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A Rock and a Hard Place

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Cases Considered:

ATCO Gas and Pipelines Ltd. v. Alberta (Energy and Utilities Board), 2009 ABCA 171

In its 2006 decision in *ATCO Gas and Pipelines Ltd. v. Alberta (Energy and Utilities Board)*, 2006 SCC 4, the Supreme Court of Canada held that the Alberta Energy and Utilities Board (EUB, now the Alberta Utilities Commission) had no jurisdiction to allocate proceeds on the sale of a utility asset to ratepayers where the sale of that asset resulted in no harm to ratepayers in terms of either rates or service. For a bare majority of the Court, Justice Bastarache held that the rights to assets rest without qualification with the utility.

As I have commented elsewhere (""Practical Necessity" or "Highly Sophisticated Opportunism"? Judicial Review and Rate Regulation After *ATCO Gas and Pipelines Ltd. v. Alberta (Energy and Utilities Board)*" (2006) 44 Alta. L.R. 445) this decision has created a significant problem for the EUB. The decision relies on the premise that utility companies bear the risk of loss associated with the ownership of assets included in rate base. In fact utilities have always been shielded from losses associated with asset ownership. There are a number of reasons for this. Most significantly, the EUB does not review assets in rate base to see if they still meet the standard for inclusion - such that an asset that has lost value and is no longer (or never was) used or useful for utility service, can remain in rate base earning a rate of return. This creates an obvious incentive for speculation/advantage-taking behaviour. A utility can purchase an asset with some connection to utility service. Once it is included in rate base, the utility can earn a rate of return on the asset until it is fully depreciated, retired or sold. If the asset loses value, the utility can leave the asset in rate base and earn the rate of return. If the asset gains value, the utility can sell the asset and retain the proceeds. Either way, the utility wins. Prior to the 2006 SCC decision this problem was avoided by not permitting the utility to keep the full proceeds of disposition when an asset was sold, thereby dampening the incentive effect. After the 2006 decision that approach to the problem was no longer available.

In a variety of subsequent decisions relating to asset disposition the EUB has attempted to address the incentive problem. It has, to this point, been wholly unsuccessful. The decision of the Court of Appeal in *ATCO Gas and Pipelines Ltd. v. Alberta (Energy and Utilities Board)* 2009 ABCA 171 represents its latest failure. In that case ATCO had purchased property within the City of Calgary in 1993 for $43,500. The majority of the land "was vacant and never actually

used for utility purposes" (para. 2). Nonetheless, it was kept in rate base, and ATCO earned a rate of return on the land from 1993 on. In 2007 ATCO accepted an offer of $1.85 million for the land. It sought approval for the sale from the EUB (as required by governing legislation) and further sought to retain the entirety of the proceeds it was to receive. The EUB recognized that the sale of the land would not harm the ratepayers in terms of rates and services (in fact rates would have decreased). Nonetheless, it ordered the proceeds held in a deferral account pending the next general rate application for ATCO. The EUB's position seems to have been that while at this time the land was not used or required to be used, ATCO had acknowledged that in 5 years it might need to purchase land proximate to this location (within 4-5km) for utility purposes. The EUB wanted to consider, in the broader context of a general rate application, whether given this fact it was appropriate for the proceeds to be used to offset that later land acquisition. The funds were ordered placed in a deferral account pending this consideration.

ATCO appealed this decision to the Court of Appeal, which in a 2-1 decision allowed the appeal. The Court applied a standard of correctness to the first question before it, namely whether the EUB had the jurisdiction to confiscate proceeds from the sale. It did so based on precedent and the nature of the question. A majority of the Court (Justices Frans Slatter and Patricia Rowbotham) held that given the 2006 SCC decision it was absolutely clear that the EUB did not have the requisite jurisdiction. The assets "were once legitimately included in the rate base." Now, however, the assets are no longer needed to provide service, are appropriately removed from rate base, and any profit should accrue to the utility (para. 29). "That there might have been some delay in removing the surplus lands from the rate base does not affect the analysis" (para. 14).

On the second question, the ability of the EUB to impose the condition, the majority imposed a reasonableness standard, again based on precedent and the nature of the question. The majority found that there was no basis for imposing a condition in this case. The fact that future land may need to be purchased does not constitute harm: "Merely because the utility has plans to spend funds on capital assets in the future cannot be 'harm' in any logical sense" (para. 32). The majority rejected the relevance of the need for symmetry in risk and reward between ratepayers and the utility, saying that "[t]his reasoning fails to recognize that it is the shareholders who bear the risk of loss as well as the profit" (para. 33). On the question of speculation the majority concluded that while "this may be a valid concern in other circumstances, there was absolutely no evidence to suggest that ATCO was engaged in real estate speculation when it purchased the Harvest Hills lands" (para. 34). Finally, the majority held that the conditioning power recognized by Bastarache J. was of no assistance to the EUB here. There was an insufficient connection between the "sale of the asset and the immediate resulting need to replace it" (para. 35).

Berger J.A. dissented. In essence, he felt that the actions of the EUB fell within the conditioning powers approved by Bastarache J. in the 2006 *ATCO* decision. It made a factual determination about harm, and about the asymmetry of risk, that were relevant and supported its decision:

> The Board was mindful that ATCO had relied on s. 37 of the GUA [*Gas Utilities Act*, R.S.A. 2000, c. G-5] to include all of the Harvest Hills property in the rate

> base because it was "required to be used to provide a service to the public." ATCO should have removed the four acre parcel from the rate base long before it was declared to be "surplus lands". It did not. Consumers paid more than they should (para. 45).

In sum, the disposition "was squarely within the jurisdiction of the board…and enjoyed ample support in the factual underpinnings proffered by the party" (para. 47).

This decision represents the dilemma created by the 2006 SCC decision in acute form. ATCO purchases an asset. It doesn't use the bulk of it, but uses enough to warrant inclusion in rate base. It leaves the asset in rate base for 14 years, earning a rate of return on it. When the market is favourable it seeks to sell the asset. Presumably, if the market had been unfavourable, it would have left the asset in rate base. The Court of Appeal says this is not speculation. I am not sure how the Court of Appeal defines speculation. If it thinks speculation means by necessity that you purchase an asset solely for speculative purposes, then perhaps this was not speculation. But if speculation means that you try to use the incentives of utility rate structures to prevent all chance of loss, and to maximize your chance of reward, then it seems to me that this was, incontrovertibly, speculation. And whatever word you use for it, it does seem the exact incentive problem that the allocation of proceeds to ratepayers was intended to correct.

It may well be that the reasons given by the EUB in this case are unconvincing. As the majority notes, the relationship between the future land purchase and the present land sale seems tenuous at best. However, the EUB did have a very real problem presented by ATCO's dealings with this land. ATCO may have purchased the land for sound utility service reasons, but by letting it act as it did, it and other utilities have just been given a tremendous incentive to purchase assets for unsound - or barely sound - reasons, with the knowledge that if the asset is included in rate base they have zero downside risk, and the possibility of tremendous upside benefit.

What can the EUB - more accurately, its successor the Alberta Utilities Commission (AUC) - do? It seems to me that what it must do is stop trying to address this problem at the point of asset disposition, and start addressing it at the level of rate base. It needs to heighten the scrutiny given to assets that the utility applies to put in rate base. And it needs to develop some mechanism for reviewing the assets currently included in rate base and removing assets that are no longer required to be used for utility service, imposing any loss associated with those assets solely on the utility.

Ideally, though, this problem would be resolved through legislative amendment. The old solution of dealing with the asymmetry of risk and reward at the point of asset disposition was efficient. It did not involve costly reviews of rate base, but allowed for a kind of rough justice through which the utility's incentive to sell high value assets was blunted but still real (especially for non-depreciable assets), while at the same time ensuring that it could remove low value assets from rate base without undue loss. It meant, in other words, that the utility was allowed appropriate autonomy in its business management while not allowing the ratepayers to be unduly harmed or disadvantaged by how it did so. Under the current system, no protection for ratepayers exists.

Under a more rigorous regulation of rate base inclusions and exclusions, the utility loses its management autonomy. Neither solution is desirable.

I understand where the majority comes from on this issue, the sense of unfairness in having a private business disentitled from the profits arising from sale of its assets. But until such time as the AUC can change how it deals with rate base, I do urge the Court to become more aware of the reality of the structure of utility rate regulation. The continued statement that the utility bears the "risk of loss" associated with its asset (para. 33) - although perpetuated by the SCC - is false, as this case clearly shows. ATCO did not need the asset but it kept earning a rate of return on it. There was no "risk" with the ownership of that asset for the utility at all and whatever the court decides, it at least owes ratepayers - who, after all, are all of us - the responsibility to cease asserting that there is such a risk.