October 9, 2015

Methodological Pluralism: Canadian Utility Law Does Not Prescribe any Particular Prudent Expenditure or Prudent Investment Test that a Regulator Must Apply

By: Nigel Bankes

Case Commented On: *Ontario (Energy Board) v Ontario Power Generation Inc*., 2015 SCC 44, (*OPG*) and *ATCO Gas and Pipelines Ltd v Alberta (Utilities Commission)*, 2015 SCC 45 (*ATCO*)

The last two weeks of September 2015 saw the release of three important court decisions dealing with utility regulation, two from the Supreme Court of Canada, the *OPG* case and the *ATCO* case, and one from Alberta's Court of Appeal, the *Utility Asset Disposition* case (*UAD*): *Fortis Alberta Inc v Alberta (Utilities Commission)*, 2015 ABCA 295. The two Supreme Court cases (which were heard together) deal with a utility's opportunity to recover operating costs and the application of prudency tests to those costs. Justice Rothstein is the principal author of both judgments. The *ATCO case* is unanimous while Justice Abella offers a dissent in the *OPG* Case. The *UAD* case deals with what I have previously referred to as the continuing fall-out from the majority decision of the Supreme Court in *Stores Block* (*ATCO Gas and Pipelines Ltd. v Alberta (Energy and Utilities Board)*, 2006 SCC 4, [2006] 1 S.C.R. 140).

This post summarizes the holdings in the *ATCO* and *OPG* decisions and then offers some preliminary comments on their implications. The post begins with some general observations on utility regulation statutes. I will aim to do a separate post on the *UAD* case.

Utility Regulation Statutes

While there is some reason for thinking that there is a "common law of utility regulation" (see for example *Chastain et al. v B.C. Hydro & Power Authority* (1972), 32 D.L.R. (3d) 443, [1973] 2 W.W.R. 481 and *British Columbia Electric Railway Co. v Public Utilities Commission of British Columbia*, 1960 CanLII 44 (SCC), [1960] S.C.R. 837 (*BC Electric*)) it is also clear that any such common law concepts can be overridden by statute and that most utility law is indeed a creature of statute. This has the inevitable consequence that the applicable utility law in any particular case must be contingent on the details of the utility statute(s) in that jurisdiction (see *OPG* at paras 104 – 105).

It is thus important to begin by recognizing that provincial and federal utility statutes exhibit some diversity in approach across at least two different dimensions: rate-making methodology and policy considerations. As to the first, while some jurisdictions and statutes prescribe the methodology that a utility regulator must follow in order to set just and reasonable rates, other jurisdictions and statutes prescribe only the outcome i.e. that rates must be just and reasonable. It is evident that it will be very difficult to obtain judicial or appellate review of rate making decisions in these latter jurisdictions on the basis that the tribunal has failed to follow any particular methodology. The *National Energy Board Act*, RSC 1985, c. N-7 provides an example of this statutory approach. That statute simply provides that:

> 62. All tolls shall be just and reasonable, and shall always, under substantially similar circumstances and conditions with respect to all traffic of the same description carried over the same route, be charged equally to all persons at the same rate.
>
> 67. A company shall not make any unjust discrimination in tolls, service or facilities against any person or locality.

In a leading decision on the judicial supervision of the NEB's rate making authority *British Columbia Hydro and Power Authority v West Coast Transmission Company Ltd. et al.,* [1981] 2 F.C. 646 at 655-56 (C.A.) the Federal Court of Appeal commented as follows:

> There are no [prescriptive] provisions in part IV of the *National Energy Board Act*. Under it, tolls are to be just and reasonable and may be charged only as specified in a tariff that has been filed with the Board and is in effect. The Board is given authority in the broadest of terms to make orders with respect to all matters relating to them. Plainly, the Board has authority to make orders designed to ensure that the tolls to be charged by a pipeline company will be just and reasonable. But its power in that respect is not trammelled or fettered by statutory rules or directions as to how that function is to be carried out or how the purpose is to be achieved. In particular, there are no statutory directions that, in considering whether tolls that a pipeline company propose to charge are just and reasonable, the Board must adopt any particular accounting approach or device or that it must do so by determining cost of service and a rate base and fixing a fair return thereon.

Similarly, the jurisdiction of the Ontario Energy Board under s.78.1 of the *Ontario Energy Board Act, 1998* is to provide for just and reasonable payments.

Alberta utility statutes offer an example of a more prescriptive approach, at least with respect to the need to establish a rate base and the methodology for doing so. Thus, s.37 of the *Gas Utilities Act*, R.S.A. 2000, c. G-5 provides that:

> **37**(1) In fixing just and reasonable rates, tolls or charges, or schedules of them, to be imposed, observed and followed afterwards by an owner of a gas utility, the Commission shall determine a rate base for the property of the owner of the gas utility used or required to be used to provide service to the public within Alberta and on determining a rate base it shall fix a fair return on the rate base.
> (2) In determining a rate base under this section, the Commission shall give due consideration
> (a) to the cost of the property when first devoted to public use and to prudent acquisition cost to the owner of the gas utility, less depreciation, amortization or depletion in respect of each, and
> (b) to necessary working capital.
> (3) In fixing the fair return that an owner of a gas utility is entitled to earn on the rate base, the Commission shall give due consideration to all facts that in its opinion are relevant.

The *GUA* is less prescriptive in relation to other matters. This allowed Justice Rothstein in *ATCO* (*ATCO* at para 32) to conclude that the *GUA* did not impose a specific methodology for approving a utility's *revenue requirements*. Thus, s.36 of the *GUA* provides that:

> The Commission, on its own initiative or on the application of a person having an interest, may by order in writing, which is to be made after giving notice to and hearing the parties interested,
>
> (a) fix just and reasonable individual rates, joint rates, tolls or charges or schedules of them, as well as commutation and other special rates, which shall be imposed, observed and followed afterwards by the owner of the gas utility,
> (b) fix proper and adequate rates and methods of depreciation, amortization or depletion in respect of the property of any owner of a gas utility, who shall make the owner's depreciation, amortization or depletion accounts conform to the rates and methods fixed by the Commission,
> (c) fix just and reasonable standards, classifications, regulations, practices, measurements or service, which shall be furnished, imposed, observed and followed thereafter by the owner of the gas utility ….

For present purposes it is useful to note that the only reference to "prudence" or "prudent" in these sections (or indeed anywhere in the *Act*) is in s. 37(2)(a) in the context of the rate base. There is no reference to prudence in s.36 or in other sections dealing with the revenue requirements of a utility.

The *Electric Utilities Act*, S.A. 2003, c. E-5.1 takes a somewhat different approach. Section 121(2), like s.62 of *NEBA*, is concerned with the overall result. Thus the "Commission must ensure that"

> (a) the tariff is just and reasonable, [and]
> (b) the tariff is not unduly preferential, arbitrarily or unjustly discriminatory or inconsistent with or in contravention of this or any other enactment or any law ….,

But the *EUA* goes on in s.122 to instruct the Commission "to have regard" to "the reasonable opportunity to recover" principle and to a number of other factors:

> 122 (1) When considering a tariff application, the Commission must have regard for the principle that a tariff approved by it must provide the owner of an electric utility with a reasonable opportunity to recover
>
> (a) the costs and expenses associated with capital related to the owner's investment in the electric utility, including
>
> (i) depreciation,
> (ii) interest paid on money borrowed for the purpose of the investment,
> (iii) any return required to be paid to preferred shareholders of the electric utility relating to the investment,
> (iv) a fair return on the equity of shareholders of the electric utility as it relates to the investment, and

> (v) taxes associated with the investment,
>
> if the costs and expenses are prudent and if, in the Commission's opinion, they provide an appropriate composition of debt and equity for the investment,
>
> (b) other prudent costs and expenses associated with isolated generating units, transmission, exchange or distribution of electricity or associated with the Independent System Operator if, in the Commission's opinion, they are applicable to the electric utility,
> (c) amounts that the owner is required to pay under this Act or the regulations,
> (d) the costs and expenses applicable to the electric utility that arise out of obligations incurred before the coming into force of this section and that were approved by the Public Utilities Board, the Alberta Energy and Utilities Board or other utilities' regulatory authorities if, in the Commission's opinion, the costs and expenses continue to be reasonable and prudently incurred,
> (e) its prudent costs and expenses of complying with the Commission rules respecting load settlement,
> (f) its prudent costs and expenses respecting the management of legal liability,
> (g) the costs and expenses associated with financial arrangements to manage financial risk associated with the pool price if the arrangements are, in the Commission's opinion, prudently made, and
> (h) any other prudent costs and expenses that the Commission considers appropriate, including a fair allocation of the owner's costs and expenses that relate to any or all of the owner's electric utilities (emphasis added).

Again, for present purposes, it is important to emphasize (and this by contrast with the *GUA*) that there are multiple references to "prudence" and "prudently incurred" in this section, although as Justice Rothstein points out (*ATCO* at para 41) the words may be used differently in some of these paragraphs.

We can deal more quickly with the second variable which is that of public policy considerations. Here the principal divide in Canadian utility statutes is between energy utility statutes and telecommunication statutes. Generally, energy regulatory statutes do not expressly confer significant policy development and implementation functions on energy regulatory tribunals. That said such statutes may, for example, instruct the regulator to facilitate an energy market: see *OEBA*, s.1 and *EUA*, s.5. By contrast, federal telecommunications statutes have long conferred on the CRTC a significant role in developing and implementing Canada's telecommunications policy. This is particularly evident, for example, in the Supreme Court of Canada's decision in *Bell Canada v Bell Aliant Regional Communications*, 2009 SCC 40, [2009] 2 SCR 764.

Justice Rothstein begins both of his judgments with some general observations on the general regulatory framework. The discussions are similar. Justice Rothstein observes that both the OEB and the AUC must approve just and reasonable rates or the recovery of just and reasonable amounts. In both cases Justice Rothstein refers to the venerable authority of *Northwestern Utilities Ltd. v City of Edmonton*, 1929 CanLII 39 (SCC), [1929] S.C.R. 186 for the proposition that "fair and reasonable" rates are those "which, under the circumstances, would be fair to the consumer on the one hand, and which, on the other hand, would secure to the company a fair return for the capital invested" (*NUL* at pp. 192-93) (*OPG* at para 15 and *ATCO* at para 7). Justice Rothstein expands on this in *OPG* as follows (*OPG* at paras 16 and 17):

> This means that the utility must, over the long run, be given the opportunity to recover, through the rates it is permitted to charge, its operating and capital costs ("capital costs" in this sense refers to all costs associated with the utility's invested capital). This case is concerned primarily with operating costs. If recovery of operating costs is not permitted, the utility will not earn its cost of capital, which represents the amount investors require by way of a return on their investment in order to justify an investment in the utility. The required return is one that is equivalent to what they could earn from an investment of comparable risk. Over the long run, unless a regulated utility is allowed to earn its cost of capital, further investment will be discouraged and it will be unable to expand its operations or even maintain existing ones. This will harm not only its shareholders, but also its customers: *TransCanada Pipelines Ltd. v National Energy Board*, 2004 FCA 149 (CanLII), 319 N.R. 171.
>
> This of course does not mean that the Board must accept every cost that is submitted by the utility, nor does it mean that the rate of return to equity investors is guaranteed. In the short run, return on equity may vary, for example if electricity consumption by the utility's customers is higher or lower than predicted. Similarly, a disallowance of any operating costs to which the utility has committed itself will negatively impact the return to equity investors. I … observe that any disallowance of costs to which a utility has committed itself has an effect on equity investor returns. This effect must be carefully considered in light of the long-run necessity that utilities be able to attract investors and retain earnings in order to survive and operate efficiently and effectively, in accordance with the statutory objectives of the Board ….

ATCO

ATCO deals with an application of the ATCO group of companies (both natural gas and electric utilities) to have the Commission permit it to recover in approved rates from its customers, the costs associated with providing cost of living increases (COLA) which matched the consumer price index (CPI) up to a maximum of 3 per cent under a defined benefit pension plan which covered some of ATCO's employees. The Commission took the view that the pension plan did not require employers to fully match CPI increases up to 3 per cent and benchmark evidence suggested that other entities in the comparator group covered between 50 and 75% of CPI. Accordingly, the Commission concluded that recovery of 50% of annual CPI (up to a maximum COLA of 3%) would be reasonable. ATCO took the view that the Commission's decision was unlawful. The pension plan had been prudently concluded and as a result the Commission could not now preclude recovery under either the *GUA* for ATCO's gas utilities or the *EUA*, for ATCO's electric utilities. In reaching its conclusion the AUC did not expressly address whether or not the two statutes required it to apply a no-hindsight prudence review; but, as Justice Rothstein acknowledged (at para 33), the fact that it proceeded without doing so implies that it understood that the relevant statutes did not require it to do so.

The Court of Appeal declined to interfere with the AUC's decision and the Supreme Court of Canada granted leave.

The next sections examine the Court's treatment of the standard of review and then the prudence analysis.

Standard of Review

Relying on *Stores Block* and another post-*Stores Block* case (*ATCO Gas and Pipelines Ltd. v Alberta Utilities Commission*, 2009 ABCA 246, 464 A.R. 275) as well as *Shaw v Alberta Utilities Commission*, 2012 ABCA 378, 539 A.R. 315, ATCO argued that the question at issue was a jurisdictional issue and that the standard of review was correctness. It will be recalled that in *Stores Block*, the majority, per Bastarache J, made a distinction between the AUC's authority under s. 26(2) of the *GUA* to approve the disposition of utility assets and the general rate setting jurisdiction of the AUC (or more correctly the AUC's predecessor, the Energy Utilities Board). While Justice Bastarache seemed prepared to concede that the Court should be deferential to the regulator's jurisdiction to set just and reasonable rates (see *Stores Block* at para 30 and *ATCO* at para 27), the power of the regulator under s.26 to allocate the proceeds of sale on the disposition of assets should attract review (at least pre-*Dunsmuir*, *Dunsmuir v New Brunswick*, 2008 SCC 9, [2008] 1 S.C.R. 190) on a correctness basis. Justice Rothstein rejected the analogy between *Stores Block* and the issues arising here. The issues before the Court in this case involved ratemaking and did not involve a "true question of jurisdiction" even assuming that there are such questions (*ATCO* at para 27). Furthermore, (*ATCO* at para 28) the issues all turned on the interpretation of the AUC's home statutes as to which the standard of reasonableness presumptively applies: *Alberta (Information and Privacy Commissioner) v Alberta Teachers' Association*, 2011 SCC 61 (CanLII), [2011] 3 S.C.R. 654, at para 30.

The Prudence Analysis

As noted above, s.37 of the *GUA* contains one reference to prudence while s.122 of the *EUA* provides many references. As a matter of statutory interpretation (and referring, *ATCO* at para 34, to *Rizzo & Rizzo Shoes Ltd. (Re)*, 1998 CanLII 837 (SCC), [1998] 1 S.C.R. 27, at para 21) Justice Rothstein concluded (*ATCO* at para 34) that "the ordinary sense of the word is such that a prudent cost is one which may be described as wise or sound." But, given some variety in the dictionary definitions of the term, it was necessary to supplement that assessment with a contextual reading of the statutory provisions. This led Justice Rothstein to conclude (*ATCO* at para 35) that there really was no difference between prudence and reasonable:

> In the context of utilities regulation, I do not find any difference between the ordinary meaning of a "prudent" cost and a cost that could be said to be reasonable. It would not be imprudent to incur a reasonable cost, nor would it be prudent to incur an unreasonable cost.

While s.121 of the *EUA* used the term prudent in different ways, use of the term (*ATCO* at para 41) did not "imply a specific methodology" nor did the statute say "anything about the time at which prudence must be evaluated." Furthermore, since prudence and reasonableness could be equated, s.121(4) of the *EUA* which imposes on the utility the burden of proving that proposed tariffs were just and reasonable also extends to establishing that expenditures are prudent. A utility is not entitled to the benefit of a presumption of prudence with respect to its expenditures. Thus, regardless of whether the costs are operating or capital, prior incurred, committed or forecast, the utility has the onus. Much the same was true of the *GUA* which also (s.44(3)) imposes on the utility the burden of showing that proposed rates are just and reasonable and therefore also (*ATCO* at para 46) "the burden of establishing the prudence of costs". Thus (*ATCO* at para 47):

> …. the Commission is free to apply its expertise to determine whether costs are prudent (in the ordinary sense of whether they are reasonable), and it has the discretion to consider a variety of analytical tools and evidence in making that determination so long as the ultimate rates that it sets are just and reasonable to both consumers and the utility.

That said, it was still necessary to establish whether the Commission's application of its prudence analysis was reasonable (in the judicial review sense of that term). Here the Court noted the distinction between forecast and committed costs which it examined in *OPG* (see further discussion below) acknowledging that a no-hindsight prudence test might be appropriate in the case of committed costs (*ATCO* at para 48 and see also *ATCO* at para 65). But the distinction between forecast and committed costs may not always be clear and any assessment must take account of factual evidence as well as legal obligations (whether based on contract, fiduciary duty or regulatory obligations). The regulator's assessment of such matters is itself (*ATCO* at para 49) owed deference by the Court.

ATCO's final argument was that the AUC's decision was unreasonable insofar as it was motivated by the Commission's desire to protect customers from rate increases. The Court rejected that characterization of the AUC's decision and in so doing provided some useful guidance for future decisions. First, the Court emphasised that a regulator cannot deny recovery on the basis of rate shock. However, a regulator can "take into account the impact of rates in deciding *how* a utility is to recover its costs" (at para 61 and note 10 (the emphasis is Justice Rothstein's)) and referring as well to *TransCanada Pipelines Ltd. v National Energy Board,* 2004 FCA 149 (CanLII), 319 N.R. 171, at para 43.) Second (*ATCO* at para 61), "[w]here costs are determined to be prudent, the regulator must allow the utility the opportunity to recover them through rates."

Third, a regulator is entitled (and obviously so) to think about the interest of consumers. Justice Rothstein put the point this way (*ATCO* at para 63):

> Indeed, it seems axiomatic that any time a regulator disallows a cost, that decision will be based on a conclusion that the cost is greater than ought to be permitted, which leads to the inference that consumers would be paying too much if the cost were incorporated into rates. But that is not the same as disallowing a cost *solely* because it would increase rates for consumers. … [And here the] Commission reasoned from the prudence of the costs themselves, not from a desire to keep rates down, to arrive at its conclusion to disallow costs.

Fourth, (and this is my assessment) it will always be difficult to review a regulator's decision on this basis (protection of consumers) absent some clear references (as in the *BC Electric Case*) in the regulator's reasoning that display a link between the regulator's objective of consumer protectionism and the disallowance of costs. Most regulators should be smart enough to avoid creating that link. Mere reference to the interests of consumers in not paying more than they "should" cannot be enough to render a decision unreasonable.

OPG

OPG dealt with the labour compensation costs element of OPG's revenue requirement. Both the Government of Ontario and the Board had previously warned OPG that it needed to get its costs, including its labour costs, under control. The Board had also instructed OPG to engage in bench-marking exercises. Benchmarking studies led the Board to conclude (*OPG* at para 32) that OPG was overstaffed and its compensation levels were excessive. Most of OPG's labour force is unionized and the remuneration rates of those employees are therefore the subject of collective bargaining. OPG sought to pass on to customers the results of its collective bargaining as part of its revenue requirements and ultimately as part of its approved tariff. The OEB refused to approve the tariff as filed and ultimately reduced OPG's proposed revenue requirement of $6.9 billion by $145 million. In so doing the Board (*OPG* at para 33) noted that there were opportunities for OPG to manage some of its labour related costs including staffing levels, promotions etc., but acknowledged that "OPG may not have been able to achieve the full $145 million in savings for the test period through the reduction of compensation levels alone because of its collective agreements with the unions." On appeal, the majority of the Ontario Divisional Court found the Board's decision reasonable and declined to interfere. The Ontario Court of Appeal however reversed and remitted the matter to the Board. The Court of Appeal drew a distinction between forecast costs and committed costs. In relation to the latter, the Board was required to conduct a no-hindsight prudence review and if that review suggested that the costs were prudently incurred then the Board should make provision for their recovery (summarized in *OPG* at para 37). The Board's failure to do so was unreasonable. The Supreme Court restored the judgment of the Divisional Court thereby confirming the OEB's decision.

The judgment contains a lengthy and important discussion (*OPG* at paras 41 – 72) of the standing of a regulatory tribunal to argue its case on an appeal or judicial review application. My colleague Shaun Fluker will post on this aspect of the decision and I will say no more about it here. I will focus instead on the prudence issues. The standard of review was straightforward in this case. All parties (*OPG* at para 73) accepted that "reasonableness is the appropriate standard of review for the Board's actions in applying its expertise to set rates and approve payment amounts under the *Ontario Energy Board Act, 1998*."

The Prudence Analysis

As noted above, the *OEBA* is less prescriptive than Alberta's utility statutes with respect to the OEB's rate setting functions; but as with the Alberta statutes, the burden of proof with respect to both reasonableness (and therefore prudence as in *ATCO*) is on the utility. Where the statute prescribes an element of the methodology that the regulator must follow (as in the case of the burden of proof), the regulator has no authority to vary that element of the methodology. Thus it is not open to the regulator to establish (*OPG* at para 80, and see also at para 104) a rebuttable presumption that the utility's expenditures are reasonable. "[T]his does not imply that the applicant must systematically prove that every single cost is just and reasonable. The Board has broad discretion to determine the methods it may use to examine costs — it just cannot shift the burden of proof contrary to the statutory scheme."

As noted in *ATCO*, the Court in *OPG* made a distinction between forecast costs and committed costs as follows (*OPG* at para 82):

> <u>Forecast costs</u> are costs which the utility has not yet paid, and over which the utility still retains discretion as to whether the disbursement will be made…. <u>[C]ommitted costs</u> are those [which] the utility has already spent … [or has] entered into a binding commitment or [is] subject to other legal obligations that leave it with no discretion as to whether to make the payment in the future (emphasis added).

The disallowance of committed costs is particularly problematic for a regulated utility because (*OPG* at para 82) "the utility and its shareholders will have no choice but to bear the burden of those costs themselves." In the long run, disallowance may also not be in the interests of consumers since "[d]isallowing recovery of the cost of failed investments that appeared reasonable at the time, for example, may imperil the financial health of utilities, and may chill the incentive to make such investments in the first place. This effect may then have negative implications for consumers, whose long-run interests will be best served by a dynamically efficient and viable electricity industry." The disallowance of forecast costs is far less problematic since such a case (*OPG* at para 82) "presents a utility with a choice: it may change its plans and avoid the disallowed costs, or it may incur the costs regardless of the disallowance with the knowledge that the costs will ultimately be borne by the utility's shareholders rather than its ratepayers."

The problem of committed costs has led utilities and some legislators, regulators and courts to develop a prudent investor test, based on conditions as they stood at the time the investment was made (or costs incurred) as part of a methodology for establishing just and reasonable rates. For present purposes this gives rise to at least two questions. First, is there a common understanding of the test, and second, is its application both permissible and required. As to the first, Justice Rothstein offered various examples of the test but referred (*OPG* at para 99) in particular to the Ontario Court of Appeal's decision in *Enbridge Gas Distribution Inc. v Ontario Energy Board* (2006), 2006 CanLII 10734 (ON CA), 210 O.A.C. 4 where that court "endorsed …. a specific formulation of the prudent investment test framework" as follows:

- Decisions made by the utility's management should generally be presumed to be prudent unless challenged on reasonable grounds.

- To be prudent, a decision must have been reasonable under the circumstances that were known or ought to have been known to the utility at the time the decision was made.

- Hindsight should not be used in determining prudence, although consideration of the outcome of the decision may legitimately be used to overcome the presumption of prudence.

- Prudence must be determined in a retrospective factual inquiry, in that the evidence must be concerned with the time the decision was made and must be based on facts about the elements that could or did enter into the decision at the time [at para 10, of the Ontario CA's judgment].

As to the second, Justice Rothstein is clearly of the view (*OPG* at para 102) that "The prudent investment test, or prudence review, is a valid and widely accepted tool that regulators may use when assessing whether payments to a utility would be just and reasonable." While the test has principally been used in the context of capital investments Justice Rothstein saw no reason why a regulator might not also apply the test to operating costs. However, Justice Rothstein was equally clearly of the view that neither the general jurisprudence nor the specific statutory scheme of the *OEBA* required the OEB to apply the prudence test to committed costs such that (*OPG* at para 103) a regulator's failure to apply "would render its decision on payment amounts unreasonable." Nor did Justice Rothstein consider (*OPG* at para 103) that the Court should create such a rule.

> As discussed above, where a statute requires only that the regulator set "just and reasonable" payments, as the *Ontario Energy Board Act, 1998* does in Ontario, the regulator may make use of a variety of analytical tools in assessing the justness and reasonableness of a utility's proposed payment amounts. This is particularly so where, as here, the regulator has been given express discretion over the methodology to be used in setting payment amounts: O. Reg. 53/05, s. 6(1).

Thus, the OEB has a measure of discretion in deciding what test to apply as part of assessing reasonableness or prudence in each and every case.

> The question of whether it was reasonable to assess a particular cost using hindsight should turn instead on the circumstances of that cost. I emphasize, however, that this decision should not be read to give regulators *carte blanche* to disallow a utility's committed costs at will. Prudence review of committed costs may in many cases be a sound way of ensuring that utilities are treated fairly and remain able to secure required levels of investment capital. As will be explained, particularly with regard to committed capital costs, prudence review will often provide a reasonable means of striking the balance of fairness between consumers and utilities (*OPG* at para 104).

While the Court was of the view that it was not automatically unreasonable for the OEB not to apply the prudent investment test to committed costs (and the Court did find that some of the OPG's costs were committed), it was still necessary to examine whether the Board's failure to apply such a test in this particular instance could be said to be unreasonable. Justice Rothstein concluded that the OEB's decision was not unreasonable and in doing so he emphasized a number of factors. First, he noted that the matter at issue here involved operating costs rather than capital costs. A "with hindsight" approach may be more problematic when applied to capital costs because it may impair the long run viability of the utility. Justice Rothstein put the point this way (at paras 107 – 108):

> … prudence review, including a no-hindsight approach (with or without a presumption of prudence, depending on the applicable statutory context), may play a particularly important role in ensuring that utilities are not discouraged from making the optimal level of investment in the development of their facilities.
>
> Operating costs, like those at issue here, are different in kind from capital costs. There is little danger in this case that a disallowance of these costs will have a chilling effect on OPG's willingness to incur operating costs in the future, because costs of the type disallowed here are an inescapable element of operating a utility. It is true that a decision such as the Board's in this case may have the effect of making OPG more hesitant about committing to relatively high compensation costs, but that was precisely the intended effect of the Board's decision.

Second, consideration of the reasonableness of the OEB's approach must take into account the fact that the relationship between a utility and its regulator is an ongoing relationship. It is a repeat-player relationship. The matter at issue here involved ongoing costs rather than a one-off expenditure and the OEB had already warned OPG that its staffing costs would be subject to scrutiny.

Third, the OEB did not take an "all-or-nothing approach" or an approach that made a hard and fast distinction between forecast costs and committed costs (*OPG* at paras 110 & 116). Rather the Board took a more global approach and effectively required the burden to be shared between consumers and shareholders. Given the difficulty of making the distinction between forecast and committed labour costs in the context of the labour costs, some of which were subject to collective agreements and some of which are subject to management's control, it was not unreasonable for the Board to proceed in this way and was consistent with the methodological discretion available to the Board and its appreciation that it is not equipped to micromanage OPG's business decisions (*OPG* at para 117). The Board's decision did not and could not force OPG to abrogate its collective agreements (*OPG* at paras 118 & 119) but it likely had an adverse impact on OPG's ability to earn its cost of capital in the short run; but in doing so it did send a clear message to OPG that it needed to improve its performance. That was entirely consistent with the Board's statutory mandate and its market proxy role (*OPG* at para 120).

Implications

These two decisions will provide much food for thought for counsel for utilities, consumers and regulators. While the language of the particular utility statute in question will always be a crucial and dominant consideration, the general flavor of these two decisions is to emphasize that utility regulators typically have a broad degree of methodological discretion in the manner in which they go about setting just and reasonable rates and in reviewing the reasonableness or prudency of utility expenditures. Past practice and judicial preference for certain methodologies should <u>not</u> be construed as requiring the application of any particular methodology. The actual application of any particular methodology may be questioned on reasonableness grounds where it will have the result of impairing the long run viability of the utility or its long run ability to earn a reasonable rate of return; but the refusal to apply any particular methodology cannot itself be unreasonable unless a method is directed by statute. The reasonableness of the application of a methodology can only be examined on a case by case basis. This suggests to me that on a go-forward basis it will be extremely difficult for any utility to question the methodological approach followed by its regulator, at least where the regulator has provided at least some reasons for its choice of methodology and some justification (at least in hard cases) why the application of that methodology does not impair the long run viability of the regulated utility.

The Court has not overruled its *Stores Block* decision. It had no need to. After all, the two cases before the Court involved the prudence of expenditures rather than the sharing of the surplus flowing from the disposition of utility assets (as in *Stores Block*) but I can't help but think that the methodological pluralism that this Court favours is far more consistent with Justice Binnie's dissenting judgment in *Stores Block* than it is with the methodological rigidity exhibited in Justice Bastarache's majority judgment.

Finally, the repeated references in both cases to the "long-run" health of the utility and to the opportunity that a utility must be accorded to earn its cost of capital over the long run (*OPG* at paras 16, 17, 76, 91 & 120 and *ATCO* at para 7) must surely be of some comfort to regulators like the AUC which are implementing performance based approaches to regulation (PBR). One implication of a PBR scheme is that utility performance is measured over a longer period than is traditionally the case, and the wish to provide incentives to improvement as part of PBR may mean that a utility will only achieve its target rate of return over the entire regulatory period and not within each year of that period.