual hedge transactions regardless of whether or not it endorses the Debt Management Strategy.

Commission determination

The Panel is unable to provide BC Hydro with any guidance or direction on its proposed Debt Management Strategy for the reasons outlined below.

There is no evidence available to the Panel to suggest that BC Hydro's proposed Debt Management Strategy is anything other than a strategy to manage the future issuance of securities. BC Hydro states that it intends to "hedge a combination of ten and 30-year forward Interest Rate Swaps and Government of Canada Bond Locks."[18] There is no evidence that BC Hydro's proposed Debt Management Strategy utilizes any other mechanism than the issuance of these securities. Therefore given the Panel's previous determination on jurisdiction, the Panel is unable to comment on the strategy.

BC Hydro suggests that the execution of any particular strategy will be solely at BC Hydro's discretion, regardless of any endorsement that the Commission might grant, depending on market conditions and a myriad of other market and business factors.[19] BC Hydro has also confirmed that the Debt Management Strategy is potentially subject to change in at least some of its particulars depending on how events unfold. To the extent BC Hydro does alter its strategy from that described in this proceeding to one that does not involve the issuance of securities, then BC Hydro is free to bring that strategy forward to the Commission for guidance and direction.

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[15] Exhibit B-4, BCUC IR 7.3.
[16] Exhibit B-1, p. 6.
[17] Exhibit B-3, CEC IR 1.1-1.2.
[18] Exhibit B-3; BCUC IR 2.2.
[19] Exhibit B-3, BCUC IR 2.3.

The Panel agrees with BC Hydro's submission that its proposed Debt Management Strategy does not constitute a security. However, this does not alter the Panel's determination that it cannot comment on the strategy.

2.2.1 Debt management regulatory account (DMRA)

BC Hydro requests approval to establish a DMRA to capture mark-to-market gains and losses of financial contracts that hedge future long-term debt (Future Debt Hedges or FDHs). For the FDHs, the difference between the market value at inception and the market value at any period in time is the mark-to-market gain or loss. It is this difference that BC Hydro proposes to record in the DMRA.

BC Hydro submits that the DMRA is necessary as the existing accounting options available to BC Hydro under its Prescribed Standards might give rise to undesirable consequences such as intergenerational inequity in customer rates and rate volatility, and increased overall debt load and finance charges as a result of impacts on dividends as further described in Appendix C of the Application.[20]

Use of the DMRA would ensure that any mark-to-market gains or losses of FDHs would be deferred in the DMRA and amortized over the term of the associated future long-term debt through finance charges.[21] Further, no interest charges will apply to the DMRA and amounts place in the account will be amortized to financing charges commencing the beginning of the test period subsequent to the test period in which the long-term debt to which the associated FDH is issued.[22] Amounts amortized into finance charges will also be eligible for inclusion in the calculation of Interest During Construction (IDC), thereby spreading their recovery over the amortization period of the underlying capital asset to which the debt is associated.

BC Hydro seeks a binding order approving the DMRA, and also seeks binding orders regarding the amortization of the DMRA balances and the accounting treatment of the associated IDC. Approval to record the amortization of mark-to-market gains or losses from the DMRA to finance charges is also requested.[23] Further, if the DMRA is approved, BC Hydro is bound in law to account for the financial results of the debt management strategy in accordance with the approval order.[24]

BC Hydro states that implicit in the Commission's approval of the DMRA would be approval of the hedging strategy since no other type of transaction will be recorded in the DMRA except for mark-to-market gains and losses from Future Debt Hedges on future debt. If the Commission did not agree with the use of future debt hedges for future debt, then BC Hydro considers it unlikely it would approve the DMRA.[25]

CEC and BCOAPO agree with BC Hydro's proposal that finance charges from the DMRA should be eligible to be included in the calculation IDC, thereby spreading their recovery over the amortization of the capital asset to which the debt is associated.[26] However, CEC recommends that the Commission, in its decision, limit the use of the DMRA to no more than 50 percent of the future long term debt to be issued during the period of F2017 to F2024.[27]

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[20] Exhibit B-1, p. 3.
[21] Ibid., p. 4.
[22] Exhibit B-1, p. 13. Appendix A, Draft Order.
[23] BC Hydro Final Submission, pp. 4–5.
[24] Ibid., p. 5.
[25] Exhibit B-3, BCUC IR 1.3.
[26] CEC Final Submission, p. 4; BCOAPO Final Submission p. 5.
[27] CEC Final Submission, p. 4.

BCOAPO agrees with BC Hydro that amortization is critical to ensuring intergenerational equity in the treatment of FDHs, and that the gains/losses from FDHs should be amortized over the remaining term of the associated long-term debt issuances.[28] CEC also submits that the proposed amortization is appropriate.[29]

BCSEA do not agree with BC Hydro's use of the term "intergenerational inequity" to refer to a situation in which costs paid by the current generation yield benefits to be received by future generations. In BCSEA's view, the temporal matching of costs and benefits, not intergenerational equity, to be the appropriate concept to apply to consideration of the merits of the DMRA compared to mark-to-market and hedge accounting.[30]

Commission determination

For the reasons described below, the Panel approves the DMRA as requested by BC Hydro with no carrying costs to be applied. The Panel directs that the gains or losses from Future Debt Hedges recorded in the DMRA will be amortized over the remaining term of the associated long-term debt issuances, commencing at the beginning of the test period subsequent to the test period in which the long-term debt to which the Future Debt Hedge is associated is issued. The Panel accepts that amounts from the DMRA amortized to finance charges are eligible for inclusion in the calculation of Interest During Construction.

If BC Hydro does not go forward with its proposed Debt Management Strategy within the next 12 months, the Panel directs that this account must be automatically closed.

While the Commission may have provided approvals for regulatory accounts relating only to currency exchange differences or commodity prices, the DMRA appears to be the first long-term regulatory account to capture the mark-to-market gains and losses relating to hedging interest rates. In the Panel's view, the establishment of a regulatory account to capture mark-to-market gains and losses on long-term future debt hedges may be unprecedented for both the Commission and perhaps Canada as a whole.[31]

However, in spite of the possibly unprecedented nature of the account, and notwithstanding the Panel's previous determinations on the proposed Debt Management Strategy and the jurisdictional issues discussed previously in these reasons, the Panel supports the establishment of this deferral account. It potentially reduces intergenerational inequity and rate volatility and improves the temporal matching of costs and benefits.

The Panel disagrees with BC Hydro's statement that implicit in the Commission's approval of the DMRA would be approval of the hedging strategy. As is previously explained in this decision, the Commission has no oversight of BC Hydro's issuance of securities. However, the UCA explicitly provides for oversight of what BC Hydro recovers in rates from its customers. The deferral account allows BC Hydro to control these recoveries to reduce intergenerational inequity and rate volatility and improve the temporal matching of costs and benefits.

Given that the Commission has no jurisdiction to deny BC Hydro the issuance of any FDH, the Panel declines to limit the use of the DMRA to no more than 50 percent of the future long term debt to be issued during the period of F2017 to F2024 as proposed by CEC.

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[28] BCOAPO Final submission, p. 5.
[29] CEC Final Submission, p. 28.
[30] BCSEA Final Submission, p. 4.
[31] Exhibit B-3, BCUC IR 2.4–2.5.

2.2.2 Reporting

BC Hydro acknowledges that the proposed accounting for the deferral in the DMRA of mark-to-market gains and losses of Future Debt Hedges is complicated. BC Hydro will track each specific Future Debt Hedge to the specific, related debt contract from execution and throughout the term of the debt until the debt is retired. BC Hydro suggests that it will develop the content of the report in consultation with Commission staff.[32]

CEC and BCOAPO agree that BC Hydro should be instructed to provide the Commission a semi-annual report. The CEC also recommend that the Commission require BC Hydro to report on the status of its hedging activities in future revenue requirements applications.[33]

Commission determination

The Panel accepts BC Hydro proposed reporting requirement for the DMRA at a level such that the Commission can understand the transactions being recorded in the DMRA, and directs BC Hydro to discuss the specific elements and timing of future reporting to meet this requirement with Commission staff.

Given the Panel's earlier determinations in regards to BC Hydro's debt management strategy and the related jurisdictional issues, the Panel does not make any specific directions at this time for any reporting requirement on the status of hedging activities in future RRAs.

[32] Exhibit B-1, p. 12.
[33] CEC Final Submission, p. 4; BCOAPO Final Submission p. 6.