

ENERGY LAW AND POLICY

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The Fair Return

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I. Introduction

In the world of the economic regulation of Canadian energy utility companies, there is nothing quite as contentious as the debate over what constitutes a fair return to the companies who invest in and operate natural gas utility franchises.

As regulated monopolies, these entities have the return on their investments determined not by the open market, but in hearing rooms with lawyers and a variety of experts testifying before a panel of energy regulators. While most of the costs of operating the utility can be observed and verified by reference to the financial accounts and expenses of the organization, the return that the utility's investors should have an opportunity to earn is singularly unobservable.

It is not surprising then that the utility and its customers rarely see eye to eye on the matter.

This article looks at the current process and result of setting allowed returns for Canadian gas utilities from the investor's point of view. It examines various ways by which allowed returns can be determined, discusses their strengths and weaknesses, and concludes that there is a growing problem with Canada's current formula-based process and its results. In short, investors are no longer being awarded the fair returns that they are entitled to have an opportunity to earn.

The article goes on to look at some of the common arguments put forth to counter this conclusion and provides reasons why such "red herring" arguments are both misguided and incorrect.

Finally, the article then makes some specific recommendations on where to go from here and discusses a process by which improvements could be made.

II. The Fair Return as a Component of Revenue Requirement

The fair return represents the component of a utility's revenue requirement that provides compensation to investors for committing their funds, or capital, to finance utility assets devoted to public utility service, or rate base. A fair return on rate base comprises the weighted average return required on all forms of investor-supplied capital, where the weights reflect the proportions of rate base financed by different types of capital, primarily debt and equity.

The regulatory compact entitles the utility to the opportunity to earn a fair return on rate base in exchange for the obligation to provide service. It is the regulator's obligation to establish the fair return, which becomes, in the context of the revenue requirement, the allowed return on rate base.

III. The Fair Return and the Cost of Capital

The fair return represents a real cost to the utility, no less real than the costs the utility incurs to pay wages or acquire materials and supplies. Investors require a

return on the capital they commit to finance utility assets for two basic reasons:

1. Committing funds to a long-term investment means investors are deferring current consumption for the opportunity to enhance future consumption. The return investors demand on the capital committed represents the compensation they require to put off current consumption to a later date.

2. Investors are assuming the risk that the actual return on the capital they have committed will be less than the return they expect or less than the return they could have earned if they had invested their funds elsewhere.

The compensation that investors require on the different types of capital used to finance utility assets depends on the relative risks that investors are bearing and on the returns that are available on alternative investments of similar risk. A fair return is synonymous with the opportunity cost of capital, which, in turn, represents the aggregate return investors require to keep their capital invested and to invest new capital in the utility.

IV. The Fair Return and the Opportunity Cost Principle

“Opportunity cost” is defined as the return foregone by investors by not investing in an alternative investment. In other words, in order to commit funds to an enterprise, investors require a return on those funds equal to what they could earn in an alternative investment of comparable risk. Implicit in the term “opportunity cost” is the recognition that investors have choices and that, given a choice of investments of similar risk, they will direct their available capital to the investment that offers the highest return for a given level of risk. If the return allowed by the regulator does not meet the opportunity cost principle, investors will seek to divert their capital elsewhere, that is, to investments of comparable risk that offer a higher return.

A fair return is one that respects the opportunity cost principle and provides a utility the opportunity to earn a return equivalent to that available to comparable risk companies. Thus, adherence to the opportunity cost principle requires that comparable risk companies be identified and the returns available to those companies be taken into account in the determination of a fair return.

V. Benefits of Returns Consistent with Opportunity Cost Principle

Adherence to the opportunity cost principle in setting the allowed return benefits the utility’s customers as well as its ratepayers in several ways.

- A fair return provides the utility the ability to access the capital it requires at reasonable cost and on reasonable terms and conditions. Allowing a return that is lower than the opportunity cost of capital or the fair return will have the perverse effect of raising the actual cost of capital to the utility, which customers will ultimately bear.
- Allowing a fair return will ensure the utility has the means to provide safe and reliable service at the levels required by customers. Allowing a fair return will provide the proper incentives to undertake the levels of capital investment required for optimal levels of system efficiency, customer service, and environmental performance.