

QUÉBEC

RÉGIE DE L'ÉNERGIE

No. R-3752-2011
Phase 2

SOCIÉTÉ EN COMMANDITE GAZ MÉTRO,
société dûment constituée, ayant sa principale
place d'affaires au 1717, rue du Havre, en les
ville et district de Montréal, province de
Québec,

(ci-après le **Distributeur** ou **Gaz Métro**)

ANNEXE A
ARGUMENTATION ÉCRITE DU DISTRIBUTEUR

1. *Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia* 262 U.S. 679 (1923), page 692 :

A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding, risks and uncertainties, but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably sufficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.

2. *Northwestern Utilities Ltd. v. Edmonton (City)* [1929] R.C.S. 186, page 192 :

The duty of the Board was to fix fair and reasonable rates; rates which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other hand, would secure to the company a fair return for the capital invested. By a fair return is meant that the company will be allowed as large a return on the capital invested in its enterprise (which will be net to the company) as it would receive if it were investing the same amount in other securities possessing an attractiveness, stability and certainty equal to that of the company's enterprise.

3. *Federal Power Commission v. Hope Natural Gas* 320 U.S. 591 (1944), page 603 :

The rate-making process under the act, i.e., the fixing of "just and reasonable" rates, involves a balancing of the investor and the consumer interests...the investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock...By that standard, the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

4. *British Columbia Electric Railway Co. v. Public Utilities Commission*, [1960] S.C.R. 837, page 848 :

I do not think it is possible to define what constitutes a fair return upon the property of utilities in a manner applicable to all cases or that it is expedient to attempt to do so. It is a continuing obligation that rests upon such a utility to provide what the Commission regards as adequate service in supplying not only electricity but transportation and gas, to maintain its properties in a satisfactory state to render adequate service and to provide extensions to these services when, in the opinion of the Commission, such are necessary. In coming to its conclusion as to what constituted a fair return to be allowed to the appellant these matters as

well as the undoubted fact that the earnings must be sufficient, if the company was to discharge these statutory duties, to enable it to pay reasonable dividends and attract capital, either by the sale of shares or securities, were of necessity considered.

[...]

The Commission is directed by s. 16(1)(a) to consider all matters which it deems proper as affecting the rate but that consideration is to be given in the light of the fact that the obligation to approve rates which will give a fair and reasonable return is absolute.

5. *Union Gas Ltd. And Ontario Energy Board et al.* [1983] O.J. No. 3191, paragraphes 44 et 48 :

The provision of the fair return is essential to preservation of the financial integrity of the appellant which is of mutual concern both to the appellant and to its customers.

[...]

The O.E.B. has a wide discretion as has already been observed to allow, disallow or adjust the components of both rate base and expense. It may not, in the exercise of its discretion, be arbitrary or capricious in either area. It therefore ought not, as a general rule, to disallow an item of expense which will be properly incurred by the utility.

6. *Duquesne Light Co. et al v. Barash et al.*, 488 U.S. 299 (1989), page 308:

Forty-five years ago in the landmark case of *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944), this Court abandoned the rule of *Smyth v. Ames*, and held that the "fair value" rule is not the only constitutionally acceptable method of fixing utility rates. In *Hope* we ruled that historical cost was a valid basis on which to calculate utility compensation. 320 U.S., at 605 ("Rates which enable [a] company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risk assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so called 'fair value' rate base"). We also acknowledged in that case that all of the subsidiary aspects of valuation for ratemaking purposes could not properly be characterized as having a constitutional dimension, despite the fact that they might affect property rights to some degree. Today we reaffirm these teachings of *Hope Natural Gas*: "[I]t is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unreasonable, judicial inquiry . . . is at an end. The fact that the method employed to reach that result may contain infirmities is not then important." *Id.*, at 602. This language, of course, does not dispense with all of the constitutional difficulties when a utility raises a claim that the rate which it is permitted to charge is so low as to be confiscatory: whether a particular rate is "unjust" or "unreasonable" will depend to some extent on what is a fair rate of return given the risks under a particular ratesetting system, and on the amount of capital upon which the investors are entitled to earn that return. At the margins, these questions have constitutional overtones.

7. *Hemlock Valley Electrical Services Ltd v. British Columbia (Utilities Commission)* (B.C.C.A.) [1992] B.C.J. No. 649 , page 20:

A distinction has been drawn in the case law between regulatory systems which afford the administrative tribunal an unfettered discretion to fix rates and those which provide the tribunal with specific statutory directions as to how these rates are to be fixed. (See *B.C. Hydro and Power Authority v. West Coast Transmission Company Ltd. et al* (1981), 36 N.R. 33 (Fed. C.A.).

The current Utilities Commission Act is an example of the latter. Sections 65(4)(b) and 66(1)(b) amount to a statutory direction as to how the Commission is to determine a just and reasonable rate. If, as posited by Martland J., a public utility is providing an adequate and efficient service, the statute is clear: a rate is unjust or unreasonable if it fails to yield a just and reasonable return on rate base. Here, while there may be room for improvement, the Commission's recommendations with respect to quality of service referred to above are calculated to achieve what is desired. Accordingly, the Commission has no discretion to fix rates which do not permit recovery of that return.

8. *TransCanada PipeLines Limited v. National Energy Board et al.* [2004] C.A.F. 149, paragraphs 6, 12, 13, 35, 36 et 43 :

The cost of capital to a utility is equivalent to the aggregate return on investment investors require in order to keep their capital invested in the utility and to invest new capital in the utility. That return will be made in the form of interest on debt and dividends and capital appreciation on equity. Usually, that return is expressed as the rate of return investors require on their debt or equity investments.

[...]

Even though cost of capital may be more difficult to estimate than some other costs, it is a real cost that the utility must be able to recover through its revenues. If the Board does not permit the utility to recover its cost of capital, the utility will be unable to raise new capital or engage in refinancing as it will be unable to offer investors the same rate of return as other investments of similar risk. As well, existing shareholders will insist that retained earnings not be reinvested in the utility.

In the long run, unless a regulated enterprise is allowed to earn its cost of capital, both debt and equity, it will be unable to expand its operations or even maintain existing ones. Eventually, it will go out of business. This will harm not only its shareholders, but also the customers it will no longer be able to service. The impact on customers and ultimately consumers will be even more significant where there is insufficient competition in the market to provide adequate alternative service.

[...]

In oral argument, the appellant conceded that it does not object to its customers having input into the Board's cost determinations and in particular, its cost of capital determination, provided the issues in dispute are restricted to the costs of the Mainline. However, the appellant does object to the Board taking the impact of tolls on customers and consumers into account in determining the Mainline's cost of equity

capital. The appellant says that the required rate of return on equity must be determined solely on the basis of the Mainline's cost of equity capital. The impact of any resulting toll increases on customers or consumers is an irrelevant consideration in that determination. The appellant does concede that when the final tolls are being fixed, the impact on the customers and consumers may be relevant, but insists that it is irrelevant when determining the required return on equity.

I think that this argument is sound and in keeping with the decision of the Supreme Court in *Northwestern Utilities*. The cost of equity capital does not change because allowing the Mainline to recover it would cause an increase in tolls. Under the Board's Equity Risk Premium methodology, the cost of equity capital is driven by the Board's estimate of the risk-free interest rate and the degree of risk investors perceive in the "benchmark" pipeline. The higher the risk, the higher their required rate of return. The degree of risk specific to the Mainline is accounted for by adjustments to its deemed capital structure. Accordingly, the cost to the Mainline of providing that rate of return on the equity component of its deemed capital structure is unaffected by the impact of tolls on customers or consumers.

9. *Consumers' Assn. of Canada (Manitoba) Inc. v. Manitoba Hydro Electric Board (Manitoba Hydro)* 2005 MBCA 55, paragraphes 63 à 65 :

The intent of the legislation is to approve fair rates, taking into account such considerations as cost and policy or otherwise as the PUB deems appropriate. Rate approval involves balancing the interests of multiple consumer groups with those of the utility. The PUB's decision to build retained earnings more rapidly than proposed in order to better protect the utility and consumers from the financial impact of future drought, clearly meets the intent of the legislation and is within the jurisdiction afforded the PUB in s. 26 of the *Accountability Act*.

The role of the PUB under the *Accountability Act* is not only to protect consumers from unreasonable charges, but also to ensure the fiscal health of Hydro. It is clear the PUB understood its role in this regard.

The PUB has two concerns when dealing with a rate application; the interests of the utility's ratepayers, and the financial health of the utility. Together, and in the broadest interpretation, these interests represent the general public interest. These issues were addressed in the PUB's decision.

10. *ATCO Gas and Pipelines Ltd. v. Alberta (Energy and Utilities Board)* [2006] 1 R.C.S. 140 , paragraphe 70 :

Furthermore, one has to recognize that utilities are not Crown entities, fraternal societies or cooperatives, or mutual companies, although they have a "public interest" aspect which is to supply the public with a necessary service (in the present case, the provision of natural gas). The capital invested is not provided by the public purse or by the customers; it is injected into the business by private parties who expect as large a return on the capital invested in the enterprise as they would receive if they were investing in other securities possessing equal features of attractiveness, stability and certainty (see *Northwestern 1929*, at p. 192). This prospect will necessarily include any gain or loss that is made if the company divests itself of some of its assets, i.e., land, buildings, etc.

11. *Gazoduc Trans Québec & Maritimes Inc.*, Décision RH-1-2008, page 6 :

L'Office confirme donc la norme du rendement équitable, telle qu'elle a été décrite à la page 19 de la décision RH-2-2004, Phase II. D'après cette norme, pour être équitable ou raisonnable, un taux de rendement total du capital doit :

- être comparable à celui que rapporterait le capital investi dans une autre entreprise présentant un risque analogue (critère de l'investissement comparable);
- permettre à l'entreprise réglementée de préserver son intégrité financière (critère de l'intégrité financière);
- permettre à l'entreprise d'attirer des capitaux additionnels à des conditions raisonnables (critère de l'effet d'attraction de capitaux) (14 : Dans la version anglaise de ses motifs de décision antérieurs, l'Office a employé le mot « standard » pour désigner chacun des éléments de la norme du rendement équitable. L'Office emploie maintenant le terme « requirement » pour confirmer le caractère obligatoire de ces éléments. Le terme « critère » a été retenu dans la version française).

12. *Décision OEB-2009-0084*, pages 18, 28 et 31 :

The Board is of the view that the FRS frames the discretion of a regulator, by setting out three requirements that must be satisfied by the cost of capital determinations of the tribunal. Meeting the standard is not optional; it is a legal requirement. As set out by Enbridge in their final comments, the Supreme Court of Canada has “described this requirement that approved rates must produce a fair return as an ‘absolute’ obligation.”¹⁰ Notwithstanding this mandatory obligation, the Board notes that the FRS is sufficiently broad that the regulator that applies it must still use informed judgment and apply its discretion in the determination of a rate regulated entity’s cost of capital.

[...]

To be clear, the approach to be used by the Board in setting the essential elements of a formula-based rate of ROE (i.e., base ROE, formula terms and adjustment factors) will be based on “economic theory and empirically derived from objective, data-based analysis.”²⁶ As such, it is not sufficient for a formulaic approach for determining ROE to produce a numerical result that satisfies the FRS on average, over time. The Board is of the view that each time a formulaic approach is used to calculate an allowed ROE it must generate a result that meets the FRS, as determined by the Board using its experience and informed judgment.

This principle is supported by the *Hope* decision, which states: “Under the statutory standard of ‘just and reasonable’ it is the result reached not the method which is controlling...”

[...]

As discussed previously, the Board confirms the following key principles with respect to its cost of capital policy. The Board has analyzed submissions, discussions at the consultation and the final written

comments of participants to the consultation with these general principles in mind.

1. Fair Return Standard. All three requirements – comparable investment, financial integrity and capital attraction – must be met and none ranks in priority to the others. It is not sufficient for a formulaic approach for determining ROE to produce a numerical result that satisfies the FRS on average, over time. The Board is of the view that each time a formulaic approach is used to calculate an allowed ROE; it must generate a number that meets the FRS, as determined by the Board using its experience and informed judgment.

2. The overall ROE must be determined solely on the basis of a company's cost of equity capital. It does not mean that in determining the cost of capital that investor and consumer interests are balanced. The opportunity cost of capital should be determined by the Board based on a systematic and empirical approach that applies to all rate-regulated utilities regardless of ownership. The Federal Court of Appeal was clear that the overall ROE must be determined solely on the basis of a company's cost of equity capital and that the impact of any resulting toll increase is an irrelevant consideration in that determination.

3. Efficient amount of investment. As it relates to a rate regulated entity's cost of capital, the role of the regulator is to determine, as accurately as possible, the opportunity cost of capital to ensure that an efficient amount of investment occurs in the public interest for the purpose of setting utility rates.

4. Predictability, transparency, and stability. The approach adopted by the Board to determine the opportunity cost of capital should result in an environment where outcomes are predictable and consistent so that investors, utilities and consumers are better able to plan and make decisions.

5. Systematic and empirically-based approach. The methodology used by the Board to determine the cost of debt and equity capital should be a systematic approach that relies on economic theory and is empirically derived from objective, data-based analysis. For example, in establishing comparability, it is possible to build a low-risk sub-set from a higher risk universe using an empirically based approach.

6. Minimize the time and cost of administering the framework. Costs imposed on all participants, including the regulated entity and the regulator, should not exceed the benefits available. This objective could be met through a simple process that reflects the concerns of interested participants and reduces the formal process requirements.