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The Regulatory Treatment of Stranded Assets in Alberta

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Case Commented On: *Fortis Alberta Inc v Alberta (Utilities Commission)*, 2015 ABCA 295

The Court of Appeal has now handed down its unanimous decision on the appeal of the Alberta Utilities Commission's (AUC) decision known as the Utility Asset Disposition (UAD) Decision in which the AUC endeavoured to provide guidance to both electric and natural gas utilities as to the implications of the Supreme Court of Canada's majority decision in *Stores Block, ATCO Gas and Pipeline Ltd v Alberta (Energy and Utilities Board)*, 2006 SCC 4. I posted on the AUC's decision here. The Court, in a reserved judgment written by Justice Myra Paperny (Justices Rowbotham and Watson concurring), declined to interfere with the AUC's decision. In its judgment, the Court of Appeal emphasized that *Stores Block* and its progeny (see below) were still good law in Alberta. Furthermore, even though other jurisdictions had been able to distinguish *Stores Block* based upon the language of their utility statutes, or to confine it to its particular facts and circumstances, that was not possible in Alberta. Indeed, the jurisprudential record suggested (*Fortis* at para 74) that the Court of Appeal in Alberta had not taken a narrow and restrictive approach to *Stores Block* but had instead "applied the principles set out in that case more broadly". As a result (*Fortis* at para 76):

> The Commission, and this Court, are bound by *Stores Block* and the subsequent decisions from this Court. Only legislative amendment, reconsideration, or a reversal of *Stores Block* by the Supreme Court of Canada can change that.

For ease of reference the *Stores Block* progeny are as follows: *ATCO Gas & Pipelines Ltd v Alberta (Energy & Utilities Board)*, 2008 ABCA 200 (CanLII), 433 AR 183 (*Carbon*), *ATCO Gas & Pipelines Ltd v Alberta (Energy & Utilities Board)*, 2009 ABCA 171 (CanLII), 454 AR 176 (*Harvest Hills*), *ATCO Gas & Pipelines Ltd v Alberta (Utilities Commission)*, 2009 ABCA 246 (CanLII), 464 AR 275 (*Salt Caverns I*), *ATCO Gas & Pipelines Ltd v Alberta (Utilities Commission)*, 2014 ABCA 28 (CanLII), 566 AR 323 (*Salt Caverns II*).

As part of its decision the Commission concluded that *Stores Block* and subsequent court and AUC decisions had supported some 19 propositions of law. The issues on the appeal involved the way in which these propositions applied to stranded assets i.e. assets that are no longer used or useful for providing utility services which assets have not yet been fully depreciated. I reproduced all of those propositions in my note on the UAD Decision (above). The particular paragraphs that speak to stranded assets would seem to be paragraphs (c), (d), (e), (j), (k), (l), (m), (n), (p), (r) & (s).

> (c) Utility assets are the property of the utility. Customers do not obtain a property interest in utility assets by virtue of receiving, and paying for, utility service (*Stores Block*, at paras 63, 64 and 68).

(d) Utility shareholders are entitled to the net proceeds of disposition of an asset sold outside of the ordinary course of business. Shareholders receive any gain and must bear any financial loss arising upon disposition. "Ownership of the asset and entitlement to profits or losses upon its realization are one and the same" (*Stores Block*, at paras 67, 39 and 70).

(e) "Shareholders have and they assume all risks as the residual claimants to the utility's profit." Utility "shareholders are the ones solely affected" when the actual profits or losses of a sale outside the ordinary course of business are realized; "the utility absorbs losses and gains, increases and decreases in the value of assets, based on economic conditions and occasional unexpected technical difficulties, but continues to provide certainty in service both with regard to price and quality" (*Stores Block*, at paras 68 and 69).

(j) The words "used or required to be used" in Section 37 of the *Gas Utilities Act* "are intended to identify assets that are presently used, are reasonably used, and are likely to be used in the future to provide services. Specifically, the past or historical use of assets will not permit their inclusion in the rate base unless they continue to be used in the system" (*Carbon*, at para 23).

(m) The *Gas Utilities Act* "does not contain any provision or presumption that once an asset is part of the rate base, it is forever a part of the rate base regardless of its function. The concept of assets becoming 'dedicated to service' and so remaining in the rate base forever is inconsistent with the decision in *Stores Block*…." "Previous inclusion in the rate base is not determinative or necessarily important" (*Carbon*, at para 29).

(n) "Past or historical use of assets does not permit their inclusion in rate base unless they continue to be used in the system." An "asset no longer used to operate the utility is no longer part of the rate base, whatever its history or earning capacity." (*Salt Caverns*, at paras 14 and 54).

(p) The Commission has the responsibility to determine the rate base, including "what assets (still) are relevant utility investment on which the rates should give the company a return" (*Salt Caverns*, at paras 30, 31 and 52).

(r) Gas utility assets that no longer have an operational purpose and are no longer used or required to be used by the utility in providing service to the public in Alberta, no matter what the historical use of such assets, should be removed from rate base and should not be reflected in customer rates (Decision 2011-450, at paras 312 and 315; Decision 2012-068, at para 147).

(s) The effective date for removal of a gas utility asset from rate base and customer rates is the earlier of: (i) the date that the utility advises the Commission that the asset is no longer used or required to be used; or (ii) the date the Commission determines that an asset no longer has an operational purpose and is no longer used or required to be used to provide service to the public (*Salt Caverns*, at paras 28, 31, 51, 52, 53 and 56; Decision 2009-253, at para 54; *Calgary Leave*, at paras 23 and 25; Decision 2012-068, at paras 146 and 147).

The Commission took the view (summarized by the Court in *Fortis* at paras 108 – 114) that all stranded assets should be removed from the rate base and any outstanding depreciation should be

for the account of the utility and not its customers. These conclusions applied to both natural gas and electrical utilities.

Justice Paperny deals separately with the appeals of the gas utilities and those of electric utilities. I will follow that approach here.

The Appeal by the Gas Utilities

The gas utilities essentially argued that the owner of a gas utility was always entitled to a return *of* its investment once an item had been allowed in to the rate base. The Commission's response to this is that the principal mechanism for ensuring a return *of* investment is through depreciation. Depreciation applies to pools of similar assets and depreciation rates are based on the statistical lives of assets within that pool. As the Court recognized (and quoting from the AUC's factum in *Fortis* at para 140):

> The reality is that some assets within the pool will be retired prior to the average service life and others will be retired after the average service life. However, the intent of the applicable depreciation principles is to recover all prudently incurred costs of all the assets within the pool over the average service life determined for the pool, when the assets are retired as the result of an ordinary retirement.

In sum, the concept of depreciation ensures that the utility is made whole on an average basis, except in extraordinary circumstances where something happens that was not contemplated in the depreciation studies. That something may be a natural event (e.g. a forest fire) or a technological development (which causes some elements of the utility's infrastructure to become obsolete). The Commission concluded that these unforeseen costs should be borne by the utility. The Court in turn concluded that this decision was neither unreasonable nor unfair, and neither was it confiscatory.

I think that the Court really gives one principal reason for this conclusion which is that a utility is in a much better position to protect itself from at least some types of extraordinary circumstances than are its customers. For example, a utility should be in a position to assess potential obsolescence or declining use of facilities and that in turn may prompt the utility to apply to the regulator to change depreciation rates. The Court put the point this way (at para 145):

> The effect of the Commission's decision is not unfair. Consistent with the repeated assertion in the governing legislation that the utilities are to produce in a prudent manner in their business plans, operations, investments and expenses, the utilities must make reasonable accommodation in those plans, operations, investments and expenses for these extraordinary situations. There is nothing that ratepayers can do about such events. But the utilities can call in expert advice to ascertain the risks of their operations, and make submissions about those risks to the Commission, which may in turn react favourably in rate or tariff setting. The Commission's determination that it should not, after the fact as it were, accept that unforeseen loss or obsolescence of capital investment should be passed on to the ratepayers, was not unreasonable. The utilities will have to adjust their strategies but that is not innately unfair, nor is it inconsistent with the objectives and proper interpretation of the governing legislation.

In relying on this analysis it seems to me that the Court is distancing itself from relying to any significant extent on the symmetrical application of *Stores Block* (i.e. the idea that since surpluses accrue to shareholders on the sale of utility assets so should the costs associated with stranded assets). Indeed I think that Justice Paperny makes this point explicitly (*Fortis* at para 148):

> In my view, the UAD decision represents a reasonable approach that is well within the statutory authority vested in the Commission and also one that is in keeping with the jurisprudence from the Supreme Court as further interpreted by this Court. Even in the absence of that jurisprudence, the legislation clearly gives the Commission the authority to make this particular choice. It is not a foregone conclusion that the Commission would have chosen to treat stranded assets differently in the absence of the *Stores Block* line of cases.

The Appeal by the Electric Utilities

The electric utilities pointed out that *Stores Block* and its progeny were all gas utility decisions. That afforded them the opportunity to argue that the symmetrical logic of *Stores Block* should not apply to them. Furthermore, they argued that the electric sector reforms that began in the 1990s and the provisions of the *Electric Utilities Act*, SA 2003, c. E, 5.1 (*EUA*) (which does not require the AUC to establish a rate base for a utility) meant that they enjoyed a particular regulatory compact which suggested that (*Fortis* at para 153) "the legislature intended that, once a cost is deemed to have been prudently incurred, the electric utility is entitled to full recovery of that cost, even if circumstances change and even if the asset is no longer used in the provision of service." The utilities supported this approach by noting that under the scheme of the *EUA* a transmission facility owner can be required to construct a new line (s. 35).

Once again, the Court of Appeal declined to intervene. The interpretation offered by the electric utilities was certainly reasonable (*Fortis* at para 157) "(b)ut that, of course, is not the question. For the appeal to succeed, it must be the only permissible interpretation." And that was not the case here for the legislation clearly afforded the Commission a degree of discretion in the way in which it treated the utility's investments (at para 159):

> The language chosen by the legislature may permit the "prudent cost recovery" model described by the appellants, but it does not mandate it. The legislation does not explicitly or implicitly guarantee full stranded cost recovery in all circumstances. It requires the Commission to provide a reasonable opportunity to recover prudently incurred costs, leaving flexibility with respect to approach in the hands of the Commission.

The Court went on to say that *Stores Block* might have limited the policy choices open to the AUC in administering its legislation. Indeed at one point the Court seems to go as far as suggesting (*Fortis* at paras 160 – 161) that *Stores Block* either prohibits or makes it much more difficult for the Commission to order the sharing of stranded asset costs between the utility and its customers. Ultimately however I think that the Court steps back from this position when it notes that the Commission has been careful not to fetter its discretion (*Fortis* at para 168):

> [T]he Commission was also careful not to fetter its discretion to deal with future cases. In paras [297] to [305] and para [313] of the UAD decision, the Commission recognized its ability to adjust for depreciation and amortization expenses of assets removed from service for unanticipated causes through its

amortization of reserve differences process. In doing so, it recognized the need to retain the flexibility to fulfill its mandate on a case by case basis.

Conclusions

The *Stores Block* decision decided that consumers had no right to share in the gains associated with the disposition of assets that were no longer used and useful in providing utility service. In making that decision the majority of the Court overruled decades of experience during which the regulator had applied its expertise to balance the interests of consumers and shareholders with an eye to fairness, to both and to the long term viability of the regulated utility. The Commission has now applied that approach to stranded assets which are removed from the rate base. The Commission's decisions will generally leave the risk of such an event with the shareholders although both the Commission and the Court seem to have left the door open to a different result in any particular case. The Commission has also served notice on its regulated utilities that they have some opportunity to manage the risk of stranded assets through appropriate depreciation applications.

It remains to ask whether this decision is consistent with two recent Supreme Court decisions on the treatment of prudent expenditures *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*). Those decisions stand for the proposition that Canadian utility law does not prescribe any particular prudent expenditure or prudent investment test that a regulator must apply (unless of course there is an explicit statutory provision to that effect). More generally, the cases stand for a deferential approach to utility regulators in the application of their expert judgment to particular cases with the ultimate goal of establishing just and reasonable rates. But the cases also seem to reject a "one size fits all" approach. Thus utility regulators must be careful of laying down rules that are insensitive to the facts of any particular case. The Court in those decisions warned that while a utility regulator might not have to apply the prudent investor test to committed expenditures, and indeed committed capital expenditures, (such that those expenditures would always be recoverable) a regulator that chose instead to apply a "with hindsight" approach should be prepared to demonstrate why that is reasonable in terms of the long run health of the utility and the circumstances of the particular case (*OPG* at paras 102 – 105). I think that the AUC's sensitive discussion of depreciation policies (as shown in the Court of Appeal's decision) will be enough to shield this decision from interference by the Supreme Court of Canada. But if these two recent cases have any message for the AUC in dealing with stranded assets, it is that the AUC must remain open in any particular case to sharing the costs associated with stranded assets between consumers and shareholders. Alas, that option is not open with respect to the distribution of any surpluses flowing from the disposition of assets, unless and until *Stores Block* is overturned, either by the Court itself or by the Alberta legislature in relation to Alberta's utility statutes.

As to that last point, this may well be an opportune time for legislative intervention. Clearly Alberta's regulated utilities (and especially the ATCO group) had no enthusiasm for any change so long as they could enjoy the fruits of *Stores Block*. Now that the Court of Appeal (and perhaps the Supreme Court of Canada in these two recent cases) has confirmed that that *Stores Block* is

not an unalloyed boon for the utilities and that regulators may reasonably require regulated utilities to bear the risk of stranded assets (at least in some if not most or all cases), this may be an opportune time for a legislative amendment to restore the discretion that Alberta's utility regulators have reasonably exercised over the past decades in relation to gains on sales. That might be a fairer and more nuanced version of the regulatory compact than that sown by Justice Bastarache in *Stores Block*.