Supreme Court of Newfoundland and Labrador, Court of Appeal
Section 101 of the Public Utilities Act (Newfoundland) (Re)
Date: 1998-06-15

V. Randell J. Earle, Q.C., for the Board of Commissioners of Public Utilities;
Ian F. Kelly, Q.C., for Newfoundland Light and Power Co.;
Mark Kennedy, for the Consumer Advocate.

(96/141)

June 15, 1998.

[1] **GREEN, J.A.:** The Board of Commissioners of Public Utilities has stated a case for the opinion of this court, pursuant to s. 101 of the **Public Utilities Act** [see footnote 1]. The questions posed concern the jurisdiction and powers of the Board as they affect the approach of the Board to the determination of a "just and reasonable return" on the rate base of a utility, as well as related matters.

The Stated Case in Context

[2] The Board is the statutory body which has the authority and duty for the "general supervision of all public utilities" in Newfoundland and Labrador and in the course of exercising that supervisory role has general authority to "make all necessary examinations and inquiries and keep itself informed as to the compliance by public utilities with the law" and, as well, it has the right "to obtain from a public utility all information necessary to enable the Board to fulfil its duties" [see footnote 2].

[3] One of the Board's primary functions with respect to electrical utilities is the regulation and approval of rates, tolls and charges [see footnote 3]. In so doing, the Board must take account of the statutory requirement that the utility is entitled to earn annually a "just and reasonable return" as determined by the Board on the rate base as fixed and determined by the Board [see footnote 4]. The process essentially involves the fixing and determining of the appropriate rate base, the determination of a "just and reasonable return" on that rate base and then the approval of a schedule of rates, tolls and charges that would be appropriate to generate the revenue which, in the Board's estimation, would be necessary to provide the determined rate of return. Once rates, tolls and charges are

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set by the Board they continue to apply until altered under the Act, as a result of a reapplication by the utility for an increase, a complaint by the public or an order for a reexamination initiated by the Board itself.

[4] It is important to remember, however, that in addition to its periodic adjudicative role which itself involves a large measure of policy implementation in arriving at its decisions, the Board has, because of its duty of "general supervision of all public utilities", an ongoing supervisory role of the activities of the utility between hearings as well, which is facilitated by statutory requirements for periodic reporting of financial information to the Board.

[5] In 1991 the Board made Orders [see footnote 5] determining a just and reasonable return for Newfoundland Light and Power Co. Ltd. [see footnote 6] and approving a schedule of rates, tolls and charges based on estimated revenue requirements necessary to cover operating expenses and to provide that level of return. The essential features of the 1991 order determining the just and reasonable rate of return were that:

> (a) The just and reasonable return was determined to be between a stated range (10.6% - 11.19%) of the company's average age rate base;
>
> (b) The rate base was determined on the basis of a hypothetical test year (1992);
>
> (c) The Board determined that the just and reasonable return, as defined, would provide an opportunity to NLP to earn a rate of return on common equity between a certain stated range (13% to 13.5%);
>
> (d) The schedule of rates, tolls and charges was determined applying a rate of return equal to the mid-point between the stated range of returns on rate base;
>
> (e) The Board ordered that a particular capital structure of NLP be adopted and continue to be the basis of NLP's financial plan.

[6] The Board had previously adopted a policy allowing NLP to retain earnings above the allowed range of return on rate base, provided those earnings were within the allowed range of rates of return on comon equity. Where the earnings exceeded the allowed rate of return on common equity, the Board, in purported exercise of its statutory powers to regulate NLP's accounting procedures, as well as other powers, required NLP

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to set up a reserve account in which these excess earnings would be held and dealt with in accordance with subsequent direction by the Board.

[7] In April of 1996, NLP petitioned the Board for another order fixing and determining a new rate base, determining a just and reasonable return and approving a revised schedule of rates, tolls and charges, amongst other matters. One of the parties represented at the hearing was the "Consumer Advocate", who was appointed [see footnote 7] by the Government of Newfoundland and Labrador to represent the interests of domestic and general service consumers in respect of the rate hearing.

[8] During the years between the making of the 1991 orders and the 1996 hearing, NLP had filed annual returns with the Board, as required by s. 59(2) of the Act, which indicated that in the years 1991, 1992 and 1993 the company's rate of return on rate base was in excess of the range determined in the 1991 Order. However, as calculated by NLP, the rate of return on common equity was always within the range that had been stipulated by the Board. The rates of return on rate base and on common equity were calculated based on actual expenses and on the actual capital structure of NLP.

[9] In its periodic reports to the Board, NLP disclosed that its actual advertising costs in 1992 exceeded the amounts projected to the Board as a forecast for 1992 which had been approved as reasonable and prudent by the Board in its 1991 Order in the course of fixing and determining the rate base.

[10] During the course of the 1996 hearing, certain submissions were made to the Board respecting, amongst other things,

> (a) whether NLP should be regarded as having earned revenue in excess of its allowed range of rate of return where its rate of return on common equity was nevertheless within the stated allowable range;
>
> (b) whether the manner of calculation of excess revenue and the proposed manner of the disposition of any excess was permitted;
>
> (c) whether NLP could and should be required to alter its capital structure so as to obtain its capital requirements in a manner other than the way in which it was presently doing;

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(d) whether the Board could and should take account, in setting future rates, of past expenditures which were in excess of amounts deemed reasonable and prudent at the time of a previous hearing.

[11] Questions arose as to the jurisdiction and power of the Board to entertain and **Act** on the sorts of submissions that were made. This prompted the Board to state the current case to this court. NLP and the Consumer Advocate were granted standing to appear and be heard at the hearing.

The Specific Questions

[12] The Stated Case poses for consideration by this court the following questions:

"(1) Does the Board have jurisdiction pursuant to the **Act** to set and fix the return which a public utility may earn annually upon:

(i) the rate base as fixed and determined by the Board for each type of service applied by the public utility; and/or

(ii) the investment which the Board has determined has been made in the public utility by the holders of common shares.

"(2). Does the Board have jurisdiction to set the rates of return referred to in Question (1) as a range of permissible rates of return.

"(3) Should a public utility earn annually a rate of return which is in excess of the rate of return determined by the Board to be just and reasonable, either on:

(i) the base rate as fixed and determined by the Board for each type of service applied by the public utility; or

(ii) the investment, which the Board has determined, has been made in the public utility by holders of common shares,

does the Board have jurisdiction to:

(i) require the public utility to use the excess earnings to reduce revenue requirements for the succeeding year; or

(ii) require the public utility to place the excess earnings in a reserve fund for the purpose of adjusting rates, tolls and charges of the public utility at a future date, or

(iii) require the public utility to rebate the excess earnings to customers of the public utility.

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"(4) Does the Board have jurisdiction to order that the rates, tolls and charges of a public utility shall be approved taking into account earnings in excess of a just and reasonable return upon,

(i) the rate base as fixed and determined by the Board for each type of service applied by the public utility, or

(ii) the investment, which the Board has determined, has been made in the public utility by the holders of common shares,

in prior years.

"(5) Does the fact that the Board has advised the public utility that it is permitted to retain earnings in excess of the rate of return determined by the Board to be a just and reasonable return, upon the rate base as fixed and determined by the Board for each type of service supplied by the public utility, but not in excess of the return determined by the Board to be a just and reasonable return upon the investment which the Board has determined has been made in the public utility by the holders of common shares, affect the jurisdiction of the Board to approve rates, tolls and charges on the basis queried in Question (4).

"(6) Does the Board have jurisdiction to order the rates, tolls and charges of the public utility shall be approved taking into account the amount of expenses previously incurred by the public utility which the Board may now consider inappropriate to be allowed as reasonable and prudent and properly chargeable to operating account notwithstanding that such classes of expenses were allowed as reasonable and prudent and properly chargeable to operating account.

"(7) Does the Board have jurisdiction to require a public utility to maintain

(i) a ratio; or

(ii) a ratio within a stated range of ratios

of equity and debt, as the means of obtaining the capital requirements of the public utility.

"(8) Does the Board, upon an application pursuant to Section 91 or otherwise, have the jurisdiction to require a public utility to obtain its capital requirements by the issue of specific financial instruments, whether common shares, preferred shares, stocks, bonds, debentures or evidence of indebtedness payable in more than one year."

Although the questions are stated above as they appear in the Stated Case filed with the court, there are several obvious typographical errors in the language used. This was recognized by the participants in references to the questions in their written arguments. In particular "supplied" was at times substituted for the word "applied" in questions l(i), 3(i)

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and 4(i) and "base rate" in Question 3(i) was replaced by "rate base." In addition, the phrase "In the event that a public utility should..." at the beginning of Question 3 was used at times in the written submissions in preference to the phrase "Should a public utility..." Nothing turns on these informal changes. They do, however, make the import of the questions clearer and I will interpret the questions in that light.

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The Legislative Framework

[13] The answers to the questions which have been posed must, of course, be given taking account of the legislative framework within which the Board operates. The Board is a creature of statute and its jurisdiction and powers to deal with matters brought before it, and the manner of dealing with such matters, must be found, either expressly or impliedly, within the statutes conferring jurisdiction on and governing the operation of the Board.

[14] While a number of specific provisions of the **Act** and related legislation will have to be referred to in the course of this opinion, certain legislative provisions, which are central to this analysis, can be conveniently set forth here:

Public Utilities Act

> "58. The board may prescribe the form of all books, accounts, papers and records to be kept by a public utility and a public utility shall keep its books, accounts, papers and records and make its returns in the manner and form prescribed by the board and comply with all directions of the board relating to those books, accounts, papers, records and returns.
>
> "69.(1) A public utility, if so ordered by the board, shall, out of earnings, set aside all money required and carry it in a depreciation account.
>
> "(2) The depreciation account shall not, without the consent of the board, be spent otherwise than for replacements, new constructions, extensions or additions to the property of the company.
>
> "(3) The board may by order require a public utility to create and maintain a reserve fund for a purpose which the board thinks appropriate, including the improvement of the public utility's status as a borrower or seeker of funds for necessary maintenance or expansion of its operations.
>
> "(4) The board, in a case where it has made an order which has the effect of increasing a public utility's revenues, may require the public utility to refrain from

distributing as dividends until further order the whole or a part of the extra revenue which is in the board's opinion attributable to the order.

"(5) An order under this section shall be made only after hearing the public utility concerned.

"70.(1) A public utility shall not charge, demand, collect or receive compensation for a service performed by it whether for the public or under contract until the public utility has first submitted for the approval of the board a schedule of rates, tolls and charges and has obtained the approval of the board and the schedule of rates, tolls and charges so approved shall be filed with the board and shall be the only lawful rates, tolls and charges of the public utility, until altered, reduced or modified as provided in this Act.

"75.(1) The board may make an interim order unilaterally and without public hearing or notice, approving with or without modification, a schedule of rates, tolls and charges submitted by a public utility, upon the terms and conditions that it may decide.

"(2) The schedule of rates, tolls and charges approved under subsection (1) are the only lawful rates, tolls and charges of the public utility until a final order is made by the board under section 70.

"(3) The board may order that the excess revenue that was earned as a result of an interim order made under subsection (1) and not confirmed by the board be

(a) refunded to the customers of the public utility; or

(b) placed in a reserve fund for the purpose that may be approved by the board.

"76. The board may upon notice to the public utility and after hearing as provided in this Act, by order rescind, alter or amend an order fixing rates, tolls, charges or schedules, or other order made by the board, and certified copies of the order shall be served and take effect as provided in this Act for original orders.

"78.(1) Except as otherwise provided in this Act, the board may fix and determine a separate rate base for each kind of service provided or supplied to the public by a public utility, and may revise the base.

"(2) In fixing a rate base the board may, in addition to the value of the property and assets as determined under section 64, include

. . . . .

(h) other fair and reasonable expenses which

(i) the board thinks appropriate and basic to the public utility's operation, and

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(ii) has, with the approval of the board, been charged to capital account,

but the expenses shall be allowed only to the extent not amortized in previous years.

"80.(1) A public utility is entitled to earn annually a just and reasonable return as determined by the board on the rate base as fixed and determined by the board for each type or kind of service supplied by the public utility but where the board by order requires a public utility to set aside annually a sum for or towards an amortization fund or other special reserve in respect of a service supplied, and does not in the order or in a subsequent order authorize the sum or a part of it to be charged as an operating expense in connection with the service, the sum or part of it shall be deducted from the amount which otherwise under this section the public utility would be entitled to earn in respect of the service, and the net earnings from the service shall be reduced accordingly.

"(2) The return shall be in addition to those expenses that the board may allow as reasonable and prudent and properly chargeable to operating account, and to all just allowances made by the board according to this **Act** and the rules and regulations of the board.

"(3) Reasonable payments each year to former employees of a public utility who have retired and are receiving payments of supplemental income from the public utility are expenses that the board may allow as reasonable and prudent and properly chargeable to the operating account of the public utility.

"(4) The board may use estimates of the rate base and the revenues and expenses of a public utility.

"84.(1) Upon a complaint made to the board against a public utility by an incorporated municipal body or the Newfoundland and Labrador Federation of Municipalities or by 5 persons, firms or corporations, that the rates, tolls, charges or schedules are unreasonable or unjustly discriminatory or that a regulation, measurement, practice or **Act** affecting or relating to the operation of a public utility is unreasonable, insufficient or unjustly discriminatory or that the service is inadequate or unobtainable, the board shall proceed, with or without notice, to make the investigation that it considers necessary or expedient.

"(2) The board may order the rates, tolls, charges or schedules reduced, modified or altered, and make other orders as to the reduction, modification or change of the regulation, measurement, practice or acts that the case may require, and may order on the terms and subject to the conditions that are just that the public utility provide reasonably adequate service and facilities and make extensions that may be required, but an order shall not be made or entered by the board without a public hearing or inquiry.

"87.(1) Where upon an investigation the rates, tolls, charges or schedules are found to be unjust, unreasonable, insufficient or unjustly discriminatory, or to be preferential

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or in violation of this Act, the board has power to cancel those rates, tolls, charges or schedules and declare void all contracts or agreements, either oral or written, dealing with them upon and after a day named by the board, and to determine and by order substitute those rates, tolls or schedules that are reasonable.

"91.(1) A public utility shall not issue shares, which for the purposes of this section shall include preferred shares, stocks, bonds, debentures or evidence of indebtedness payable in more than 1 year from the date of issue, except as provided in subsection (2) until it has obtained approval from the board for the proposed issue;

. . . . .

"(3) After hearing the application and where satisfied that the proposed issue by a public utility of its shares, stocks, bonds, debentures or other evidence of indebtedness is to be made in accordance with law and for a purpose approved by the board, it is the duty of the board to make an order approving the proposed issue to the amount that it considers appropriate, and also to prescribe the purpose to which the issue or the proceeds of the issue are applied.

. . . . .

"(5) Without first obtaining the approval of the board,

(a) a public utility shall not make a material alteration in the characteristics of its stocks or shares, or its bonds, debentures, securities, or other evidence of indebtedness as those characteristics are described by the board in granting its approval of the issue;..."

Electrical Power Control Act. 1994 [see footnote 8]

"3. It is declared to be the policy of the province that

(a) the rates to be charged, either generally or under specific contracts, for the supply of power within the province

(i) should be reasonable and not unjustly discriminatory,

(ii) should be established, wherever practicable, based on forecast costs for that supply of power for 1 or more years,

(iii) should provide sufficient revenue to the producer or retailer of the power to enable it to earn a just and reasonable return as construed under the Public Utilities **Act** so that it is able to achieve and maintain a sound credit rating in the financial markets of the world, and

. . . . .

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(b) all sources and facilities for the production, transmission and distribution of power in the province should be managed and operated in a manner

(i) that would result in the most efficient production, transmission and distribution of power,

(ii) that would result in consumers in the province having equitable access to an adequate supply of power,

(iii) that would result in power being delivered to consumers in the province at the lowest possible cost consistent with reliable service,...

. . . . .

"4. In carrying out its duties and exercising its powers under this **Act** or under the Public Utilities Act, the public utilities board shall implement the power policy declared in section 3, and in doing so shall apply tests which are consistent with generally accepted sound public utility practice."

Approach to Interpretation

[15] The court was not referred to any decisions in this or other jurisdictions which directly addressed, let alone answered, the specific types of questions which have been posed. To answer the questions, therefore, it is necessary to develop a theoretical frame of reference within the context of the general language of the existing legislation so as to determine the approach to be taken to its application in concrete situations.

[16] It is necessary to examine the specific legislative provisions in the larger regulatory context and against the background of the purposes of the legislation and the general principles which have been developed as part of regulatory practice [see footnote 9]. This approach follows from s. 118 of the **Act** which provides:

"118.(1) This **Act** shall be interpreted and construed liberally in order to accomplish its purposes, and where a specific power or authority is given the board by this **Act**, the enumeration of it shall not be held to exclude or impair a power or authority otherwise in this **Act** conferred on the board.

"(2) The Board created has, in addition to the power specified in this **Act**, all additional implied and incidental powers which may be appropriate or necessary to carry out the powers specified in this **Act**.

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> "(3) A substantial compliance with the requirements of this **Act** is sufficient to give effect to all the rules, orders, acts and regulations of the Board, and they shall not be declared inoperative, illegal or void for an omission of a technical nature."

[17] In addition, the **EPC Act** [see footnote 10], provides that the Board, in carrying out its duties and exercising its powers under the **Public Utilities Act** must implement the power policy of the province, as declared in s. 3 of the Act, and in so doing must "apply tests which are consistent with generally accepted sound public utility practice".

[18] It follows from these provisions that a literal and technocratic interpretation and application of the provisions of the **Act** is to be avoided, in favour of an interpretation which will advance the underlying purpose of the legislation [see footnote 11], as well as the power policy of the province and be consistent with generally accepted sound public utility practice.

[19] In answering the questions posed, therefore, it is necessary to identify generally accepted principles of sound public utility practice and to give to the legislation an interpretation which follows those principles and advances the stated legislative policy of the Province.

[20] The trade off for the regulation by the state of the rates, tolls and charges of monopolistic utilities in the interests of consumers is the statutory recognition that the utility should be entitled to earn a fair return for its efforts. Although differing in details, the regulatory statutory regimes existing throughout North America can, as a generalization, be said to be broadly similar in approach [see footnote 12], although in recent years the regulatory schemes and their coverage are being affected more and more by the trends towards deregulation.

[21] The regulatory body in question (in Newfoundland, the Board of Commissioners of Public Utilities) is generally charged with balancing the competing interests of consumers and the investors in the utility [see footnote 13]. As deGrandpre observed:

> "This involves the Board attempting to make sure that, in the consumers' interests, the service provided is adequate and provided at just and reasonable rates and, for the utility and its investors, that those rates provide a sufficient income."

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[22] This balancing of interests is found in the province's stated power policy in s. 3 of the **EPC Act** where, emphasizing the interests of the utility, it is declared that the rates charged for the power should provide sufficient revenue to the utility to enable it to earn a just and reasonable return "so that it is able to achieve and maintain a sound credit rating in the financial markets of the world" [see footnote 15] while at the same time declaring that the rates should be "reasonable" [see footnote 16] and that the utilities' facilities should be managed and operated in a manner that would result in power being delivered to consumers "at the lowest possible cost consistent with reliable service" [See footnote 17]. This policy finds legislative expression in the regulatory mechanisms of the **Act** itself, which provides that a utility must provide service and facilities which are "reasonably safe and adequate and just and reasonable" [see footnote 18] and prohibits a utility from charging rates, tolls and charges unless they have been approved by the Board [see footnote 19] while at the same time stating as a general principle that the utility is entitled to earn annually a just and reasonable return on its rate base [see footnote 20].

[23] This statutory entitlement of the utility to earn a "just and reasonable" return is the linguistic touchstone for the balancing exercise. This phrase emphasizes the fairness aspect, both to the utility, in earning sufficient revenues to make its continued investment worthwhile and to maintain its credit rating in financial markets, and to the consumer, in obtaining adequate service at reasonable rates. It also emphasizes the need for a tempering of each interest group's economic imperative by consideration of the interests of the other.

[24] Having said that, the entitlement of the utility to a fair return on its investment is always regarded as of fundamental importance [see footnote 21]. In the United States, controls which fail to allow a fair return have the potential of running afoul of constitutional strictures against confiscation of property without due compensation. While the same constitutional concerns may not be present in Canada, the case law has at times nevertheless referred to the entitlement to a fair return as a "common law right" [see footnote 22] which should be read into the legislation even where it is not specifically expressed.

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[25] There is no uniform methodology employed in the regulatory jurisdictions in North America for the determination of a just and reasonable rate of return [see footnote 23]. What recurs, however, is a theme that the process is not an exact science and depends on a variety of factors necessary to balance the competing interests involved. Rate setting is essentially a prospective exercise where determinations are made on the basis of estimates and information that will not necessarily remain static.

[26] Most jurisdictions adopt a "multiple factor" approach. The **Bluefield Waterworks** case [see footnote 24] in the United States emphasized early on that the determination of a fair rate of return

> "...depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts." [see footnote 25]

[27] Statements such as "the company will be allowed as large a return on the capital invested in the enterprise...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" [see footnote 26] often occur. For the rationale for such statements one need look no further than the provincial policy, stated in s. 3(a)(iii) of the **EPC Act** that the utility must be "able to achieve and maintain a sound credit rating in the financial markets of the world" so as to be able to raise the money necessary for the proper performance of its functions. To achieve such a goal of attracting capital, factors such as comparisons with other comparable enterprises, the respective costs of debt and equity, the capital breakdown between debt and equity and general economic conditions, amongst other things, are considered.

[28] In **Federal Power Commission v. Hope Natural Gas Co.** [see footnote 27], another landmark United States case, the court emphasized that it is the "end result of the process which has to be judged as to whether the rate is "just and reasonable". As a result, in the words of deGrandpre:

> "In stating that the end result was the only point of consideration, whatever the means of arriving thereat, the court opened the door to a wide variety of ways and means to arrive at a proper calculation of returns. In effect, it left the valuation of rate bases to the Commission's or Court's discretion." [see footnote 28]

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DeGrandpré's conclusion, based on his survey of North American regulatory regimes, is later stated as follows:

> "The constantly changing economic conditions are perhaps a good reason why there should be no stringent rules for determining a rate of return. As was often stated, the process is one which calls for common sense, good judgment and a proper appreciation of all surrounding factors." [see footnote 29]

[29] This approach is also reflected in the decision of this court in **Newfoundland Light & Power Co. v. P.U.C. (Bd.)** where O'Neill, J.A., speaking for the court in rejecting an argument that the Board of Commissioners of Public Utilities had exceeded its jurisdiction in determining a just and reasonable rate of return by not adopting a particular methodology (a "comparable earnings" test), stated:

> "...it is within the discretion of the Board, having heard all the evidence and giving consideration to the various tests which may be used, to make its ruling on the basis of what in the Board's opinion will give to the applicant a just and reasonable return and permit it to maintain a sound financial credit rating." [see footnote 30]

The Board therefore has a broad discretion to adopt appropriate methodologies for the calculation of allowable rates of return. So long as the methodologies chosen are not inconsistent with generally accepted sound public utility practice and the purposes and policies of the **Act** and can be supported by the available opinion evidence, the determination of what constitutes a just and reasonable return in a given case will generally be within the province of the Board and will not normally be interfered with [see footnote 31]. The jurisdiction of the Board must therefore be defined to enable that process to occur.

[30] Because setting the rate of return is not an exact science no matter what methodology is chosen, because the viewpoint is essentially prospective, it has been recognized that there is a "zone of reasonableness" within which a rate of return chosen by the Board should be regarded as just and reasonable. This has been expressed by the United States Supreme Court in the following language:

> "Statutory reasonableness is an abstract quality represented by an area rather than a pinpoint. It allows a substantial spread between what is unreasonable because too low and what is unreasonable because too high." [see footnote 32]

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This notion has also at times been recognized in Canada, [see footnote 33]

[31] This leads to another point: because the setting of the rate of return is based on projections, one cannot be sure that the rate of return will be achieved in practice. Although the utility is "entitled" by s. 80 of the **Act** to have the Board determine a just and reasonable rate of return based on appropriate predictive techniques and methodologies, it is not "entitled", in the sense of being guaranteed, to that rate of return [see footnote 34]. The utility therefore takes the risk that its chosen management techniques and the future economic climate may not yield its expected success. Although some of the activities of the utility are regulated within the framework of the statutory objectives, the utility nevertheless remains subject to business risks and the effects of management decisions. To that extent, the financial risks associated with the operation of the utility, just as in the case of any private business, are to be born by the investors in the enterprise, not the consumer of the service.

[32] The corollary of this position is that the utility must be accorded a degree of managerial flexibility in decision-making in order to be able to minimize the risks to which it must respond. Thus, it is often said that the powers of the Board must be regulative and corrective, but not managerial, and they do not therefore contemplate a retroactive adjustment of the actions of management.

[33] This leads to the general principle of non-retroactivity which prevents a utility from recovering expenses incurred in the past out of current rates. The utility must live with the decisions it makes and the economic vicissitudes that occur [see footnote 35].

[34] By the same token, it is sometimes argued that the occurrence of the reverse situation, of the utility doing better than expected, should mean that the utility should be able to reap the advantage of better and more efficient management techniques and favourable economic conditions and keep any surplus. The concern for the consumer interest is often put forward as a brake on this idea, however. The requirement that the consumer receive power "at the lowest possible cost" [see footnote 36] consistent with the utility's requirement of earning a just and reasonable return for its purposes means, it is

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often argued, that the regulator ought to have power to ensure that excessive returns are somehow accounted and compensated for.

[35] Another factor that is referred to in the cases is the recognition that the capital structure of the utility will often have a bearing on the total cost of capital and this will therefore be important where the determination of the rate base depends on the total debt and equity capital requirements. DeGrandpre observes that "the reasonableness of the ratio of debt to equity is a question of fact left to the appreciation of the Board or Court" [see footnote 37]. Thus, issues such as whether the Board can dictate to the utility a particular mix of debt and equity or, for the purpose of setting the rate of return, do so on the basis of a notional blend of capital requirements if the actual blend is not in accordance with what the Board feels is optimal to ensure a fair return as well as low rates, tolls and charges, often surface. Indeed, this issue is presented in this case.

[36] Having conducted this brief survey, I will now attempt to state some general principles to be used in the interpretation and application of the local legislation:

1. The **Act** should be given a broad and liberal interpretation to achieve its purposes as well as the implementation of the power policy of the province;

2. The Board has a broad discretion, and hence a large jurisdiction, in its choice of the methodologies and approaches to be adopted to achieve the purposes of the legislation and to implement provincial power policy;

3. The failure to identify a specific statutory power in the Board to undertake a particular impugned action does not mean that the jurisdiction of the Board is thereby circumscribed; so long as the contemplated action can be said to be "appropriate or necessary" to carry out an identified statutory power and can be broadly said to advance the purposes and policies of the legislation, the Board will generally be regarded as having such an implied or incidental power;

4. In carrying out its functions under the **Act**, the Board is circumscribed by the requirement to balance the interests, as identified in the legislation, of the utility against those of the consuming public;

5. The setting of a "just and reasonable" rate of return is of fundamental importance to the utility and must always be an important focus of the Board's deliberations; however, the "entitlement" of the utility to a just and reasonable rate of return does not guarantee it that level of return. The "entitlement" is to have the Board address that issue and to make its best prospective estimate, based on its full consideration of all available evidence, for the purpose of setting rates, tolls and charges.

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6. The Board has jurisdiction, which will not generally be interfered with on judicial review, to make a determination of what is a just and reasonable rate of return within a "zone of reasonableness" and in so doing is not constrained in its choice of applicable methodologies, so long as they can be rationally justified in accordance with sound utility practice and are not inconsistent with the achievement of the purposes and policies of the legislation.

[37] It is now necessary to consider each of the specific questions that have been posed. In approaching them, it is worth remembering that the questions have been posed in the abstract and ask for answers to broadly-identified issues of jurisdiction. The case is not an appeal and there can be no findings of fact made by this court in arriving at its conclusions. The information provided by the Board as to past hearings was given as background only so as to assist the Court in better understanding the scope and potential importance of the questions. While the answers given may provide guidance with respect to specific issues that have arisen in hearings in the past, they cannot be taken as an adjudication of those issues in the specific factual context in which they arose.

Question No. 1

"(1) Does the Board have jurisdiction pursuant to the Act to set and fix the return which a public utility may earn annually upon:

(i) the rate base as fixed and determined by the Board for each type of service applied by the public utility; and/or

(ii) the investment which the Board has determined has been made in the public utility by the holders of common shares."

[38] It will become apparent from the ensuing discussion that a number of the questions posed on this stated case are interrelated in the sense that the answer to some of them will provide a strong impetus for a particular response in others. This is particularly evident in Question 1.

[39] The answer to Question 1 in fact involves a consideration of two sub-issues. The first relates to the legal significance of a determination by the Board on a given application of the just and reasonable return to which the utility is entitled. The second sub-issue, which is affected by the decision

[40] on the first, relates to the powers of the Board to make determinations with respect to the rate of return on a utility's common equity portion of its capital structure.

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(a) The Legal Significance of a "Determination"

[41] It is to be noted that Question 1 asks whether the Board has jurisdiction to "set and fix" the utility's return whereas s. 80(1) of the **Act** speaks in terms of the utility being entitled to earn a return as "determined" by the Board. The use of this differing terminology in the question, as explained by counsel for the Board at the hearing, was designed deliberately to raise the issue as to whether the Board may, by determining the level of return, be said to be prescribing that level as an upper limit to the level of earnings to which the utility may be entitled and thereby exercise certain powers with respect to disposition of any excess that may in fact be earned. This issue becomes more focused when Question 3 is considered. The answer to that question will, to some extent, be influenced by the power which the Board can be said to have under s. 80 with respect to the setting of a level of return.

[42] It is obvious, of course, that in the process of approving rates, tolls and charges under s. 70(1) the Board must determine what is a just and reasonable return on the utility's rate base in order to determine the level of revenue needed by the utility [see footnote 38]. This flows from the utility's "entitlement" in s. 80(1) to earn that level of return. The determination of a just and reasonable return on rate base is therefore an essential component in the series of calculations which the Board must undertake in the process of approving rates, tolls and charges. If the determination of a just and reasonable return is merely a step in the process of approving rates, tolls and charges under s. 70(1), that is, if it is only an intermediate calculation necessary to arrive at the final result of consumer rate approval, the "determination" of a just and reasonable level of return will have no independent legal significance, in the sense of prescribing the limit of the utility's return for other purposes of the Board's functions.

[43] On the other hand, if the determination of a just and reasonable level of return has, as it were, an independent life of its own, in the sense of it not being a mere intermediate calculation but can be "set and fixed", in the sense of being prescribed, it could, for example, be used to support an argument that a utility is not entitled to earn in excess of a just and reasonable return. As indicated, this impacts directly on Question 3.

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While counsel for NLP suggested that there may be other mechanisms available to deal with excess earnings (by means of the use of a designated excess revenue reserve fund), that would not require the derivation of such a power from s. 80, counsel for the Board and the Consumer Advocate both indicated that they were concerned about the legal basis for the derivation of the operation of an excess revenue account from other parts of the legislation, such as the administrative and supervisory power of the Board to regulate a utility's accounts. It is appropriate therefore that this matter be addressed.

[44] The issue boils down to this: If the power to "determine" the return encompasses the notion of fixing, in the sense of prescribing the limits of entitlement, one would be able to derive from s. 80(1) a power in the Board to say to the utility that it may earn that level of return and no more. If not, the power to determine would simply be part of a calculation that leads to consumer rate setting with no independent existence or significance for regulatory practice generally.

[45] **Black's Law Dictionary** [see footnote 39] explains "determine" in part as follows:

> "To bring to a conclusion, to settle by authoritative sentence, to decide....To adjudicate on an issue presented...
>
> "To estimate...
>
> "To decide, and analogous to 'adopt' or 'accept'..."

[46] The **Concise Oxford Dictionary** [see footnote 40] defines the word in pertinent part as:

> "1. v.t. & i. settle, decide, (dispute, person's fate...), come to a conclusion, give decision, be the decisive factor in regard to...; ascertain precisely, fix;...
>
> "3. v.t. & i. (esp. Law) bring or come to an end.
>
> "4. v.t. limit in scope, define; fix (date) beforehand."

[47] For what limited value these definitions can have in this context, it would appear that the primary meaning of the word determine, with its emphasis on coming to a final decision and amounting to a decisive factor as well as the notion of ascertaining

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something precisely and "fixing", encompasses something more than a mere calculation in a broader process.

[48] Having said that, it is to be noted that s. 80(1) is structured in such a way that its emphasis is on the entitlement of the utility to a just and reasonable return, as determined by the Board, rather than involving the express conferral on the Board of a power to prescribe the level of return. The structure of the subsection could be said to be directed towards establishing a minimum base line of entitlement without saying anything expressly about the power of the Board to create a cap. To put the matter beyond doubt, the insertion of the words "and no more" after the language entitling the utility to a just and reasonable return would certainly have clearly indicated a prescriptive power in the Board, if that had been intended. Furthermore, although the return is referred to as being "determined" by the Board, the subsection goes on to indicate that the return so determined is applied to the rate base "as fixed and determined" by the Board. On a strict linguistic analysis alone, the use of the word "fixed" in conjunction with "determined" in one place would imply that its absence in the other was deliberate.

[49] Notwithstanding these matters, I am not satisfied that a linguistic analysis of the subsection can provide the answer in this case. Even a cursory perusal of the remaining provisions of the **Act** indicates that there is no uniform terminology chosen to describe the various decision-making functions in which the **Board** may engage. For example, the **Act** provides that the Board may "inquire into and determine" [see footnote 41] the valuation of a utility's assets and may "determine" [see footnote 42] those values in accordance with a number of stated rules. It may "ascertain and determine" [see footnote 43] what are proper and adequate rates of depreciation of classes of utility property. Its role with respect to the utility's rates, tolls and charges is one of "approval" [see footnote 44]. Indeed, if there is any decision of the Board which is contemplated as having operative legal effect and to amount to a "fixing" of the utility's rates, tolls and charges from which the utility may not deviate, it is the "approval" contemplated in this regard; yet the word "fix" does not appear. In another context, the Board may "fix and determine" [see footnote 45] a separate rate base for each kind of service supplied by a utility; yet when describing what is to be included in the calculation of rate base, the reference to "determine" is dropped and it is

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simply described as "fixing a rate base" [see footnote 46]. Finally, the term "approval" surfaces again in the context of the power of the Board to authorize new stock issues of the utility [see footnote 47].

[50] To resolve this conundrum, resulting from inconsistency in terminology, resort must be had to the purposes of and policies underlying the legislation as mandated in s. 118 of the **Act** as well as s. 4 of the **EPC Act**. As indicated previously [see footnote 48], the Board is required, in carrying out its functions under the **Act**, to balance the interests, as identified in the legislation, of the utility against those of the consuming public. The notion of a "just and reasonable return" in s. 80(1) is the benchmark against which fairness to the utility and the consumer is to be measured. It is pivotal in the balancing exercise. The interests of the consuming public in obtaining power at the lowest possible cost consistent with reliable service [see footnote 49] must accommodate the utility's interest in being afforded the opportunity to earn a fair rate of return for its efforts. In the methodology adopted by the Board, the approval of appropriate rates, tolls and charges necessarily factors the just and reasonable return, and only that level of return, into that calculation. Otherwise, the interests of the consumer would not be protected in obtaining power at the lowest possible cost. It is therefore inherent in the process that in determining a just and reasonable return for the utility, the utility should have the opportunity of earning that return but, other things being equal, should not expect to earn any more. Accordingly, determining the just and reasonable return necessarily involving prescribing the return and in that sense can be said to amount to "setting and fixing" the rate of return.

[51] It follows from this that the use of the word "determine" can, in the context of the use of that and other terminology in the Act, encompass something more than the notion of mere calculation and extends to the idea of prescribing, or fixing, a level of return in the nature of a legal decision which can bind and have effect on the utility for other purposes related to the Act.

(b) The Power to Set and Fix the Level of Return on Common Equity

[52] In order to determine the just and reasonable return on rate base to which the utility is entitled by s. 80(1), the Board must first determine the cost to the utility of the

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various components of its sources of funds. The costs associated with long term debt and preference shares are generally static over the period covered by a particular rate hearing. Accordingly, they are often described as "embedded costs". The rate of return necessary to be earned on rate base to cover the cost of debt and preference shares can therefore usually be easily determined based on the interest rates or dividend rates applicable to such instruments. In the case of common equity, however, the cost to the utility of this source of funds depends upon a number of factors, especially current market conditions which, by nature, can be volatile.

[53] At a rate hearing, therefore, the Board usually faces a greater difficulty in determining the component of rate of return on common equity than on the other sources of funds because their embedded costs are usually well defined.

[54] Since the rate base is financed by a combination of debt, preference shares and common equity, the rate of return on which is different for each component, the overall rate of return on rate base is calculated as a weighted average of the rates of return on the various individual components [see footnote 50].

[55] As a generalization, it is sometimes said that the cost of common equity is often higher than that of debt [see footnote 51]. The rate of return on common equity may therefore be expressed as a percentage which is higher than the overall rate of return on the full rate base because the higher equity cost will be weighted downwards by the rates for the other components.

[56] The issue raised by Question l(ii) is whether the Board may set and fix the rate of return on common equity, as a component of the overall rate of return on rate base in a manner such that it can be used as an independent benchmark for other purposes in the same way as the overall determination of return on rate base can be. Alternatively, is the "determination" of the rate of return on common equity to be treated in the narrower sense of a mere calculation leading to the final determination of overall return?

[57] Section 80(1) makes no reference at all to determining, let alone setting and fixing, the rate of return on common equity. The calculation of an appropriate rate of return

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on common equity is truly a mere component in the overall process of determining a just and reasonable return on rate base. Furthermore, there is nothing in the purpose of the **Act** or the policies which the Board is to implement which would lead inexorably to the conclusion that the Board ought to have the power to prescribe a rate of return on common equity as a component of an overall return or rate base, any more than it ought to have a power to prescribe a return on any other component.

[58] The Consumer Advocate submitted that inasmuch as s. 80(1), by its express language, contemplates that the only measure of what NLP may earn annually is to be determined by a just and reasonable return on rate base, to allow the utility to measure what it may earn annually based upon a different factor, such as a rate of return on common equity which could very well be higher than the overall rate of return on rate base and might lead to a higher overall return that could be said to be justified, would be to allow the utility to earn more than that to which it is statutorily entitled.

[59] It is to be noted, however, that in its previous orders [see footnote 52] the Board has not sought to determine the level of return on the basis of anything other than a rate of return on rate base. For example, in the 1991 Order, the Board ordered:

> "A just and reasonable return for [NLP] is determined to be between 10.96% and 11.19% on its average rate base for 1992, which will provide an opportunity to earn a rate of return on common equity between the range of 13.00% to 13.50%." (Emphasis added)

The reference to the range of rates of return on common equity appears to have been inserted more as information in support of a rationale for the determination of the overall return on rate base, since the Board states that the determination of the return on rate base "will provide" an "opportunity" to earn a rate of return on common equity. Similarly, the 1996-97 Order simply described the rate of return on rate base as being "derived from" a given range of return on common equity. This is the correct approach.

[60] As to whether the Board may make other decisions, for example relating to the manner in which an excess revenue fund should be maintained, by reference to the contemplated rate of return on common equity, is a separate matter which should be dealt with in that context.

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[61] I therefore conclude that the power to "determine" a just and reasonable return on rate base, as contained in s. 80(1) does not include within it a power to "set and fix a rate of return on common equity" but it obviously does contemplate that the analysis of appropriate rates of return on common equity will be undertaken and factored into the conclusion as to what is a just and reasonable return on rate base.

[62] Accordingly, giving the words "set and fix" in the question a meaning which implies the notion of prescribing, I would answer Question 1 as follows:

As to

1.(i) – Yes

1. (ii) – No

Question No. 2

"(2) Does the Board have jurisdiction to set the rates of return referred to in Question (1) as a range of permissible rates of return"

[63] In light of my answer to the second part of Question 1, it is only necessary to address Question 2 in the context of whether the Board has jurisdiction to set the rate of return on rate base as a "range of permissible rates of return".

[64] It has already been stressed that the determination of a just and reasonable return on rate base involves a consideration of the differing costs of the components of the utility's capital structure and that in arriving at the overall rate of return, it is permissible for the Board to use a weighted average of the rates associated with each individual component. It has also been pointed out that the cost of common equity is often difficult to estimate with precision. The best that experts are often able to do is estimate rates within a reasonable range. Inasmuch as the cost of common equity is weighted into the overall rate of return on rate base, that range would also have to be reflected in the ultimate rate of return on rate base, as determined by the Board.

[65] In **Northwestern Utilities Ltd. v. City of Edmonton** [see footnote 53] Smith, J., emphasized:

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> "The question of a fair rate of return on a risky investment is largely a matter of opinion, and is hardly capable of being reduced to certainty by evidence, and appears to be one of the things entrusted by the statute to the judgment of the Board."

[66] It is evident, as **Newfoundland Light & Power Co. v. P.U.C. (Bd.)** [see footnote 54] demonstrates, that the determination of a just and reasonable return is an area in which the Board is accorded a broad discretion as to the methodology to be adopted. Obviously, the striking of a balance between the interests of the utility and the consumer, whilst at the same time attempting to comply with the Board's obligation to approve rates which will produce a fair return to the utility, cannot be done with the precision of a simple mathematical calculation. Realistically, the balance can only be struck within a reasonable range. It is for that reason that the courts have, on subsequent appeal or applications for judicial review, generally deferred to the determinations of boards in this regard provided the determination is not arbitrary or capricious and can be said to fall within a reasonable range [see footnote 55]. As indicated in the earlier discussion [see footnote 56], in the United States the notion of a "zone of reasonableness" as an "area rather than a pinpoint" has been recognized. Whilst this notion has been enunciated as a justification for deference to Board decisions in the context of challenges on appeal or judicial review, it nevertheless indicates a recognition of what is inherent in the rate setting process.

[67] I see no reason, therefore, why, instead of attempting to justify a particular decision ex post facto by an argument that a particular rate falls within a zone of reasonableness, the Board could not expressly indicate what it believes that area of reasonableness to be by expressing what it believes to be a just and reasonable return in terms of a range of rates of return. This indeed is a practice that has been adopted elsewhere [see footnote 57].

[68] It is to be noted that s. 80(1) does not speak in terms of a "rate" or "rates" of return; rather, it speaks of a just and reasonable "return". It is not limited by its language to the pinpointing of a particular rate of return. I conclude that a liberal construction of the word "return" in the context of s. 80(1) leads to the conclusion that it can include a range of rates of return.

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[69] Of course, in applying the rate of return to the rate base, as ascertained by the Board, a single figure will have to be used since rates, tolls and charges are expressed as finite numbers. The Board in practice has chosen the mid-point of its stated range of rates of return as the figure to be used for this purpose. This is a perfectly acceptable practice for the purpose of setting the rates. By expressing a range, however, the Board leaves open to the utility the flexibility of earning more than the mid-point up to the maximum end of the range so as, in effect, to give the benefit of the doubt to the utility that the expert evidence favouring the upper end of the range turns out to be the more accurate and to provide an incentive to the utility towards managerial efficiency.

[70] The Consumer Advocate expressed concern in argument that the use of the word "permissible" in Question 2, as qualifying the phrase "rates of return", might be misleading. As I understand the argument, the concern is that the adoption of a range approach might lead to the conclusion that the "entitlement" of the utility to a just and reasonable return would be regarded as an entitlement, or guarantee, of earning up to the maximum end of the range. While the utility, if it earned as much as the maximum would be entitled to keep that amount of earnings, it is not, for reasons already given, guaranteed that level of return if it is not in fact successful in earning them. The Board is under no obligation to adjust future rates or to take other steps to make up any such shortfall. Any rate of return earned within the range would be regarded as permissible and it is only when a rate of return exceeds the upper limit of the range that it would be regarded by the Board as subject to any excess revenue regulation.

[71] Accordingly, recognizing that, on my analysis, Question 2 only relates to whether the Board has jurisdiction to set rates of return as a range in relation to its determination of a just and reasonable return on rate base, the answer I would give to Question No. 2 is: "Yes".

Question Nos. 3 and 4

" (3) Should a public utility earn annually a rate of return which is in excess of the rate of return determined by the Board to be just and reasonable, either on

(i) the base rate as fixed and determined by the Board for each type of service applied by the public utility; or

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(ii) the investment, which the Board has determined, has been made in the public utility by holders of common shares,

does the Board have jurisdiction to

(i) require the public utility to use the excess earnings to reduce revenue requirements for the succeeding year; or

(ii) require the public utility to place the excess earnings in a reserve fund for the purpose of adjusting rates, tolls and charges of the public utility at a future date, or

(iii) require the public utility to rebate the excess earnings to customers of the public utility.

"(4) Does the Board have jurisdiction to order that the rates, tolls and charges of a public utility shall be approved taking into account earnings in excess of a just and reasonable return upon,

(i) the rate base as fixed and determined by the Board for each type of service applied by the public utility, or

(ii) the investment, which the Board has determined, has been made in the public utility by the holders of common shares,

in prior years."

[72] The analysis leading to the answers to Questions 3 and 4 can be considered together since they both address the same general theme: the scope of the Board's powers to deal with situations where a utility in fact earns a rate of return that is greater than that determined to be a just and reasonable return.

[73] It was suggested by counsel for NLP that the concept of "excess earnings" does not exist under the **Act** other than by reference to a definition of what is to be deposited into a reserve fund which the utility may be ordered to create and maintain pursuant to s. 69(3) of the Act. This submission follows from the position taken by NLP that the Board has no power under s. 80(1) to "set and fix", in the sense of prescribing, a maximum rate of return. NLP had submitted that the Board's power to deal with excess earnings comes solely from its statutory powers to prescribe the form of accounts to be maintained by the utility [see footnote 58] and to create a reserve fund "for a purpose which the Board thinks appropriate" [see footnote 59] which could include the purpose of dealing with excess returns. This argument has already been rejected in the analysis relating to Question 1. It follows, therefore, that the issue of excess earnings may present itself for consideration by the Board in circumstances even where a reserve account has not been ordered to be set

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up. For the purpose of regulation by the Board, the concept of excess earnings is derived from the process of prescribing a just and reasonable return on rate base and not by the decision to require the creation of a reserve account. The question to be considered is what enforcement mechanisms the Board may use to deal with excess earnings so identified.

[74] If, as determined in the answer to Question 1, the Board has jurisdiction flowing from s. 80(1) to prescribe the maximum rate of return which a utility may earn in a given year, it is a necessary consequence of such a determination that revenue earned in excess of the maximum of the prescribed range of return is excess revenue to which, by definition, the utility will not be entitled. The Board accordingly must have jurisdiction to regulate how that excess revenue is to be dealt with.

[75] Question 3 requires the court to consider the range of enforcement mechanisms which the Board may employ to ensure that the utility does not benefit from any windfall profits resulting from earnings in excess of the just and reasonable return to which it is entitled. Three scenarios are proposed:

> (1) use excess earnings to reduce revenue requirements for the succeeding year ("Revenue Reduction Approach");
>
> (2) place the excess earnings in a reserve fund to enable an adjustment of rates, tolls and charges at a future date ("Reserve Fund Approach");
>
> (3) require a rebate of excess earnings to consumers ("Rebate Approach").

Question 4 is really a subset of the Revenue Reduction Approach. In one sense it really asks the same question as in Question 3(i) but does not limit the process to the application of excess earnings to only the year next succeeding the year in which the excess earnings have been achieved. It appears to ask the court to address the question of whether, in the absence of the existence of a reserve account, the Board may, upon being made aware of excess earnings in prior years, reach back into those prior years and take account of those excess earnings by using them to reduce rates, tolls and charges in subsequent periods below what would otherwise be indicated.

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[76] In approaching these questions, it is important to bear in mind the nature of the rate setting process and the general principles which are recognized as being applicable to govern the manner in which that process is carried out.

[77] The process of rate setting is generally prospective by nature. Although the Board must set rates for the future, it only has data from past experience, the evidence from utility officials as to planned changes in operations and the opinions of experts as to future economic trends as a guide to what the revenue requirements of the utility will likely be. It is, therefore, necessarily speculative. In developing the utility's requirements, the Board focuses on a "test year" as the basis for its estimates and adjustments. Traditionally, in North America the test year was chosen as the latest 12 month period for which complete data were available [see footnote 60]. More recently, due largely to inflation, boards adopted a forward-looking test year which in effect amounts to a forecast of what expenses and costs, and hence revenue requirements, will be. This has been the practice of the Board [see footnote 61] and is supported by the **Act** [see footnote 62] and the **EPC Act** [see footnote 63]. Past experience of course remains relevant, however, insofar as it gives insight into the possibility of forecasting error [see footnote 64].

[78] Because the process is prospective, there is a good possibility that all of the assumptions will not be achieved in practice. The actual rate of return may therefore differ from the rate, or range of rates, prescribed at a previous hearing. On paper, this difference may appear to redound to the benefit or detriment of the utility depending upon whether the actual rate is greater or less than the rate or range prescribed.

[79] When, as a result of actual experience, it appears that the actual rate of return was greater than the rate prescribed for the same period, it becomes necessary to address what the Board can do, if anything, to ensure that the earnings in excess of the prescribed level, (which by definition will be regarded as greater than a just and reasonable return on the rate base), are not allowed to remain with the utility or its investors. In the **Bell Rebate** case [see footnote 65], Gonthier, J., observed that differences between projected and actual rates "call for a high level of flexibility in the exercise of the [Board's] regulatory duties".

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[80] Those opposing a broad jurisdiction on the part of the Board to define and deal with excess revenue couch the objection, at least in part, in terms of a violation of the non-retroactivity principle [see footnote 66]. In its narrow sense, it is a principle of benefit to consumers, that "today's rate payers should pay the cost of today's services and not the cost of past or future services" [see footnote 67]. More broadly, it also yields a presumption (which is of benefit to the utility as well), flowing from the idea that the Board acts prospectively in setting rates, that the Board cannot or, even if it has jurisdiction, should not as a general rule, make orders that have the retroactive effect of disturbing existing rights already enjoyed by the utility. In practical terms, it leads to the argument that where rates, tolls and charges have been approved by the Board as being permissible for the utility to charge, the Board cannot or should not make a subsequent order that has the direct or indirect effect of reducing or otherwise changing those rates. In other words, changing past transactions or attaching new consequences to past transactions would be prohibited.

[81] As Penning points out [see footnote 68] the retroactivity rule has its genesis in general rules of statutory interpretation that guard against interpreting a statutory provision as having a retrospective operation unless it is clear that such an effect was intended. It is not an immutable rule but can give way to contrary legislative intention.

[82] Doctrinally, in the context of utility rate regulation, the retroactivity principle is described by Penning in this way:

> "...the rule is concerned more with issues of fairness, both to customers and to utility shareholders. The customer-related fairness issue is often referred to as the 'inter-generational equity' problem, which, broadly stated, means that today's customers ought not to be held responsible for expenses associated with services provided to yesterday's customers. The fairness concern in terms of utility shareholders arises because to attract and maintain reasonably-priced equity investment in a utility, shareholders require some certainty that matters already dealt with by the regulator have some degree of finality associated with them." [see footnote 69]

[83] It was argued that one of the questions that is theoretically presented in this case is the degree to which the Board is authorized to trespass on the no-retroactivity

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principle in fulfilment of its legislative powers, specifically, to enforce a prescription that a utility may earn a just and reasonable return and no more.

[84] In reality, however, in light of the prospective nature of this Opinion, the non-retroactivity principle is not, in practical terms engaged by Question No. 3. The answers to previous questions have already established that the concept of excess revenue is to be determined by reference to the meaning of a "just and reasonable return" as that phrase is understood in s. 80(1); and not by the definition used to operate an excess revenue account. All participants in the regulatory process must therefore take account of that concept and conduct their activities accordingly. The "rules of the game" are known.

[85] Section 59 of the **Act** requires the utility, unless otherwise ordered by the Board, to close its accounts at the end of each calendar year and to file with the Board its balance sheet, together with such other information as may be required by the Board, before April 2nd of the following year. Effectively, therefore, within 3 months after the utility's year end, both the utility and the Board will know the financial position of the company for the previous year and from that, as well as any other information which the Board may require, a determination of the actual level of return earned by the utility in the previous year can be made. Applying the known definition of excess revenue, by reference to the upper end of the range of return on rate base, as determined by the Board's prior orders under s. 80(1), it can be determined whether there has been any excess revenue earned. There is no revisiting and revision of a prior order respecting the allowable return on rate base. The examination of actual results in the context of a comparison with the previously prescribed rate merely leads to enforcement of the original order. Any decision by the Board with respect to disposition of excess revenue will therefore not retroactively interfere with past revenues which the utility assumes belong to it and which may be disbursed to shareholders or otherwise spent. Given the concept of excess revenue, as explained in this option, the utility knows in advance that it is not entitled to excess revenue so defined and may institute whatever accounting practices are necessary to segregate and deal with such revenues pending direction from the Board.

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[86] The situation is conceptually no different from the concept behind an excess revenue account set up under s. 69(3), which the utility accepts as a legitimate way of dealing with such revenue. Just as in the case of an excess revenue account, the definition of excess revenue is known in advance and the utility can account for such revenue accordingly.

[87] The scenario contemplated by Questions 3 & 4 is unlike the situation which arises where an interim order setting rates, tolls and charges is subsequently superseded by a final order, resulting in excess revenue being earned in the intervening period because the rates, tolls and charges charged in that period pursuant to the interim order were higher than those which were ultimately found to be justified in the final order. In that situation, if the final order is treated as being operative as and from the date of the interim order that was superceded, the final order will, indeed, have a retroactive effect. In the context of the Newfoundland legislation, that situation is specifically contemplated and authorized by s. 75(3) of the **Act**.

[88] In the situation presently under consideration, however, there is no subsequent order of the Board which retroactively changes previously-approved rates, tolls or charges or revises the prescribed level of return to which the utility is entitled. All that occurs is the subsequent examination of actual results and a determination of whether excess revenue was in fact earned by applying a pre-existing standard derived from a previous Board order made under s. 80(1).

[89] I recognize that, to the extent that the utility in the past may have been operating under the impression, perhaps engendered by positions taken by the Board, that excess revenue need only be calculated by reference to the excess over the rate of return on common equity as defined for the purpose of operating the existing excess revenue account, it may consider that if the concept of excess earnings as discussed in this Opinion is applied at this stage to those previous years, there may effectively be a change in the "rules of the game". In that practical sense, there would be a "retroactive" readjustment.

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[90] The court is not being asked, however, to determine the position of the utility specifically in relation to the years 1991 through 1996 and to determine the entitlement of the utility to excess revenues as calculated by reference to the current definition. The degree of NLP's misapprehension, if any, the actions of the Board in dealing with the excess revenue issue in the past, the degree to which NLP may have acted to its prejudice, and the degree to which the utility may nevertheless be required to disgorge excess revenues in previous years in accordance with presently understood concepts raise complex issues of mistake of law in the law of restitution and the defence of change of position which require for their resolution a detailed factual base. It would be inappropriate to attempt to answer such questions in this Opinion.

[91] The issue, therefore, is not whether the Board may revise the definition of excess revenue and then apply the revised definition to the results of previous years. That might well engage the principle of non-retroactivity. Here, assuming (without deciding) there was a misapprehension in the past as to how excess revenue should be calculated, the "change" in calculation method comes about, not because of a retroactive change in the rule by the Board but by a (perhaps) unanticipated declaration and clarification by the Court of what the law is and how it is or should be applied.

[92] I turn now to the determination of the powers of the Board to deal with excess revenue once it has been determined to exist.

[93] The only express provisions of the **Act** dealing with excess revenue are s. 69(4) which provides a power to require a utility to refrain from distributing extra revenue as dividends until further order, and s. 75(3) which enables the Board to order that excess revenue earned as a result of an "interim order" made under s. 75(1) and not confirmed by final order be either refunded to customers or placed in a reserve account for an approved purpose. Does the fact that similar powers are not expressed in respect of "final" orders mean that they were not intended to be available?

[94] I do not believe so. The power to deal with excess revenue is inherent in the nature of the regulatory scheme the Board is required to administer. The starting point is the power, found to exist in the answer to Question 1, that the Board may prescribe a rate

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of return under s. 80(1) which carries with it the necessary corollary that the utility is only entitled to earn that level of return, as determined by the Board to be just and reasonable. It follows that unless the Board is to be a "toothless tiger" it must be accorded the means by which revenues earned in excess of the prescribed level of return are used in furtherance of the objectives and policies of the legislation and not simply for the benefit of the utility's investors. Such policies as the maintenance of a sound credit rating by the utility [see footnote 70], the efficient production, transmission and distribution of power [see footnote 71], the delivery of power at the lowest possible cost [see footnote 72] and the provision of reliable service [see footnote 73] are all candidates for the use of the excess. It does not follow, as the Consumer Advocate argued, that any dealing with the excess should involve only a return or rebate to consumers so as to ensure that the goal of delivery of low cost power is vindicated. While the maintenance of low rates is an important objective of the legislation, it is not the only one. As emphasized earlier [see footnote 74], the Board is always engaged in a balancing exercise between the interests of the consumer and the interests of the utility. It is not correct to say that any revenues earned in excess of a just and reasonable return belong to the consumer. Just as the utility is not "entitled" to earn and retain revenues in excess of such a level of return, so also the consumer is not absolutely "entitled" to the excess. The Board, having identified that an excess exists, must deal with it in furtherance of the objectives of the legislation.

[95] The means whereby the excess is dealt with should not be, unless expressly limited by the legislation, rigidly prescribed provided the means chosen comport with the objectives and policies of the legislation. It is worth repeating Gonthier, J.'s, observation in the **Bell Rebate** case that the fact that the differences between projected and actual rates of return are common calls for "a high level of flexibility in the exercise of the [Board's] regulatory duties", [see footnote 75]

[96] Counsel for NLP argued that the only power of the Board to deal with excess revenue, aside from interim order situations, flows from its power in s. 58 to prescribe the form of books and accounts to be kept by the utility and that, if it ordered, pursuant to s. 69(3), the creation of a reserve fund "for a purpose which the Board thinks appropriate", it could stipulate that the accounts should be kept in such a way as to require excess

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revenues to be accounted for in such a reserve account. I do not find the jurisdiction to deal with excess revenue in the power to prescribe the utility's accounts. That is only a procedural means of exercising powers, the jurisdiction for which must be found elsewhere. Whilst the creation, pursuant to s. 69(3), of a reserve fund to deal with excess revenues could be said to be "a purpose which the Board thinks appropriate" (provided that purpose is consistent with the powers otherwise conferred on the Board), there is nothing in the language of s. 69(3) which expressly makes it applicable to an excess revenue situation and there is certainly nothing there which would purport to make the use of a reserve fund for the purpose of dealing with excess revenue as the only mechanism which would be at the Board's disposal to deal with this issue.

[97] I conclude that, bearing in mind the approach to interpretation mandated by s. 118(2) of the Act, the Board must of necessity have broad powers to deal with revenue earned by a utility in excess of the prescribed rate of return. Inasmuch as the ascertainment of the existence of excess revenue can only be made following a subsequent review, any order dealing with excess revenue will of necessity have certain retrospective elements about it. But that is not the same as saying that an order dealing with excess revenue ascertained by application of a pre-existing concept of what constitutes excess revenue is a retroactive order. It was argued by NLP that the setting up of a reserve account would be the only method that would not involve any trespass on the principle of non-retroactivity because the utility would know in advance that it had to set up its reserve account and could therefore provide for it without running the risk of spending or distributing excess revenues in ignorance of the fact that they would have to be held accountable for them.

[98] For reasons already given, this argument is unconvincing. By virtue of the answers given to Question 1, the utility knows that it is only entitled to earn a just and reasonable rate of return pursuant to any order made by the Board to that effect under s. 80(1). It can monitor its financial progress and can organize its accounts in such a way as to account for excess revenue so as to prevent the possibility of it being disposed of before any subsequent order dealing with the excess may be made. The utility does not need an express order of the Board requiring it, as a general rule, to set up a reserve

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account for this purpose. Nevertheless, the use of a reserve account is a convenient way of doing this. It may well be, however, that the Board may, through other directions with respect to the manner of keeping accounts, develop other accounting procedures that will enable the utility to identify excess returns and to segregate them for other use.

[99] A reserve fund could be ordered by the Board to be used in the future to improve service, or to keep rates low or for some other purpose that is consistent with the objectives and policies of the legislation. Whether the advancement of these policies is done formally through the use of a reserve fund or through some other mechanism such as an order setting further rates, tolls and charges taking the prior excess revenue into account, the utility should not be prejudiced, in light of the fact that it knows that it is not entitled to earn a return in excess of a just and reasonable return.

[100] A rebate to consumers would also be permissible since it would have the indirect effect of ex post facto keeping the rates low. While it is true that any rebate would not, because of the fluid nature of the customer base, result in a return to exactly the same body of consumers who had paid the original rates, this is not an insuperable objection to using this type of mechanism. Penning [see footnote 76] observes:

> "As a practical matter, however, at least some of this concern appears misplaced. By far the majority of today's rate payers for the majority of regulated public service utilities were also yesterday's rate payers -especially since the time frames at issue are typically not more than a year or two. So the unfairness argument about cost allocation loses some of its force. Furthermore, to the extent it is still present, it can be dealt with through the choice of mechanism design - so instead of adjusting all rates, through either surcharges or refunds, the individual customers who met the timing criteria would receive an adjustment to their bill."

[101] This recognition was echoed by Gonthier, J., in the **Bell Rebate** case [see footnote 77] as follows:

> "...it is true that the one time credit ordered by the appellant will not necessarily benefit the customers who are actually billed excessive rates. However, once it is found that the appellant does have the power to make a remedial order, the nature and extent of this order remain within its jurisdiction in the absence of any specific statutory provision on this issue. The appellant admits that the use of a one time credit is not the perfect way of reimbursing excess revenues. However, in view of the cost and the complexity of finding who actually paid excessive rates, where these

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> persons reside and of quantifying the amount of excessive payments made by each, and having regard to the appellant's broad jurisdiction in weighing the many factors involved in apportioning respondent's revenue requirement among its several classes of customers to determine just and reasonable rates, the appellant's decision was imminently reasonable..."

[102] Accordingly, I conclude that each of the Revenue Reduction, Reserve Fund and Rebate approaches to dealing with excess returns are within the jurisdiction of the Board and could, in particular circumstances, all constitute reasonable responses to a finding that the utility has earned in excess of a just and reasonable return.

[103] I would also add that the setting up of a reserve fund in a given case does not exhaust the ways in which the Board may deal with excess revenue. The methodologies proposed are not mutually exclusive. The Board has jurisdiction to deal with all revenue in excess of a just and reasonable return on rate base using one, or a judiciously blended combination, of the methodologies identified.

[104] Having said that, it must be emphasized that just because the Board has the jurisdiction to use these approaches, the particular circumstances may well dictate that one or more of them may be inappropriate in a given case. For example, the ordering of a rebate to consumers of the total amount of an excess return might not, in the light of the general financial condition of the utility, be appropriate when measured against such legislative objectives as the maintenance of the utility's sound credit rating. It might be appropriate, when all of the interests are properly balanced, for the Board, for example, to order that only the excess over a stipulated rate of return on equity, or some other measure, be refunded or otherwise dealt with. These are all matters to be considered by the Board in a given case.

[105] The answers to Questions 3 and 4 can be given as follows:

As to:

3(i) – Yes
3(ii) – Yes
3(iii) - Yes

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[106] The answer to Question 4 is also "yes" on the assumption that what is being asked is not whether the Board may retroactively revise a previous order but merely whether, applying a defined and understood concept of excess revenue, (ie. an excess of a just and reasonable return on rate base) the excess so determined to have existed in prior years may then be taken account of and applied in setting future rates, tolls and charges.

Question 5

> **"Does the fact that the Board has advised the public utility that it is permitted to retain earnings in excess of the rate of return determined by the Board to be a just and reasonable return, upon the rate base as fixed and determined by the Board for each type of service supplied by the public utility, but not in excess of the return determined by the Board to be a just and reasonable return upon the investment which the Board has determined has been made in the public utility by the holders of common shares, affect the jurisdiction of the Board to approve rates, tolls and charges on the basis queried in Question (4)."**

[107] In order to understand the import of this question, it is necessary to review the approach taken by the Board to the definition of excess earnings in past years.

[108] In correspondence passing between NLP, Newfoundland Telephone Company Limited (which at that time was regulated by the Board) and the Board during the late 1980's, there was considerable discussion as to the manner of defining "excess revenue" for the purpose of the operation of the reserve account which the Board had required the utilities to maintain for that purpose. As a result of these discussions, the Board approved a change in the utilities' systems of accounts to recognize a new definition of excess earnings. As indicated, this was accomplished by defining the excess revenue account in the utilities' system of accounts as follows:

> "This account shall be credited with any revenue in excess of the maximum return on common equity determined by the Board at the previous rate hearing to be refunded to customers or used for such purposes as the Board may order."

[109] By the operation of this definition, the situation could occur whereby the utility might earn a rate of return on rate base in excess of the maximum range of returns determined by the Board pursuant to s. 80(1) but could nevertheless be within the range

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of return on common equity used by the Board for the purpose of determining a just and reasonable return on rate base under s. 80(1). If that eventuality occurred, there would be no requirement on the utility to pay anything into the excess revenue account; yet, the result would be that the utility would have earned more than a just and reasonable return on rate base. In light of the answer given to Question 1, the benchmark for determining excess revenue is the range of return on rate base determined by the Board to be just and reasonable. Does the Board have jurisdiction to deal with this money as excess earnings in light of the fact that it has defined excess earnings for the purposes of the utility's accounting by reference to the maximum return on common equity?

[110] Question 5, we were told, attempts to address this issue. As phrased, however, the question merely asks whether the fact that the Board has "advised" (presumably, in the form of its order changing the definition of excess revenue for the purposes of the establishment of the excess revenue account) the utility of this new definition of excess revenue "affect" the jurisdiction of the Board to approve rates, tolls and charges. The short answer to this question, strictly construed, is "no". The Board cannot limit its jurisdiction, in the sense of its legal power, by determinations made in exercise of its powers. It either has the jurisdiction or it does not. Whether it chooses to exercise the jurisdiction is another matter.

[111] As a result of the discussions at the hearing, however, it is apparent that there is a more fundamental issue at stake. The assumption appears to be that if the Board chooses to define excess revenue for the purpose of establishment of the excess revenue account in terms of revenue earned in excess of the maximum return on common equity, it is in effect saying that revenue earned below that maximum but which happens to be in excess of the just and reasonable return on rate base as determined by the Board under s. 80(1) is necessarily money which the utility can keep. This position is obvious from the arguments made by counsel for NLP since his position has been throughout that excess revenue has no meaning other than by reference to the definition used for the purposes of the excess revenue account. As indicated previously [see footnote 78], this is not a correct interpretation of the situation. The same assumption is also apparent from the position taken by the Consumer Advocate who argues that the decision of the Board to define

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excess revenue for the purpose of the excess revenue account in terms of exceeding the return on common equity, as opposed to rate base is ultra vires the Board because the Board must determine excess revenue by reference to revenues which are earned in excess of a just and reasonable return on rate base.

[112] The assumption that the definition of excess revenue for the purpose of the operation of the reserve account is equivalent to the concept of excess revenue flowing from earnings in excess of a just and reasonable return on rate base as prescribed under s. 80(1), is false. I agree with the Consumer Advocate, for reasons already given [see footnote 79], that any revenues earned in excess of the maximum range of a just and reasonable return on rate base are revenues to which the utility is not automatically entitled. It does not follow, however, that for the purposes of regulating the accounts of the utility, the Board is prevented from requiring payment into an excess revenue account on a different basis (provided it does not deprive the utility of the level of return on rate base to which it has been determined to be entitled). The Board can and should deal with all revenue earned in excess of a just and reasonable return on rate base; however, it does not have to require that all of it be paid into an excess revenue account.

[113] As indicated in the answers to questions 3 and 4, the Board has a broad jurisdiction as to how to deal with the excess and it may well be that, in the circumstances obtaining, it will determine that only a portion (i.e. that portion above the maximum return on common equity) should be paid into a reserve account. It might determine that the rest should be rebated to consumers or used by the utility in furtherance of the objective of ensuring that it maintains a sound credit rating in the financial markets of the world. In short, there is nothing wrong in principle with the Board defining excess revenue for the purposes of a reserve account differently from the notion of excess revenue as determined by a comparison with a just and reasonable return on rate base as determined by s. 80(1). In so doing, however, the Board ought not to assume that any additional excess revenue ought necessarily to be returned to the utility to be used as it sees fit. The Board has jurisdiction, and in exercise of its legislative mandate it ought to exercise that jurisdiction, to make a determination as to how that remaining excess revenue, if any, should be dealt with consistent with the objectives and policies of the legislation.

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[114] Accordingly, the technical answer to Question 5 is "no" but so as to limit any confusion over the implications of the wording of the question, I would add that the Board has jurisdiction to define excess revenue for the purposes of maintenance of a reserve account by reference to the maximum level of return on common equity (or any other appropriate measure for that matter) but that does not mean that the Board may for all purposes define the level of excess revenue to which the utility is not entitled by reference to that measure; rather, the Board must determine, on the specific circumstances of the case, what is to be done with respect to any excess revenue measured against a just and reasonable return on rate base. If all or a portion of the excess revenue, measured against the return on rate base, is not ordered to be paid into a reserve account, it must nevertheless be dealt with in some other manner consistent with the objects and policies of the legislation. It should not be simply assumed that such excess revenue if not required to be paid into a reserve account belongs to the utility to be dealt with as it sees fit.

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Question 6

"Does the Board have jurisdiction to order the rates, tolls and charges of the public utility shall be approved taking into account the amount of expenses previously incurred by the public utility which the Board may now consider inappropriate to be allowed as reasonable and prudent and properly chargeable to operating account notwithstanding that such classes of expenses were allowed as reasonable and prudent and properly chargeable to operating account."

[115] The just and reasonable return on rate base which the Board determines that the utility is entitled to earn annually is "in addition to those expenses which the Board may allow as reasonable and prudent and properly chargeable to the operating account...". [see footnote 80] Thus, in the process leading up to the prospective setting of rates, the Board may look at the type and level of projected expenses of the utility in the test year and determine whether they are reasonable and, if not, only allow, for the purposes of calculation of a just and reasonable return on rate base, such types and levels of expenses as are, in the opinion of the Board, reasonable.

[116] In the 1991 rate hearing, certain types and levels of projected advertising expenses were approved by the Board. At the 1996 rate hearing, it was suggested that in

the light of what actually happened in the years subsequent to 1991, the utility had in fact incurred advertising expenses well in excess of the amounts approved as reasonable and also of a type different from those which were approved, i.e. for corporate image building rather than related to the supply of service. The issue posed by Question No. 6 is whether expenses of a class which were previously approved as reasonable but which are in excess of the projected amounts can be disallowed by the Board for the purposes of rate regulation.

[117] The level of operating costs is obviously an important factor in fixing rates. It is generally accepted that Board supervision as to reasonableness of such costs is therefore essential to effective regulation [see footnote 81]. Phillips describes the matter thus:

> "Commissions seldom challenge expenditures controlled by competitive forces, such as those for plant maintenance, raw materials and labor. Conflicts do arise over whether certain expenditures should be charged to operating expenses or paid for by owners out of earnings.
>
> "Management might vote itself high salaries and pensions. Payments to affiliated companies for fuel and services might be excessive. Expenses for advertising, rate investigations, litigation and public relations should be closely scrutinized by the commissions to determine if they are extravagant or if they represent an abuse of discretion. In all cases, moreover, the commissions should require proof as to the reasonableness of a utility's charges to operating expenses." [see footnote 82]

Accordingly, the power to determine reasonable rates necessarily requires supervision of operating expenses.

[118] In defining the parameters of such supervisory power, however, the Board must account for a competing principle, namely, that the Board is not the manager of the utility and should not as a general rule substitute its judgment on managerial and business issues for that of the officers of the enterprise. [see footnote 83]

[119] Nevertheless, it is recognized that regulatory boards have a wide discretion to disallow or adjust the components of both rate base and expense [see footnote 84]. In an American case [see footnote 85] the matter was put as follows:

> "The contention is that the amount to be expended for these purposes is purely a question of managerial judgment. But this overlooks the consideration that the

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> charge is for a public service, and regulation cannot be frustrated by a requirement that the rate be made to compensate extravagant or unnecessary costs for these or any other purposes."

[120] Having said that, however, there will normally be a presumption of managerial good faith and a certain latitude given to management in their decisions with respect to expenditures. In the United States, the test for disallowance is usually "abuse of discretion" showing "inefficiency or improvidence" or "extravagant or unnecessary costs". [see footnote 86]

[121] When the issue becomes a retrospective examination of actual expenses as compared with what was projected and determined to be reasonable and prudent, there ought, similarly, to be caution exercised before determining that an expense was improperly incurred. The circumstances facing a utility are not static and a considerable latitude has to be given to the decisions of management in making expenditures to respond to the new situations as they present themselves.

[122] Nevertheless, it is still within the jurisdiction of the Board to supervise and review both the type and level of expenses incurred by the utility in respect of its operations. If it did not have that jurisdiction, the actual rate of return earned on rate base in a given year would be subject to manipulation by the utility as, for example, in a year where near the close of the fiscal period it appears that the rate of return will be more than anticipated, the utility, if totally unsupervised, could make large expenditures, unrelated to the delivery of service, simply to bring the rate of return in line with what had been projected.

[123] The jurisdiction of the Board to take account of deviations from estimates of expenses when setting future rates does not differ from that pertaining to its jurisdiction with respect to taking account of excess revenue. The disallowance of an expense may lead, in effect, to a greater rate of return, and potentially to excess revenue if the resulting actual adjusted rate of return is in excess of the previously determined acceptable range of return. The excess revenue over a just and reasonable range of return on rate base can be dealt with by the Board as discussed in the answers to Questions 3 and 4. It does not remain the property of the company.

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[124] Accordingly, the answer to Question 6 is "yes". In giving this answer, however, I would emphasize that the question that was asked is a jurisdictional one. It does not give, in the circumstances of a particular case, a wide unfettered power to "second guess" managerial decisions with respect to expenses. In this regard, I agree with the comments of Phillips:

> "Public utilities...cannot spend freely and expect all expenditures to be included as allowable operating expenses. In effect, this means the commissions are permitted to question both the judgment and integrity of management. And if rates must be high enough to yield sufficient revenue to cover all operating expenses, the consumer has the right to expect that such expenditures will be necessary and reasonable.
>
> "At the same time, managerial good faith is presumed. Public utilities must be given the opportunity to prove the necessity and reasonableness of any expenditure challenged by a commission (or intervenor). To justify an expenditure, a company must show that the expense was actually incurred (or will be incurred in the near future), that the expense was necessary in the proper conduct of its business or was of direct benefit to the utility's rate payers, and that the amount of the expenditure was reasonable. Moreover, it must be emphasized again that a public utility may still spend its money in any way it chooses. Management's function is to set the level of expenses; the commission's duty is to determine what expense burden the rate payer must bear."

Question Nos. 7 and 8

> **"(7) Does the Board have jurisdiction to require a public utility to maintain**
>
> **(i) a ratio; or**
>
> **(ii) a ratio within a stated range of ratios**
>
> **of equity and debt, as the means of obtaining the capital requirements of the public utility.**
>
> **"(8) Does the Board, upon an application pursuant to Section 91 or otherwise, have the jurisdiction to require a public utility to obtain its capital requirements by the issue of specific financial instruments, whether common shares, preferred shares, stocks, bonds, debentures or evidence of indebtedness payable in more than one year."**

[125] These two questions will be considered together because the issues they raise are interrelated.

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[126] In theory, both the overall level of capitalization and the individual components of a utility's structure are of interest to regulatory boards. Clearly, if a utility is allowed to engage in financing practices which result in overcapitalization, the whole viability of the enterprise may be threatened with consequent impact on the delivery of service to the public.

[127] Furthermore, unlike in competitive conditions where the enterprise would not be able effectively to raise its prices over those of its competitors even if its costs of capital were excessive, overcapitalization of a regulated utility may well affect rates. That is because, in principle, rates must be set at such a level as to allow for recovery of the utility's costs, including its costs of capital, as well as a just and reasonable return. Overcapitalization, if uncontrolled, would increase the utility's costs and hence its rates. If the utility is not permitted to recover its costs in this regard it will, like any unregulated business, face bankruptcy with the consequence of disruption of service to customers. Overcapitalization may therefore indirectly put an upward pressure on rates to ensure the continued viability of the utility to enable service to be maintained. Alternatively, service may suffer.

[128] Arguably, the purpose of s. 91 of the **Act** is to enable the Board to control the risk of overcapitalization and its impact on the viability of the utility, or at least on its credit standing. By examining each proposed new security issue in advance, the Board has a chance of minimizing the adverse effects of overcapitalization before they occur.

[129] The composition of a utility's capital structure, that is, the mix of debt and equity, is also a matter that is necessarily of interest to regulatory boards.

[130] Because the costs of the individual components of a utility's capital structure, i.e. the embedded costs of debt and preference shares and the reasonable rate of return on common equity, are given a weighted cost, proportional to their share of the total capital structure, for the purpose of deriving a reasonable rate of return on rate base, the level of the actual proportional share of each component will necessarily have an effect on the result of the overall determination of a just and reasonable return on rate base. The

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makeup of the utility's capital structure can therefore influence that determination. [see footnote 87]

[131] Phillips [see footnote 88] expresses it this way:

> "...the traditional theory of business finance holds that the average cost of capital to a firm varies with the capital structure upon which it is based. The interest rate on debt is normally lower than the cost of equity capital. Consequently, within limits determined by such factors as the risk of a business, the overall cost may be somewhat lower when the debt-equity ratio is high than when the debt-equity ratio is low."

It is too simplistic, however, to say that in all cases, the higher the debt equity ratio, the lower will be the overall costs of capital. As deGrandpre [see footnote 89] points out:

> "It is often argued that if utilities increased their debt ratio, their cost of capital would be reduced since the cost of debt is less than the cost of equity. This may be true, but then the rate of return would have to be increased under the risk factor since the interest has to be paid before dividends and the investor might find himself deprived of dividends because of insufficient earnings."

The debt equity ratio can, therefore, have a complicated effect. What is undeniable, however, is that the debt-equity mix does have an effect on the rate of return. Hence, it is something which, in principle, should come within the regulatory umbrella in fulfilment of the policies of keeping the costs to consumers low and of ensuring a sound credit rating for the utility. The higher the cost of capital, the higher will be the return necessary to be awarded to the utility to enable it to maintain a sound credit rating in world financial markets. This would inevitably lead to higher rates, tolls and charges which would work against the policy of providing power to consumers at the lowest possible cost consistent with reliable service.

[132] From this, the Consumer Advocate and the Board itself argued that it is a necessary and appropriate power on the part of the Board to regulate the ratio of debt to equity in a utility's capital structure. Without such a power, the Board is limited, it was suggested, in its ability to ensure that sources and facilities for the production, transfer and distribution of power are managed and operated in a manner that would result in power being delivered to consumers at the lowest possible cost consistent with reliable service.

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[133] In like manner, it was argued that the Board has the power, as a necessary incident of the legislative scheme, to stipulate, from time to time, that a public utility must obtain its capital requirements by the issue of financial instruments of a specified nature.

[134] Granting that the level of overall capitalization and the composition of the capital structure of a utility are both matters of regulatory concern, at least insofar as they affect the utility's rate of return on rate base and hence the cost to consumers of the delivery of reliable service, the question to be determined is the degree of intrusion which the Board may undertake into the financial affairs of the utility. Can it be proactive and, as Question 7 suggests, "require" the utility to maintain a particular debt-equity ratio or, as Question 8 implies, "require" the utility to finance its activities in a particular way, or is it limited to passive disallowance of particular financing proposals either in the process of setting rates or in the course of other applications?

[135] In approaching these questions, it has to be remembered that there is no such thing as one ideal capital structure. It is a function of economic conditions, business risks and "largely a matter of business judgment" [see footnote 90]. Furthermore, a given capital structure cannot be changed easily or quickly. As well, the long-term effects of changes on capital structure on the enterprise and on the future cost of capital may not be easily predictable. Capitalization decisions also have other business dimensions that transcend the considerations relevant to the issues directly presented in the regulatory process.

[136] All of these considerations favour an approach that, in principle, should limit the degree of intrusion by the Board into the managerial control by the utility over financial decision-making. As emphasized earlier [see footnote 91] the powers of the Board should be generally regulatory and corrective, not managerial. A debate has nevertheless occurred over whether regulatory agencies can and should "fix" debt-equity ratios and restrict new financing techniques to specified types of instruments [see footnote 92]. Phillips notes that:

> "These methods, however, have limitations. For example, since the financial conditions of individual utilities vary, no one ratio of debt to equity is correct. The

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> refusal to approve a bond issue may lead to no issue at all, since, if a utility's earnings are insufficient to maintain its stock at par, it is in no position to issue more stock; bonds are the only way new capital can be raised. As a result of these problems, few commissions are willing to substitute their judgments for those of management..." [see footnote 93]

[137] An alternative to actual intrusion into the utility's financial affairs in the form of a direction as to how the enterprise should be structured is for the regulator, for the purpose of setting rates, to base its estimates of the cost of capital on a hypothetical appropriate capital structure, thereby disregarding the utility's actual capitalization [see footnote 94]. The justification for this approach is given by Phillips who, citing other authors, states:

> "Locklin has argued that most commissions 'disregard actual capital structures and set up an ideal or normal structure for the purpose. To do otherwise would burden the public with the higher costs of obtaining capital that result from a capital structure that is something less than ideal, and may, in fact, be quite unsound'. And Rose argues: 'When a commission in determining cost of capital disregards the actual capital structure or a capital structure proposed by management it is no more invading the domain of management than when it disregards unreasonable expenses for labor, fuel, or other productive factors in prescribing rates'." [see footnote 95]

It appears, however, that actual capitalization has also been used as a basis [see footnote 96]. Nevertheless, the arguments in favour of the ability of the Board to disregard the actual capital structure in an appropriate case and base its determinations upon a hypothetical structure are convincing. Indeed, this has occurred in Canada [see footnote 97]. Without such a power, the Board would not be able effectively to fulfil its mandate of promoting the delivery of reliable service to consumers at the lowest possible cost and at the same time maintaining a sound credit rating for the utility in the financial markets of the world. Having said that, in exercising that power, it goes without saying that the Board ought to have a healthy respect for managerial judgment [see footnote 98] in such matters since if a hypothetical capital structure is used that is too far off the mark of the actual structure, it may in practical terms make the utility unable to meet its actual commitments, thereby threatening its credit standing and possibly affecting service to customers.

[138] It is not necessary to go further, for the purpose of promotion of the objectives and policies of the legislation, and accord to the Board a power of actual intrusion into the

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capital structure of the utility. The distinction between actual intrusion and disallowance for rate making purposes is justified in the context of the existing legislation and enables the Board to respect the principle of general deference to managerial decisions.

[139] The question that remains is whether s. 91 of the Act, which is the only provision expressly dealing with the powers of the Board respecting capital structure, can be said, either expressly, or by necessary implication, to accord greater powers to the Board.

[140] On its face, s. 91 appears to be limited to a situation where the Board may approve or disapprove of a particular proposal from the utility for the issuance of a proposed form of securities. It is expressed in terms of a power of negative disallowance rather than positive direction.

[141] As noted previously [see footnote 99], s. 91 enables the Board to control the level of overall capitalization. Is that the only purpose for which a disallowance under s. 91 can be made? Obviously, an indirect effect of an approval or refusal of a particular security issue could be to affect the utility's future proposed debt-equity ratio and hence the composition of its capital structure. In practical terms, the power to disallow a specific proposal will enable the Board to exercise at the very least, by means of moral suasion in discussion, a degree of positive influence over total capitalization as well as capital structure. The power of disallowance under s. 91 may, in my view, be used, in appropriate cases, to further such objectives. Section 91(3) requires the Board, before approving a security issue, to be satisfied that it is in accordance with law and "for a purpose approved by the Board". Accordingly, so long as the power of approval or disallowance under s. 91 is exercised in a manner that is consistent with and in furtherance of any of the policies which the legislation was designed to serve, it will be within the jurisdiction of the Board to so act. In that way, the Board may influence the total level of capitalization as well as the particular debt-equity ratio. It does not, however, permit the Board to direct the utility to raise money in a particular way or to maintain a particular debt-equity ratio. In other words, it cannot be used as a springboard for an aggressive intrusion into the day to day financial and managerial decision making of the utility with respect to the capital structure of the

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enterprise. Nor can the general policies underlying the legislation justify such a power. As indicated, financing is undertaken for considerations that are not necessarily directly related to utility regulation. Furthermore, it has also been noted that, within the regulatory context, the utility is still subject to business risks and the effects of management decisions and the utility, other things being equal, ought to have the power to respond to that zone of risk. To that extent, the utility must be able to make financial decisions related to the overall health of the enterprise for reasons other than strictly regulatory ones, provided that in so doing it does not trespass on the objectives and policies of the legislation.

[142] Accordingly, while recognizing that a degree of influence over the utility's capital structure and over the choice of financial instruments to be used in financing the enterprise can be exercised by means of the powers conferred by s. 91 and the powers inherent in the regulatory scheme itself, the answers to Questions 7 and 8, insofar as the questions imply an ability to directly stipulate particular financing results, is, in each case, "no".

General Observations

[143] In answering the foregoing questions, it is worth emphasizing that the answers are given in terms of the jurisdiction of the Board. The fact that the Board may have jurisdiction, in the sense of legal power, to do something does not mean that, in a particular case, the power ought to be exercised. In the arguments which were presented on the hearing of the stated case, it was apparent that some of the positions taken by a party were being advanced out of a concern that if the jurisdiction was conceded, it would necessarily follow that the Board would exercise its power in a manner adverse to that party.

[144] The question of whether the Board should in fact exercise powers within its sphere of jurisdiction and the question of the manner in which those powers should be exercised raise very different considerations. It must always be remembered that, as has been emphasized throughout this opinion, the Board is charged with balancing the competing interests of the utility and the consumers of the service it provides. Neither set

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of interests can be emphasized in complete disregard of the interests of the other. Thus, in choosing to exercise a particular power within the Board's jurisdiction, the Board must always be mindful of whether, in so acting, it will be furthering the objectives and policies of the legislation and doing so in a manner that amounts to a reasonable balance between the competing interests involved.

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Opinion

[145] Pursuant to s. 101 of the **Act**, I would summarize my opinion on the questions posed as follows:

Question 1 (i) – Yes
Question 1 (ii) – No
Question 2 – Yes
Question 3(i) – Yes
Question 3(ii) – Yes
Question 3(iii) – Yes
Question 4 – Yes
Question 5 – No
Question 6 – Yes
Question 7 – No
Question 8 - No

I emphasize that inasmuch as the import of the answers given depends on my interpretation of the questions posed, it is necessary to read the answers in the context of the rest of this Opinion.

[146] Pursuant to s. 102, the Deputy Registrar of the court is directed to remit this Opinion to the Board.

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[147] **O'Neill, J.A.** [dissenting in part]: The Board of Commissioners of Public Utilities (the Board) is a statutory body existing under the provision of the **Public Utilities Act**, R.S.N. 1990, c. P-47, as amended (the Act).

[148] The general powers of the Board are set out in s. 16 of the **Act:**

> "The board shall have the general supervision of all public utilities, and may make all necessary examinations and inquiries and keep itself informed as to the compliance by public utilities with the law and shall have the right to obtain from a public utility all information necessary to enable the board to fulfil its duties."

[149] In addition to the powers and obligations given to and imposed on the Board by the Act, the Board has certain duties and powers under the **Electrical Power Control Act**, 1994, Chapter E-5.1, as amended and, by s. 4 of that **Act**, is specifically directed to "implement the power policy" of the Province, as set out in s. 3 of that **Act**, and in doing so to apply tests "which are consistent with generally accepted sound public utility practice".

[150] By s. 101 of the **Act**, the Board may, of its own motion, state a case in writing for the opinion of the court upon a question which in the opinion of the Board is a question of law.

[151] On August 14, 1996, the Board stated a case requesting the opinion of the court with respect to certain specific questions as set out therein. Following an application for directions, the court ordered that, inter alia, certain parties be notified of the proposed hearing. Subsequently Newfoundland Light & Power Co. Ltd., a utility, and "the Consumer Advocate" were granted status to appear and be heard at the hearing before the court.

[152] In its application to the court, the Board stated that in the course of a hearing before it, the submissions of various parties raised questions as to the jurisdiction of the Board under the **Act** and the Board thereupon stated a case for the court upon the following questions:

> "(1) Does the Board have jurisdiction pursuant to the **Act** to set and fix the return which a public utility may earn annually upon:
>
> (i) the rate base as fixed and determined by the Board for each type of service supplied by the public utility; and/or
>
> (ii) the investment which the Board has determined has been made in the public utility by the holders of common shares.
>
> "(2) Does the Board have jurisdiction to set the rates of return referred to in Question (1) as a range of permissible rates of return.

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"(3) Should a public utility earn annually a rate of return which is in excess of the rate of return determined by the Board to be just and reasonable, either on

> (i) the rate base as fixed and determined by the Board for each type of service supplied by the public utility; or
>
> (ii) the investment, which the Board has determined, has been made in the public utility by holders of common shares,

does the Board have jurisdiction to

> (i) require the public utility to use the excess earnings to reduce revenue requirements for the succeeding year; or
>
> (ii) require the public utility to place the excess earnings in a reserve fund for the purpose of adjusting rates, tolls and charges of the public utility at a future date; or
>
> (iii) require the public utility to rebate the excess earnings to customers of the public utility?

"(4) Does the Board have jurisdiction to order that the rates, tolls and charges of a public utility shall be approved taking into account earnings in excess of a just and reasonable return upon

> (i) the rate base as fixed and determined by the Board for each type of service supplied by the public utility, or
>
> (ii) the investment, which the Board has determined, has been made in the public utility by the holders of common shares,

in prior years.

"(5) Does the fact that the Board has advised the public utility that it is permitted to retain earnings in excess of the rate of return determined by the Board to be a just and reasonable return, upon the rate base as fixed and determined by the Board for each type of service supplied by the public utility, but not in excess of the return determined by the Board to be a just and reasonable return upon the investment which the Board has determined has been made in the public utility by the holders of common shares, affect the jurisdiction of the Board to approve rates, tolls and charges on the basis queried in Question (4).

"(6) Does the Board have jurisdiction to order the rates, tolls and charges of the public utility shall be approved taking into account the amount of expenses previously incurred by the public utility which the Board may now consider inappropriate to be allowed as reasonable and prudent and properly chargeable to operating account notwithstanding that such classes of expenses were allowed as reasonable and prudent and properly chargeable to operating account.

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"(7) Does the Board have jurisdiction to require a public utility to maintain

(i) A ratio; or

(ii) A ratio within a stated range of ratios

of equity and debt, as the means of obtaining the capital requirements of the public utility.

"(8) Does the Board, upon an application pursuant to Section 91 of the **Act** or otherwise, have the jurisdiction to require a public utility to obtain its capital requirements by the issue of specific financial instruments, whether common shares, preferred shares, stocks, bonds, debentures or evidence of indebtedness payable in more than one year."

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Question #1

"(1) Does the Board have jurisdiction pursuant to the Act to set and fix the return which a public utility may earn annually upon:

(i) the rate base as fixed and determined by the Board for each type of service supplied by the public utility; and/or

(ii) the investment which the Board has determined has been made in the public utility by the holders of common shares."

[153] It may be useful to set out here the relevant parts of ss. 37, 70 and 80 of the **Act:**

"37.(1) A public utility shall provide service and facilities which are reasonably safe and adequate and just and reasonable.

"70.(1) A public utility shall not charge, demand, collect or receive compensation for a service performed by it whether for the public or under contract until the public utility has first submitted for the approval of the board a schedule of rates, tolls and charges and has obtained the approval of the board and the schedule of rates, tolls and charges so approved shall be filed with the board and shall be the only lawful rates, tolls and charges of the public utility, until altered, reduced or modified as provided in this Act.

"80.(1) A public utility is entitled to earn annually a just and reasonable return as determined by the board on the rate base as fixed and determined by the board for each type or kind of service supplied by the public utility but where the board by order requires a public utility to set aside annually a sum for or towards an amortization fund or other special reserve in respect of a service supplied, and does not in the order or in a subsequent order authorize the sum or a part of it to be charged as an operating expense in connection with the service, the sum or part of it shall be deducted from the amount which otherwise under this section the public

> utility would be entitled to earn in respect of the service, and the net earnings from the service shall be reduced accordingly.
>
> "(2) The return shall be in addition to those expenses that the board may allow as reasonable and prudent and properly chargeable to operating account, and to all just allowances made by the board according to this **Act** and the rules and regulations of the board.
>
> "(4) The board may use estimates of the rate base and the revenues and expenses of a public utility."

[154] In the past, the Board has ordered that a just and reasonable return for a utility is "determined" to be between two stated percentages of its annual rate base for a test year, and ordered the utility to file, for examination by the Board, a schedule of rates, tolls and charges which will comply with the Board's determination, and, if so found to comply, approval is granted for those rates, tolls and charges.

[155] The rate base is arrived at by calculating the utility's net investment in plant and equipment required for the rendering of the regulated service.

[156] While not having fixed the return which the utility may earn, the Board has, in its orders, directed that a utility establish an "excess revenue reserve" into which revenue exceeding a certain rate of return on equity is to be deposited.

[157] The Board, in its order dated December 4, 1991, having fixed the average rate base for Newfoundland Power for the year 1992, and having determined a just and reasonable return for Newfoundland Power on its average rate base for that year, noted that that return would provide an opportunity for it to earn a somewhat higher rate of return on common equity:

> "A just and reasonable return for [Newfoundland Power] is determined to be between 10.96% and 11.19% on its average rate base for 1992, which will provide an opportunity to earn a rate of return on common equity between the range of 13.00% to 13.50%."

[158] The Board's position before the court was that since what is a just and reasonable return on rate base is influenced by the proportion of the various financing components, including long term and short term debt and preferred shares, it is imperative that the Board be able to set and fix the return which the holders of the common shares in

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the utility may earn since the market conditions for debt could alter the return to the holders of the common shares significantly.

[159] Although s. 80 does not specifically provide for a rate of return for common shares, the determination of a rate of return on the common shares of a utility is very much a part of the rate making process. Further, it must be noted that by s. 3 of the **Electrical Power Control Act**, the policy of the Province is declared to be that the rates to be charged, either generally or under specific contracts, for the supply of power within the Province "should provide sufficient revenue to the producer or retailer of the power to enable it to earn a just and reasonable return as construed under the **Public Utilities Act** so that it is able to achieve and maintain a sound credit rating in the financial markets of the world...".

[160] For Newfoundland Power it was argued that the Board has the jurisdiction to determine the just and reasonable return on the rate base and, as part of that process, the jurisdiction to determine the return on common equity, it being one of its sources of funds. I see no distinction between "determine" and "set and fix" insofar as the jurisdiction of the Board here is concerned. The calculations and projections made by the Board in arriving at the rate of return, whether specifically on rate base or the return on common equity, involve by their very nature, looking into the future, estimating as best can be done the revenues and expenditures contemplated for the utility's operations, the costs of money which may vary substantially, up and down, and then to fix a rate base, and a just and reasonable return on that base upon which the rates, tolls and charges will be based and approved.

[161] Although the Board is supplied on a regular basis and has the authority to demand all the financial information it requires of a utility, the rates are, in effect, established for relatively long periods, (in excess of one year) and the likelihood of the accuracy of the forecasts which are necessarily made in setting the rate base and the rates of return is somewhat diminished.

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[162] For the Consumer Advocate it was argued that s. 80(1) only gives the Board the jurisdiction to calculate the rate of return on rate base and does not allow a calculation of what return the common equity shares will have.

[163] As noted earlier, common shares constitute one of the components of the financial make-up of a utility and, as argued by counsel for the Board, while, theoretically, the Board only determines a just and reasonable return on the rate base as fixed and determined by it, in a practical sense, the return on common equity must be considered as part of the mix in setting the return on rate base, just as are the rates of interest paid on preferred shares, bonds and other financial obligations.

[164] In the result, in my opinion, questions l(i) and l(ii) should be answered in the affirmative.

Question #2

"Does the Board have jurisdiction to set the rates of return referred to in question (1) as a range of permissible rates of return?"

[165] There is no question but that the rate setting process of the Public Utilities Board is prospective and is performed by the Board's making estimates of the myriad of factors which have to be considered. The problem is exacerbated by the fact that the process is not one which is contemplated to be reviewed regularly or on a short term basis. The meaningful interpretation of the word "return" as it appears in s. 80(1) allows for and, in the circumstances, contemplates a range of rates of return. It follows then that a just and reasonable return, though it may be stated as a fixed percentage, may be a range of rates which is determined to be just and reasonable. In making such a determination, the Board is clearly acting within its jurisdiction. As noted earlier, a consideration of a just and reasonable return on common equity as one of the components of the financial investment in the company is a necessary part of the process of arriving at a just and reasonable return on rate base, and this return may also be stated as a range.

[166] I would answer question 2 in the affirmative.

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Question #3

"Should a public utility earn annually a rate of return which is in excess of the rate of return determined by the Board to be just and reasonable, either on:

> **(i) the rate base as fixed and determined by the Board for each type of service supplied by the public utility; or**
>
> **(ii) the investment, which the Board has determined has been made in the public utility by holders of common shares,**

does the Board have jurisdiction to

> **(i) require the public utility to use the excess earnings to reduce revenue requirements for the succeeding year; or**
>
> **(ii) require the public utility to place the excess earnings in a reserve fund for the purpose of adjusting rates, tolls and charges of the public utility at a future date, or**
>
> **(iii) require the public utility to rebate the excess earnings to customers of the public utility?"**

[167] Under s. 69 of the Act, the Board has very broad powers including requiring a public utility to set aside from earnings monies in a depreciation account and creating and maintaining a reserve fund. Section 69 of the **Act** is as follows:

> "69.(1) A public utility, if so ordered by the board, shall, out of earnings, set aside all money required and carry it in a depreciation account.
>
> "(2) The depreciation account shall not, without the consent of the board, be spent otherwise than for replacements, new constructions, extensions or additions to the property of the company.
>
> "(3) The board may by order require a public utility to create and maintain a reserve fund for a purpose which the board thinks appropriate, including the improvement of the public utility's status as a borrower or seeker of funds for necessary maintenance or expansion of its operations.
>
> "(4) The board, in a case where it has made an order which has the effect of increasing a public utility's revenues, may require the public utility to refrain from distributing as dividends until further order the whole or a part of the extra revenue which is in the board's opinion attributable to the order."

[168] The answer to the question also requires a consideration of the powers of the Board as set out in ss. 58 and 59 of the **Act**.

[169] By ss. 58 and 59, the Board may prescribe the form of all books of account and records to be kept by the public utility and to make its returns to the Board on such forms

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as may be prescribed by it. By s. 59, unless otherwise ordered by the Board, the utility shall close its accounts at the end of each calendar year and shall file with the Board its balance sheet, together with such other information as may be required by the Board, before April 2nd of the year following. In effect, approximately three months after the close of the utility's financial year, the Board is made aware of the exact financial position of the company at the end of the previous year and of any other information which it may require.

[170] It will be seen from s. 69(3) that the Board has the power to direct a utility to set up reserves out of revenue to be used for replacement of equipment, new construction, extensions or additions to the property of the company. As well, reserves may be ordered to be created which would have the effect of "improving the status of the utility as a borrower or seeker of funds for necessary maintenance or expansion". There is a further power which comes to the Board from s. 69(4) and that is to require the utility to set up a reserve of monies which may have been in excess of those anticipated by the Board at the time of setting the rate of return and to prevent the distribution of that money or any part of it as dividends until the further order of the Board.

[171] In the setting of rates, the Board is looking into the future and addressing the anticipated revenues and expenses of the utility with the many variables which may occur. It follows then that it must have the authority to anticipate that there will be variations from what was forecast. While the rates, tolls and charges are set following a hearing and only by an order following a hearing, the constant reporting which a utility must make to the Board allows the Board to be kept informed as to the financial operations of the utility and, in the result, to be aware of how these revenues and expenditures affect the rate of return anticipated by the Board and set out in its order. At the same time, as stated earlier, the rate of return on rate base and on common equity are set not as specific percentages but as a range.

[172] In order P.U. 6-1991, the following appears at p. 56:

> "The applicant has applied for a rate of return on common equity in the range of 13.5% to 14.0%, with rates set at 13.75%. The midpoint of the range was chosen

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since it is consistent with past practice and gives the Company the motivation to strive for a higher range (up to 14.0%) while giving them an opportunity to remain within the range if they are unable to come in on forecast (i.e. earn 13.5%)."

And later at p. 72:

"The Board orders a range of 13.00% to 13.50% be adopted as the Company's rate of return on common equity with rates being set at the mid-point of the range, 13.25%. In the opinion of the Board this will give [Newfoundland Power] the opportunity to earn a fair and reasonable return and will increase [Newfoundland Power's] interest coverage in 1992 to 2.87 times.

"The Board believes that [Newfoundland Power's] interest coverage in 1991 of 2.81 times at existing rates, which is an increase from 2.7 times in 1990, together with the increase to 2.87 in 1992 is satisfactory."

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[173] In my view, when rates, tolls and charges are set, the revenues generated belong to the company. If the net revenues are less than forecast and result in a return on rate base or on common equity less than as set out in the Board's order, then that loss is the company's loss. Revenues which are greater than anticipated belong to the company and any revenues in excess of those forecast by the Board as reflected in its order belong to the company and cannot be used, except as discussed in the following paragraph, to reduce the revenues of the utility in the future.

[174] I see nothing to preclude the Board's directing that those revenues of a utility in excess of the top of the range allowed by the Board in its order as a return on common equity, be set aside and maintained in a reserve fund by an order of the Board, as contemplated by s. 69 "for a purpose which the [B]oard thinks appropriate, including the improvement of the public utility's status as a borrower or seeker of funds for necessary maintenance or expansion of its operations". I do not view any revenues of a utility in excess of those required to achieve the higher point of the range of return either on rate base or on common equity as becoming excess funds unless and until they are set aside by an order of the Board as authorized by s. 69. Until such order, these funds remain the property of the utility and may be treated as such. The creation of a reserve fund is a power given to the Board to be exercised as it sees fit. Indeed, s. 69(4) gives the Board the authority to "require the utility to refrain from distributing as dividends until further order the whole or a part of the extra revenue which is in the [B]oard's opinion, attributable to the

order". Indeed, it may happen from time to time that circumstances may so change following the making of an order that a utility may need to and may actually earn revenues in excess of those contemplated by the Board when the last order was issued.

[175] It follows from what I have said that the Board does not have the power to order rebates to the customers of the utility other than out of such a reserve fund. To order a rebate from revenues other than those which have been placed in a reserve fund and, in that sense, not available to the company directly, would be to make a retroactive order. A sufficiently good reason for this is that just as additional billings are not permitted to be made to customers because of revenues which have fallen below the range set when the order was made, so any additional revenues may not be paid out. The role of rate making is prospective and this in itself in my view would preclude any reaching back.

[176] Reference should also be made to s. 80(1) which in my view contemplates, by the use of the words "earn annually", that each year becomes a separate unit and the revenues from one year may not be applied to another year so as to effect any change in the financial makeup of the utility, except through the use of the reserve fund, which, on its creation by order of the Board, has the effect of removing funds from the particular financial year affected by the order of the Board creating or ordering the placing of funds in the reserve fund and, in effect, makes those monies unavailable for the general use of the utility, including the payment of dividends to the holders of common equity.

[177] I would answer question 3(i) in the negative, 3(ii) in the affirmative and 3(iii) in the negative.

Question #4

"Does the Board have jurisdiction to order that the rates, tolls and charges of a public utility shall be approved taking into account earnings in excess of a just and reasonable return upon,

(i) the rate base as fixed and determined by the Board for each type of service supplied by the public utility; or

(ii) the investment which the Board has determined has been made in the public utility by the holders of common shares,

in prior years?"

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[178] Although the Board's jurisdiction is to fix and determine a rate base which will enable the utility to earn annually a just and reasonable return on that rate base, it follows that, depending on the range settled upon by the Board in its order and considering that the rates, tolls and charges are set using the mid-point of that range as a basis, the utility may, from time to time, record net revenues which are less than or more than that contemplated by the range as set. Although the wording of s. 80 of the **Act** states that the utility is entitled to earn a just and reasonable return, it does not follow that it may not nor should not have revenues in excess of those contemplated. At the same time, for reasons which may be beyond the complete control of the utility, the revenues received might be substantially below those anticipated when the rates, tolls and charges were set and approved.

[179] In my view, the Board cannot set rates, as argued by counsel for the Board, in a manner that would compensate for prior "excess" earnings. At the same time, in setting rates, as it must do prospectively, the Board must be alive to the various factors which may have caused the utility in any previous year to earn more or less than that anticipated by the Board in its order, and it must factor those causes into the percentages and ranges for return on rate base and for return on common equity in future orders.

[180] I would answer question 4 in the negative.

Question #5

> **"Does the fact that the Board has advised the public utility that it is permitted to retain earnings in excess of the rate of return determined by the Board to be a just and reasonable return, upon the rate base as fixed and determined by the Board for each type of service supplied by the public utility, but not in excess of the return determined by the Board to be a just and reasonable return upon the investment which the Board has determined has been made in the public utility by the holders of common shares, affect the jurisdiction of the Board to approve rates, tolls and charges on the basis queried in Question 4."**

[181] Counsel for the Board argued that the authority of the Board to amend, alter or rescind any order made by it is plenary and the Board has full power to reconsider any order made previously by it, notwithstanding that there is a right of appeal in respect of its decisions on questions of law. Further, he argued that the fact that the Board has

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previously ruled or ordered a particular basis for the calculation of excess revenue does not preclude the Board from considering the effect of such earlier decisions in determining what revenues will be required by the utility in setting new rates based on a just and reasonable return in accordance with a new method of calculation.

[182] Counsel further argued that since there is no fixed term for the continuing application of any approved rates, tolls or charges, the Board is not precluded from altering its previous order and assessing what is a just and reasonable return based upon its current assessment of the utility. Counsel argued that s. 87(1) of the **Act** clearly sets out that power:

> "87.(1) Where upon an investigation the rates, tolls, charges or schedules are found to be unjust, unreasonable, insufficient or unjustly discriminatory, or to be preferential or in violation of this Act, the board has power to cancel those rates, tolls, charges or schedules and declare void all contracts or agreements, either oral or written, dealing with them upon and after a day named by the board, and to determine and by order substitute those rates, tolls or schedules that are reasonable."

[183] The investigation undertaken under s. 87(1) follows upon a complaint made to the Board as set out in s. 84(1) and following upon the procedures set out in ss. 85 and 86 of the **Act**.

[184] The legislation empowers and indeed directs the Board to conduct a constant monitoring of the financial position of the utility and gives the Board the authority to institute a correction process at any time. It does not, in my opinion follow, as argued by counsel for the Board, that the Board in setting new rates, tolls and charges may take into account earnings of the utility in previous years in excess of a just and reasonable return upon the rate base or upon the investment which the Board has determined has been made in the public utility by the holders of common shares. This is so notwithstanding that the Board has previously ordered or advised a utility that it is permitted to retain earnings in excess of the rate of return determined by the Board to be a just and reasonable return upon the rate base as fixed and determined by the Board where not in excess of the return determined by the Board to be a just and reasonable return upon the investment made by the holders of common shares.

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[185] Counsel for the utility argued that the Board does not have jurisdiction to order that the rates, tolls and charges shall be approved taking into account earnings in excess of a just and reasonable return, either on rate base or on common equity, in prior years. Counsel further argued that such a power would "constitute retroactive appropriation of past revenues for future purposes". He further argued that the only mechanism available to the Board, where a utility earns in excess of the rate of return on rate base or on common equity, is to require the utility to deposit excess revenue, as defined by the Board, into a reserve account in the year earned. It is then, he argued, that the Board may approve the application of these funds as revenue in determining the rates, tolls and charges for a future period but any funds not ordered to be deposited in the reserve account are funds of the utility, belong to the utility, and cannot be considered in setting future rates. To do so, he argued, would be to change the system of accounts so that funds which were not excess in a previous year will then become excess and be brought forward - a retroactive order which is beyond the jurisdiction of the Board.

[186] For the Consumer Advocate it was argued that although the Board had advised the utility that it was permitted to retain earnings in excess of the rate of return as determined by the Board, it is not precluded from later making an order under s. 80(1) and s. 76 of the **Act** rescinding, altering or amending any existing order and in declaring these earnings as excess revenue. The Consumer Advocate also argued that in light of its position taken in response to question 4, the Board does not have jurisdiction to order that the "excess revenue" earned in previous years by the utility should be taken into account in setting rates, tolls and charges in subsequent years but that the Board must order that it be rebated to customers of the utility.

[187] I agree with the position taken by the utility. I would answer question 5 in the negative.

Question #6

"Does the Board have jurisdiction to order the rates, tolls and charges of the public utility shall be approved taking into account the amount of expenses previously incurred by the public utility which the Board may now consider inappropriate to be allowed as reasonable and prudent and properly

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chargeable to operating account notwithstanding that such classes of expenses were allowed as reasonable and prudent and properly chargeable to operating account.".

[188] The example given by the Board in its factum illustrative of the situation giving rise to question 6 is as follows:

> "In determining in 1991 what was a just and reasonable return on the basis of projections for test year, 1992, the Board was presented with projections for the future cost of operating expenses including advertising. The actual cost of advertising for 1995 exceeded the projection for 1992 by some $314,000.00. As such, the amounts for advertising contemplated by the Board as being reasonable, prudent and properly chargeable to operating account vary significantly for the year 1995 from the estimate upon which the Board determined a just and reasonable rate of return."

[189] Counsel for the Board argued that "the circumstances of a significant increase in expenses over the estimates used for the test year is indistinguishable from the circumstances of an increase in net earnings. For the same reasons as advanced by it in question 5, it argued that the Board had jurisdiction to order that the rates, tolls and charges could be approved taking into account these expenses, previously incurred, but now considered inappropriate to be allowed as reasonable and prudent.

[190] For the utility, it was argued that once rates, tolls and charges are set, the resulting revenue belongs to the utility except for any amounts which the Board may order to be deposited into an excess revenue account. Further, although the Board has the authority to determine whether the expenses comply with s. 80(2), which jurisdiction is necessary to ensure the integrity of the excess revenue account, the Board does not have jurisdiction to disallow the amount of any operating expense which is reasonable or which had previously been allowed as a just allowance. Further, it argued that the Board may not disallow an expense because it is of the opinion that had it been the manager, it would not have made that expenditure. The question is whether the expenditure is one that could have been made by a reasonable and prudent manager.

[191] The utility further argued that there should be no "microscopic review" especially with the benefit of hindsight. Counsel argued that the Board makes its annual review of the returns made by the utility and, in the specific example here, the Board had obviously

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made the decision that that expense, although it exceeded predictions, was reasonable (or at least the fact that it didn't say anything about it would indicate that it was reasonable). That expense should not, except in very rare circumstances, be later held to be unreasonable. The utility's position was stated in its factum as follows:

> "The Board does not have jurisdiction to order that rates, tolls and charges shall be approved taking into account the amount of such 'disallowed' expenses. The Board's jurisdiction is limited to disallowing expenses which it determines not to be 'reasonable and prudent and properly chargeable to operating account' or otherwise not a 'just allowance' under s. 80(2). The disallowance of an expense would lead to the company earning a somewhat greater return on common equity for the purpose of the excess revenue account for the year in which the expense was incurred. However, this revenue remains the property of the company and its shareholders unless the amount disallowed would mean that the company's return on common equity would exceed the maximum return on common equity previously allowed by the Board. If that were to occur, the amount which would be beyond the maximum return on common equity would be deposited into the 'excess revenue account'."

[192] For the Consumer Advocate, it was argued that the Board may take into account past expenses in order to forecast more accurately future revenues and expenditures. However, its counsel argued that the Board does not have jurisdiction to set future rates, tolls and charges designed to compensate for past expenses that the Board may now consider inappropriate to be allowed as reasonable and prudent and properly chargeable to operating account.

[193] I agree with the arguments proferred by the utility and the Consumer Advocate.

[194] I would answer question 6 in the negative.

Questions #7 & 8

Question #7

"Does the Board have jurisdiction to require a public utility to maintain:

(i) A ratio; or

(ii) A ratio within a stated range of ratios

of equity and debt, as the means of obtaining the capital requirements of the public utility."

Question #8

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"Does the Board, upon an application pursuant to Section 91 or otherwise, have the jurisdiction to require a public utility to obtain its capital requirements by the issue of specific financial instruments, whether common shares, preferred shares, stocks, bonds, debentures or evidence of indebtedness payable in more than one year."

[195] In his decision which I have read in draft, Green, J.A., considered questions 7 and 8 together because, as he stated, the issues they raise are interrelated. I agree with the reasoning of Green, J.A., in dealing with these questions and I would answer both questions, as he did, in the negative.

[196] I would also agree with the comments made by Green, J.A., in that part of his decision, entitled "General Observations".

Conclusion

[197] In the result then I would answer the questions posed as follows: 1(i) yes, 1(ii) yes, question 2 - yes, question 3(i) - no, question 3(ii) - yes, question 3(iii) - no, question 4 - no, question 5 - no, question 6 -no, question 7 - no, and question 8 - no.

Order accordingly.

Footnotes

1. R.S.N. 1990, c. P-47 as amended (hereinafter the “**Act**”)

2. **Act**, s. 16

3. **Act**, s. 70

4. **Act**, s. 80

5. Board Orders P.U.6 (1996) and P.U.7 (1991)

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