

Advocacy Centre for Tenants - Ontario v. Ontario Energy Board: Public Utility Rate-Rate-Making: Economic Regulation or Taxation?

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1. Introduction

In *Advocacy Centre for Tenants-Ontario v. Ontario Energy Board*,¹ the Ontario Divisional Court held that public utility regulators may set rates based on a customer's socio-economic status. Essentially, it held that high-income customers can be required to subsidize the cost of serving low-income customers. In doing so, the Divisional Court made a dramatic departure from the existing law and policy behind public utility regulation – one that fundamentally changes the nature of the obligations that regulators, and the utilities they regulate, may impose on customers. According to the Court, public utility regulators may allocate costs among customer classes at their discretion, without reference to any one class's contribution to the costs of the service provided to it.

From the legal perspective, this approach leaves virtually no room for the legal concept of undue discrimination among customers. More broadly, it treats public utility regulation as aimed at allocating costs among customers on the basis of a taxing power – redistributing wealth from some groups to others – which is at odds with the more conventional understanding of public utility regulation as economic regulation aimed largely at achieving economic efficiency through remedying market failures.

In my view, the decision is wrong at law. Given, however, that it is unlikely to be appealed, restricting its reach will have to be done on a largely voluntary basis by economic regulators, perhaps with guidance from governments. This will require a level of discipline and restraint that regulators may or may not be prepared to exercise. I will argue here that it would not be in the interests of regulators, in terms of their

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¹ (2008), 293 D.L.R. (4th) 684, 166 A.C.W.S. (3d) 384 [*Advocacy Centre* cited to D.L.R.].

credibility and independence, to take up the invitation offered by the Court to expand their regulatory powers.

2. Background to Decision: The Ontario Energy Board's Practice

The issue came to the Court by way of an appeal from a majority decision of the Ontario Energy Board (OEB) which held that it did not have jurisdiction to set gas distribution rates on the basis of a customer class's ability to pay. The Low Income Energy Network had argued that taking into account ability to pay was based on the Board's authority to set "just and reasonable" rates for services, a power that extends to rates set for the electricity sector, including distribution, transmission, and publicly-owned nuclear and baseload hydro-electricity generating facilities.

A two-member majority of the Board held that it did not have this power – that just and reasonable rate-making required it to set rates on the basis of a customer's contribution to utility costs. In making this determination, the majority's view was consistent with past OEB practice and an earlier decision wherein it stated:

The Board is required by its legislation to "fix just and reasonable rates," and in doing so it attempts to ensure that no undue discrimination occurs between rate classes, and that the principles of cost causality are followed in allocating the underlying rates.²

Further, this principle was to apply regardless of whether the underlying rate setting methodology was based on cost of service or performance based regulation. For example, in dismissing a request by a gas utility to set rates based on a range of revenue-to-cost ratios between rates classes in its performance-based regulation proposal, the Board stated it was:

...also not prepared to accept the argument that there is no need to provide revenue and cost information on a rate class basis. The Board has generally relied on the revenue-to-cost ratio in determining that there is no unfair assignment of cost responsibility among rate classes. Evidence in this proceeding established no other basis upon which to check for cross-subsidization other than to use cost information.³

² *Decision with Reasons*, EBRO493 (1997) (O.E.B.) at 316-17.

³ *Union Gas Limited: Decision with Reasons* (6 September 2001), RP-1999-0017 at para. 2.457, online: Ontario Energy Board http://www.oeb.gov.on.ca/documents/cases/RP-1999-0017/decusuib_1999.pdf [emphasis added].

The minority in the decision appealed from also emphasized that cost causality is fundamental to setting rates for customers. It held, however, that the Board did have the authority to depart from cost causality under “exceptional circumstances,” although it did not indicate what those circumstances would be.⁴

In any event, both the majority and the minority agreed that setting a just and reasonable rate was based on cost causality. They disagreed on whether the Board may ever depart from this principle on the basis of exceptional circumstances.

3. The Divisional Court’s Approach

In the Divisional Court, a two-member majority upheld but went well beyond the Board’s minority opinion. It held that the legal restriction on the Board’s rate-making authority is that a utility must earn a reasonable rate of return. However, when it comes to allocating the costs of this return among customers:

...so long as the global amount of return to the utility based upon a “cost of service” analysis is achievable, then the rates/prices (and the methods and techniques to determine those rates/prices) to generate the global amount is a matter for the Board’s discretion in its ultimate goal and responsibility of approving and fixing “just and reasonable rates.”⁵

As a result, the entitlement to a just and reasonable rate belongs to the utility. The concept of a just and reasonable rate does not create an entitlement for customers. Seen another way, a regulator cannot impose a charge on utility for the benefit of low-income customers, but it can impose such a charge on other utility customers.

As a prelude to explaining why I believe that this conclusion is fundamentally flawed, I would like to address some of the underlying principles of public utility regulation.

4. The Rationale for Public Utility Rate-Making

Public utility rate-making is aimed at dealing with the problem of natural monopoly with respect to specific types of services such as gas and electricity transmission and distribution or water works. The

⁴ *Enbridge Gas Distribution Inc.: Decision* (26 April 2007), (2006) EB-2006-0034 at 20, online: Ontario Energy Board http://www.oeb.gov.on.ca/documents/cases/EB-2006-0034/decision_egd_rate_affordability_20070426.pdf.

⁵ *Advocacy Centre*, *supra* note 1 at 701.

problem of natural monopoly is that, if left to market forces, certain types of services will not be provided in an economically efficient manner. These services are characterized by what economists call “sub-additivity of costs,” which means that, from a societal perspective, it is more economic for one service provider to provide the service than it is for several service providers to compete to provide the service. That is what makes the service a “natural monopoly.” Sub-additivity of costs is similar to, but not the same as, economies of scale. Many goods and services are accompanied by economies of scale. Most of these services are most efficiently provided, however, in competition with alternative, substitute services. Public utilities services, on the other hand, are most efficiently provided on a monopoly basis. The leading textbook on the topic states the issue as follows:

What is required for natural monopoly to render competition infeasible is subadditivity of costs, which exists when all the industry output (or array of outputs) demanded can be produced more efficiently only by a single firm. An output-specific natural monopoly means that an industry’s single-product output can be produced more cheaply by a single firm than for any division of that output amount two or more firms.⁶

Thus, under the condition of sub-additivity of costs, one firm can produce an output more efficiently than a number of competing firms: from a societal perspective, it is socially optimal to have one firm rather than several firms produce a service. Leaving the production of the service to the market, by definition, would lead to uneconomic production of the public utility service.⁷ Accordingly, a public utility regulator is established for two objectives: to enforce the monopoly by preventing entry by other service providers; and to set an economically efficient price for the monopoly service so that an economically efficient amount of the service is produced and purchased. In this way, a just and reasonable rate provides a signal for both the utility shareholder (to invest an optimal amount in providing the service) and the customer (to expend an optimal amount in purchasing the service).

⁶ James C. Bonbright, Albert L. Danielsen, and David R. Kamerschen, *Principles of Public Utility Rates*, 2d ed. (Arlington: Public Utilities Reports, Incorporated, 1988) at 22-23.

⁷ Specifically, under conditions these conditions there would be too little production of the service—the service would be withheld to increase price. As a result, the production of the service would decrease to a socially undesirable amount. For a detailed explanation, see W. Kip Viscusi, Joseph E. Harrington, and John M. Vernon, *Economics of Regulation and Antitrust*, 3d ed. (MIT Press, 2000) at 339-44.

Examination of the purchase of services by customers must also take into account that different customers have different types of economic demands. Residential customers perform a different economic function than, for example, industrial customers. In order to protect the integrity of each customer class's economically efficient decisions, the costs of utility services are allocated among customer classes by reference to each class's contribution to the costs of service. To depart from this contribution is to "unduly discriminate" among customers. Again, according to Bonbright, Danielsens and Kamerschen, an inherent component of a just and reasonable rate is "[a]voidance of undue discrimination in rate relationships so as to be, if possible, compensatory (i.e., subsidy free with no intercustomer burdens)."⁸

As a result, monopolies are created and supported by regulation in order to provide public utility services (such as gas distribution) at prices that reflect the economic relevance of that service to customers. The regulator's job is to set the price accordingly.

5. The Problems with the Divisional Court's Approach

The Divisional Court seemed to miss the point of public utility regulation altogether. According to the Court, in a section of the decision entitled "The Purpose of the Act and the Reason for the Board's [E]xistence," the purpose of public utility rate-making is consumer protection:

The Board's mandate through economic regulation is directed primarily at avoiding the potential problem of excessive prices resulting because of a monopoly distributor of an essential service. In performing this regulatory function, it is consistent for the Board to protect the interests of all customers vis-a-vis the reality of a monopoly.⁹

As a result, according to this approach, the purpose of a public utility regulator is to prevent utilities from charging excess prices. The regulator achieves that end by allowing a utility to earn only a reasonable rate of return on its investment. Once the regulator finishes with that job, its mandate – the "reason for its existence" – is fulfilled and it can then be free to allocate the contribution to the utility's revenue among customers largely as it pleases.

Accordingly, under this theory, the allocation of costs among customers is discretionary. Thus there is no concern about undue

⁸ Bonbright, Danielsens and Kamerschen, *supra* note 6 at 384.

⁹ *Advocacy Centre*, *supra* note 1 at 696.

discrimination among customers. On the contrary, the concept of undue discrimination is almost impossible within the Divisional Court's construct.

Moreover, the Divisional Court's decision gives support to a school of thought that has criticized public utility regulation. For the "realist school," public utility regulation is a way to transfer wealth from groups that are ineffective in influencing regulators to groups that are. With respect to cross-subsidies in rates specifically (the issue in the *Advocacy Centre* case), the argument is that rate-making is, in reality, a form of taxation. Richard Posner expresses this argument as follows:

Taxation in common parlance refers to the use of the powers of the state to extract money from its subjects in order (1) to defray the cost of services that the politically dominant elements of the state wish to provide and that the market would not provide in the desired quantity and at the desired price, or (2) to transfer money from one group to another, or (3), often, to do both. By this test regulation is in part a system of taxation of public finance. The basic mechanism is the internal subsidy. A firm produces a service below its real cost, and the deficit is made up by (usually) other customers of the firm who pay higher prices than they would otherwise. Were it not for the power of the state, acting through the regulatory agency, to control entry, the system would not be viable.¹⁰

The Divisional Court's decision gives effect to this critique. In short, it allows a public utility regulator to set rates so that some customers under-contribute and other customers over-contribute to achieve a socially desirable goal. As long as all customers are protected from being charged excessive rates by a utility, some subsets of customers have no legal protection from being charged excessive rates for the benefit of other customers.

In my opinion, this is incorrect. Public utility rate-making is not about protecting customers from monopolists; it is about determining an economically efficient rate so that the public utility service is properly priced. This includes providing an appropriate rate of return to utility shareholders; it also includes compensatory rates to customers. Departures from either of these principles violate a legal entitlement.

¹⁰ Richard A. Posner, "Taxation by Regulation" (1971) 2 Bell J. Econ. & Mgmt Sci. 22 at 28-29.

6. *The Consequences of the Divisional Court's Approach on Expertise and Independence*

The Divisional Court's approach is unlikely to be appealed to a higher court – the appeal arose from a public interest advocacy group seeking an expansive approach to the OEB's jurisdiction, and the OEB is unlikely to challenge that approach by appealing the decision.

Having said this, an approach to rate-making that provides the OEB with discretionary authority to set rates based on non-economic factors is unlikely to serve the institutional interest of the Board as it relates to its status as an expert, independent regulator.

The Board's expertise is based on economic regulation. If it strays from that area to impose rate-making with social purpose in mind, there could easily be a watering-down of its claim to expertise. Parties will appear before the Board seeking social assistance, and ultimately, its credibility could be impaired.

The Board's independence is also based on its separation from day-to-day politics. In fact, one of the rationales for economic regulation is to remove technocratic decision-making from political influence.¹¹

If the Board is pursuing social policy through rate-making, however, it becomes more difficult to distinguish the decisions that it makes from the decisions that governments make. Further, governments – being democratically accountable – arguably have much more legitimacy in making decisions that are driven by social policy than economic efficiency. It could therefore be expected that parties put pressure on governments to use the regulator's taxing authority for economic benefit. Governments may see the value of having access to a new source of revenue that is not included in public accounting (because it is collected from ratepayers not taxpayers) and find the temptation to use this power to be almost irresistible.

7. *Conclusion*

In light of the foregoing, public utility regulators should be reluctant so simply take up the invitation that the Divisional Court has offered them. It will be necessary to come up with some principled limitations on the use of this new type of taxing power if they want to maintain their claims to expertise and independence.

¹¹ See e.g. Charles F. Phillips, *The Regulation of Public Utilities*, 3d ed. (Arlington: Public Utilities Reports, Incorporated, 1993) c. 4.