Fair Return for Utilities — Concept or Reality ?

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Because they provide a service which is essential to the every day life and since they are traditionally looked upon as natural monopolies, public utilities are subject to governmental regulation. Special administrative tribunals make sure that the utilities' most important obligation, namely to give the best available service at the lowest possible price, is fulfilled. In the discharge of this obligation, the regulatory authorities must not deprive the shareholders of a fair return on their investment.

Historically, public utilities have become monopolies for two reasons: first, because it was found that public interest was best served when costly duplication could be avoided; secondly, because of the very high investment of fixed capital required for the setting up of their operations and their continuous need for additional capital thereafter.

It must be borne in mind that public utilities considered for the purpose of this article are privately owned corporations. Therefore it is only natural that their owners will expect it to show a profit at the end of the year. State-owned utilities are now taking a more realistic view: they also expect earnings on their investments. In some cases the rate of return expected by the state is determined in the enacting legislation.

In our economic system, profit is the goal to which everyone reaches: motivation behind any investment will be to get a reasonable return; in an ordinary or unregulated enterprise this will depend on numerous factors such as the measure of demand for the product sold or the services rendered, the ability to manage the undertaking, etc. One factor is striking in the field of public utilities: the demand is and will presumably remain constant since the service is essential and the corporation is the only one capable of satisfying it. Therefore, if public utilities were not regulated, their profits might theoretically be the highest.

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It will be the regulatory body's duty to "balance the investor and the consumer interests".[1] For the latter's benefit it will make sure that the service is adequate and provided at just and reasonable rates. For the corporation and its owners, it will ascertain that these rates provide a sufficient income.

In curtailing the return or profits which a public utility company may earn, the state is taking away something which in principle, would rightly be its own. When the state of Illinois decided to regulate the handling and storage of grain in Chicago, it reduced the rates which were previously charged and one operator contested that regulation alleging that it was contrary to the XIVth Amendment: this amendment safeguards any citizen from having his property confiscated by the state, without due compensation. The Supreme Court of the United States held that the operations regulated by the enactment had become business "affected with a public interest and had ceased to be *juris private* only".[2]

But the idea that fixing low rates was equivalent to confiscation was accepted and thence the concept of a "confiscatory rate of return". In the American system, the return to a utility is determined by a Commission or Board and will not be reviewed by the Courts unless it is confiscatory. In such cases, the injured party will seek a *writ of certiorari* against the Commission on the basis that it has deprived him of rights guaranteed by the Constitution; such matters must be dealt with by a Court of Law.

Although the Canadian Constitutional documents contain nothing comparable to the American XIVth Amendment, the principle is accepted. As will be seen, several provincial Acts on Public Utilities guarantee a "just and reasonable" or a "fair" return. The same principle underlies legislation regarding expropriations.

The *Railway Act*[3] and some provincial legislations do not specify the right of a utility to a reasonable return but such right has been taken for granted by Courts and regulatory bodies.

In 1960 the Supreme Court of Canada[4] clarified this problem in the following manner: the *Public Utilities Act* of British Columbia[5]

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[1] *Federal Power Commission, et al,* v. *Hope Natural Gas Co.,* 51 P.U.R. (N.S.) 193, 320 U.S. 591, at p. 603; *Re: Area Rate Proceeding for Permian Basin,* 75 P.U.R. (3d) 257.

[2] *Munn* v. *Illinois,* 94 U.S. 113, at p. 126.

[3] R.S.C. 1952, c. 234.

[4] *B.C. Electric Railway Co. Ltd.* v. *Public Utilities Commission of B.C.,* [1960] S.C.R. 837.

[5] R.S.B.C. 1948, c. 277.

had repealed a disposition in the old *Water Act*[6] allowing a public utility a "fair return on the value of all property acquired by it and used in providing services to the public..."

The Court wondered if the repeal of that section took away from the utility its right to a fair return. It decided in the negative and considered such right as "a common law right".[7] It referred to a decision of the Judicial Committee of the Privy Council which stated:

> In considering the construction and effect of this Act the Board is guided by the well known principle that a statute should not be held to take away private rights of property without compensation, uuless the intention to do so is expressed in clear and unambiguous terms.[8]

Even if it is often mentioned in legislation and discussed by the Courts, the rate of return has not judicially been defined, either in the abstract or in its contents, in any exhaustive fashion.

The definition given by Barnes in *The Economics of Public Utility Regulation* has been accepted and quoted in numerous instances; it reads thus:

> The rate of return is that percentage of the "rate base" which the utility is entitled to earn for interests, dividend payments, and related requirements.[9]

In Canada, the following definition has been given:

> The rate of return is that percentage which, when multiplied by the rate base, provides a return which fairly compensates the company for the use and risks inherent in the investment of its money.[10]

In other words, the rate of return is the expression in percentage of what the company is left with after operating expenses and taxes have been paid and depreciation has been provided for. The contents are subject to changes: in Barnes' explanation of "related requirements", such items as discounts and costs of marketing on securities, underwriting fees, etc. are included. The Supreme Court of the United States held that the return should also provide for something to be posted to the surplus account.[11]

The rate of return obtained from the financial statements of a company will only become significant when compared to that of

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[6] R.S.B.C. 1924, c. 271.

[7] *B.C. Electric Railway Co. Ltd.* v. *Public Utilities Commission of B.C.*, [1960] S.C.R. 837, at p. 845.

[8] *Colonial Sugar Refining Co.* v. *Melbourne Harbour Trust Commissioners*, [1927] A.C. 343, at p. 359.

[9] I.R. Barnes, *The Economics of Public Utility Regulation*, (New York: 1947) at p. 516.

[10] *Re: Shell Oil of Canada*, 31 P.U.R. (3d) 503.

[11] *United Railways & Electric Co. of Baltimore* v. *West, Chairman, et al*, 280 U.S. 234.

other companies where the same investment would have earned more, or less, or when it is related to general economic conditions.

As appears from these definitions, the rate of return is closely tied with the rate base. It is not within the scope of this article to discuss in detail the different methods of determining the rate base.

Let us say that it varies from one case to another and the following may be considered: the owner's equity; the total capital; the net costs of equipment and plant; the net original cost of same, etc. However, as a result of the *Smyth* v. *Ames*[12] decision, emphasis has been put on the physical assets. In comparing rates of return, great care must always be taken to make sure that the rate base is the same in both cases.

The rate of return has been classified as reasonable, confiscatory or non-reasonable and non-confiscatory. The reasonable rate of return is that which attracts new capital on favorable terms. As we have stated earlier, the public utility is always concerned with getting additional capital in order to meet the increasing demand for its services, the increase in the price of equipment and labour and to keep up to date with the latest technological developments. The utility will therefore constantly be seeking to attract the prospective investor who will look for the best return which his investment will bring; this, in turn, will be directly related to the return which the corporation earns.

If the reasonable rate of return attracts additional capital, the confiscatory one will either fail to do so or will provoke withdrawals. In practice it is very difficult to diagnose such actions; although a decrease in the market value might be a symptom, it is by no means conclusive since it might coincide with a general downturn in the stock market or profit taking by important stockholders. In Barnes' opinion, a persistent and continued low market price compared to the book value of the shares, combined with an unusually high yield, the whole under normal general conditions, will be a good indication of capital being withdrawn.[13]

Between these two concepts stands a "zone of reasonableness", which is a zone between the lowest rate of return which is reasonable and the highest confiscatory one. The concept was expressed by the Supreme Court of the United States as follows:

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[12] 169 U.S. 466.

[13] Barnes, *op. cit.*, p. 522.

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.[14]

These concepts are general and offer no precise formula to determine the contents or even the principles governing the contents of a just and reasonable rate of return. Basically, this is always a question of fact that should be arrived at with good judgment and common sense. We will look at the ways in which the Courts of Law and the regulatory bodies have elaborated on these concepts in the United States and Canada.

American decisions

In 1898, the Supreme Court of the United States recognized and confirmed that a public utility had a right to earn a "fair return" and put down the basis of such upon the "reasonable value of its property used and useful in the public service".[15] The formula was immediately subject to discussion in view of the vagueness of such terms as "fair" and "reasonable value" which were not defined by the Court. However the decision had settled an important point in allowing the company the right to a return. Thereafter and to this day, unless legislation provided otherwise, decisions have been divided on how to ascertain the value of the property, some considering the original cost and others the reproduction cost, amongst other factors.

Once this right had been recognized, there remained to determine the contents of the right and the methods of arriving at a specific figure. The "cause célèbre" which established rules that were thereafter followed, discussed and applied at variance, was the 1923 case of *Bluefield Waterworks and Improvements Co.* v. *Public Service Commission of West Virginia*, where the rule was thus formulated:

What annual rate will constitute just compensation depends upon many circumstances and must be determined by the exercise of a fair and enlightened judgment, having regard to all relevant facts. A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but it has no constitutional right to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures. The return should be reasonably suf-

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[14] *Montana-Dakota Utilities Co.* v. *Northwestern Public Service Commission*, 341 U.S. 246, at p. 251; see also *Federal Power Commission* v. *Natural Gas Pipe Line Co.*, 315 U.S. 575.

[15] *Smyth* v. *Ames*, *supra*, n. 12, at p. 546.

ficient to assure confidence in the financial soundness of the utility, and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.[16]

It appears at the very outset that a Commission having to determine a rate of return must decide on the merits of the facts presented to it, just like any Court of Law. The decision must rest on the evidence adduced before the Commission and should not be set arbitrarily or with other considerations in mind.

Let us consider the factors which should, according to the Supreme Court decision in the *Bluefield* case,[17] be accounted for in determining the reasonableness of a rate of return.

1. As already stated, the public utility is, by the nature of its obligations,[18] always concerned with attracting additional capital. Conditions being normal, the utility should be able to do so under favorable terms, if it offers an interesting return to the investor.

If, for such purpose, the utility has to continually increase its dividend payments or offer an interest rate on its bonds or debentures higher than that paid by other business or even equal to the latter (considering that the risk involved is lesser), there is no doubt that investors will not consider its return adequate since they will have to be attracted by such extraordinary and artificial means.

2. The comparison that is called for by the Court between the public utility and "other business undertakings" is vague and has led to many discussions on its terms. The Court has definitely ruled out, and understandably, the "highly profitable enterprise" and the "speculative venture". If we compare the earnings of two corporations upon their physical assets, we might be led into error for we have no assurance that these assets were valued under the same rules. Since special accounting methods are prescribed for public utilities, a comparison between two of them might be more appropriate, but nowhere is it indicated that both terms of the comparison should be utilities. As a matter of fact, if comparisons were limited to other utilities there would be created a special category, set apart from general enterprises. This would be nonsense in view

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[16] 262 U.S. 679, at 693.

[17] *Ibid.*

[18] In the *B.C. Electric Co.* Case, *supra*, n. 4, at p. 852, the Supreme Court of Canada stated: "These four sections last mentioned involve a statutory obligation on the part of a public utility to make capital outlays for extension of its services."

of the very important contribution that utilities make to the economy generally. The determination of the rate of return would become meaningless and fall in uniformity, the comparison with other fields and economy in general being absent.

A more accurate and realistic approach might be to compare the return of the particular utility with an average index of all utilities or industrials, or of a certain number of large corporations of a particular nature, etc. Such indexes are easily obtainable and will certainly give an adequate image of the present conditions. Much later, the Supreme Court of the United States defined the terms of the comparison as including any "enterprise having corresponding risks".[10]

3. The third factor to be considered in arriving at a reasonable rate of return is the general economic conditions. When a public utility applies for a review of its rates, the data which is furnished to the Commission is forcibly very recent or is estimated for the year or years to come, since the changes which it is seeking will apply in the future. Economic conditions vary from year to year, even from month to month and this is why it has been often repeated that in determining a rate of return a Commission should not rely on past decisions. These might be considered to ascertain the variation in economic conditions over a given period of time but even this might not be indicative of what will happen in the future. Fortunately, numerous studies and expertises are constantly being made and adjusted for that purpose, and they may be relied upon. This is perhaps the most delicate aspect of the decision to be made by a Commission, for even a slight change in economic conditions may result in the rate of return being confiscatory, if it has been set on the borderline.

4. The cost of capital is another factor in the making of the rate and has often been the most important, if not the sole factor. Both the cost of debt and the cost of equity must be ascertained. Consideration may be given to the current cost of money or the historical cost to the company. The former is indicated by the official interest rate or the interest on bonds; however utilities usually pay less because of the reduced risks and the assurance of a quasi constant demand for services.

If the cost of debt is reasonably easy to ascertain the cost of equity is far more difficult to determine.

What has been called the "historical cost" of money to the utility might be an appropriate indication: a computation of the interest

[10] *Federal Power Commission* v. *Hope Natural Gas Co., supra,* n. 1, at p. 603.

on bonds and the yield on equity which the utility had to offer in the past to attract investors should help in determining future requirements. This is not to say however that the investor will be satisfied with a low return even if the risk is considerably reduced when he can fare much better in an ordinary business undertaking. This is especially proven nowadays when large corporations with brilliant prospects affording diminished risks are offering a good yield and a possibility of capital appreciation.

The capital structure of the company will have a direct bearing on the cost of its capital, the overall cost being the sum of the cost of equity and debt capital.[20] As a rule public utilities may have a higher debt ratio than ordinary enterprise without endangering their attractiveness to investors because of the lesser degree of risk. The ratio is of importance to a regulatory body if it considers total capital as a rate base. The cost of total capital investment will be higher if it comprises mostly equity capital which costs more to a company. The reasonableness of the ratio is a question of fact left to the appreciation of the board or court.

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.

5. The general feeling is that utilities are not subject to risks. This may be true to a certain extent only when compared to other corporations. However, the utility is subjected to general economic conditions like any business; more so since it is expected to go on providing services, even if it is deprived of its usual sources of capital due to a shortage of money, or if the economy is in an upswing. The same deprivation may occur because of a determined and fixed return which would render it unattractive to the investor.

Another risk related to its fixed earnings may be that the company would be left with no alternative but to reduce its dividends if expenses increase drastically.

The possibility that on the long range the service provided for by the utility might become obsolete as a result of technological and

[20] The cost of capital may be arithmetically put as follows: (The figures are hypothetical)

50% debt	@	5%	=	2.50%
+ 50% equity	@	10%	=	5.00%
Total Cost				7.50%

scientific developments constitutes another important risk — witness what water transportation has lost to railways and in turn what these have lost to airways. This is why, in order to survive, utilities must innovate and diversify. A necessary expense of a healthy utility is one on research and development. A static utility is heading for the graveyard.

We have now examined two of the leading cases up to 1944, in the field of rate-making in the United States; the first *(Smyth* v. *Ames)* determined the basis on which the rate of return should be calculated. Unless special legislation provided otherwise, the fair value of the property "used and useful in the service of the public" should be taken. The second *(Bluefield)* set forth the factors which were to be considered in order to arrive at that percentage of the base constituting a reasonable return.

In 1944 came another important decision from the Supreme Court in the same field, the case of *Federal Power Commission* v. *Hope Natural Gas Co.*[21]

The Court stated two general principles: *first* that a presumption of validity is attached to a commission's decision and the burden of proving the contrary rests on the utility; *secondly* that regulation does not insure a utility that its business will produce net revenues. This should not, however, be interpreted as meaning that owners of the utility are not entitled to a dividend: the "economic obligation to pay dividends" had been stated in *Smyth* v. *Ames.*

It then re-asserts the factors enumerated in the *Bluefield* decision to arrive at a just and reasonable rate of return:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner shonld be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital...[22]
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> ...Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called "fair value" rate base.[23]

We have already noted the emphasis put by the Court on the risk factor in comparing a particular utility with any enterprise.

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[21] *Supra,* n. 1.
[22] *Ibid.,* at p. 603.
[23] *Ibid.,* at p, 605.

The important and innovating pronouncement of this decision is the following:

> Nor is it important to this case to determine the various permissible ways in which any rate base on which the return is computed might be arrived at. For we are of the view that the end result in this case cannot be condemned under the act as unjust and unreasonable from the investor or company viewpoint.[24]

This was a radical change in the interpretation which had been given the *Smyth* v. *Ames* decision on the rate base being the value of the property. 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 Commissions' or Courts' discretion.

The valuation of the property advocated by the first decision had given rise to innumerable views and endless discussion. Some had considered the original cost, less depreciation; others had accepted the reproduction cost; others yet had devised other formulae. Furthermore, additional discussions arose within one field between experts retained to assess such values.[25]

In examining Canadian provincial legislation, we will see that the components of the "fair value" basis may differ.

For the case under consideration, the Court considered the owners' equity, or the net worth of the company without regard to the debt capital.

The *Hope* decision also broadened the *Bluefield* case geographically. It will be remembered that the latter considered that the return should be equal to "that generally being made... in the general part of the country".[26] It is important to note that the *Hope* decision omitted this factor. This omission is quite understandable in view of the great facility with which a person may invest in any part of the country if it should be more satisfactory to him. In the early part of the century the general economic conditions were certainly different in the Western States and the risks were certainly greater in that part of the country. The same reasoning would certainly apply to Canada.

Thereafter, we will find that decisions have considered numerous rate bases according to the case presented before the Board.

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[24] *Ibid.*, at p. 603.

[25] In this case, experts estimated the reproduction costs of the assets at $66,000,000 so that the company's return to the previous years would have been 3.27% whereas its rate of return on investment had been 9%.

[26] *Supra*, n. 16.

One of the more often used rate base, when legislation does not provide otherwise, is the capitalization of the utility. Although it had been mentioned as a relevant factor in the *Smyth* v. *Ames* case, it had been practically disregarded by subsequent decisions.[27]

> In its rejection of security capitalization as a rate base, the Court has not distinguished between those situations where the security issues were largely fictitious (that is, where the securities were issued without the receipt of equivalent consideration by the issuing corporation) and those where changes in prices left the outstanding capitalization excessive with respect to contemporary costs of construction. Undoubtedly one of the most potent reasons for the rejection of capitalization as a measure of the company's right to income has been the fact that these securities had been issued without any supervision by public authority. It is significant that in Massachusetts, where the issuance of utility securities has been regulated from the virtual inauguration of the industry, the commissions of that state have based their regulation of rates largely on a consideration of the revenue required to meet the interest and dividend payments on outstanding securities.[28]

Now that the Commissions have such an absolute control over securities issued by the utilities, the capitalization as a rate base offers no threat to the investor.

Canadian decisions

As in the United States, certain regulated enterprises come under federal jurisdiction while others fall under provincial legislation; both levels of Government have created regulatory bodies to deal with these businesses. As a rule, utilities which affect more than one province or which are declared to be operated for the "general advantage of Canada" are regulated through Boards or Commissions created by federal statutes; the others, whose fields of action are restricted to one particular province are attended to by provincial Boards or Commissions.

1. Federal Boards.

The Canadian Transport Commission established by the *National Transportation Act*[29] succeeded the Board of Transport Commissioners for Canada which in turn had succeeded the Canadian Railway Commission. The Commission has jurisdiction over all transport by railway, air, water, over pipe lines or roads, and, through the *Railway Act*,[30] over telephone and telegraph companies.

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[27] It had been advocated by Justice Brandeis (in a dissenting opinion) in *Missouri ex rel Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. 276.

[28] Barnes, *op. cit.*, at p. 375.

[29] 14-15-16 Eliz. II, c. 69.

[30] R.S.C. 1952, c. 234, s. 372 *et seq.*

It is of importance to note that nowhere is it mentioned in the relevant legislation that in the fixing of rates and charges the Commission is to consider the return to the utility nor does it contain provisions regarding the valuation of the rate base.

Since they found no English decisions for lack of regulatory bodies in the United Kingdom, Canadian Courts and Commissions have constantly referred to American decisions.[31] This was certainly a most sensible solution in view of the great similarities between general and economic conditions in both countries.

As we have seen, the Supreme Court of Canada, in 1960, went to a common law principle to assert the origin of the right of a public utility to a fair return. However such a right had been recognized and taken for granted. As early as 1921, this was stated as a fact:

> It is obvious that as a Railway is under private management, a return on capital is necessary if additional capital is to be obtained as needed.[32]

In several instances, the Canadian Railway Commission stated that in fixing rates, it should be ascertained that the utility will get, from these rates, enough income to provide for: 1) operating costs including all taxes; 2) maintenance costs; 3) provisions for depreciation, renewals and replacements; 4) provisions for a just and reasonable return to the company on its capital investment.[33]

Since the *Railway Act* does not provide for a rate base, the Boards acting under its authority and the Courts have been at liberty to take whichever they felt was warranted.

The Canadian Railway Commission, from the very beginning showed reluctance in accepting the reproduction cost as the fair value. In *City of Montreal* v. *Bell Telephone Co.*,[34] it refused to decide between the original cost and the replacement cost and found that the Company being in a satisfactory financial condition, there was no need to increase rates. In another case in 1927,[35] it considered capital as a rate base and stated that it could not "assent" to the "propriety" of reproduction cost. The capital investment was definitely the most often used rate base by the Commission and was accepted by the Supreme Court of Canada in *Northwestern Utilities* v. *City of Edmonton* where it said:

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[31] For statement that American decisions should be given due consideration by Canadian Boards, see *Ottawa* v. *Ottawa Electric Railway Co.*, 59 C.R.T.C. 136; *The King* v. *Rideout, et al*, [1949] 4 D.L.R. 612.

[32] *In re: Nipissing Central Railway Co.*, XI B.J. 196.

[33] *B.C. Telephone Co.* v. *Vancouver*, (1921), 27 C.R.C. 259.

[34] (1912), 15 C.R.C. 118.

[35] *Bell Telephone Co.* v. *Montreal, Toronto, Ottawa*, (1927), 34 C.R.C. 1.

...The duty of the board was to fix fair and reasonable rates; rates 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. By a fair return is meant that the company will be allowed as large a return on the capital invested in its enterprise (which will be net to the company) 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. In fixing this net return the board should take into consideration the rate of interest which the company is obliged to pay upon its bonds as a result of having to sell them at a time when the rate of interest payable thereon exceeded that payable on bonds issued at the time of the hearing. Properly to fix a fair return the board must necessarily be informed of the rate of return which money would yield in other fields of investment. Having gone into the matter fully in 1922 and having fixed 10% as a fair return under the conditions then existing, all the board needed to know in order to fix a proper return in 1927, was whether or not the conditions of the money market had altered, and, if so, in what direction, and to what extent.[36]

The *Bluefield* decision had a great influence on Canadian decisions. It was specifically referred to in several instances[37] and the factors which it said should be considered in determining the reasonableness of the rate of return were constantly applied.

In 1964, the Board of Transport Commissioners for Canada requested a public hearing into several aspects of the operations of The Bell Telephone Company of Canada and announced its intention to look into the rate of return of the Company.

In the judgment which it rendered after a lengthy hearing[38] the Board examined the jurisdictional aspect of its order and following the same line of reasoning which the Supreme Court had followed in the *B.C. Electric Railway Co.* case,[39] decided that the provisions of the *Railway Act* were wide enough to give it jurisdiction.

The principal section of the *Railway Act* which confers jurisdiction on the Board over the Company is section 380 which, by subsection (13) thereof, extends and applies the provisions of the Act to the Company, with the exception of certain specified sections, "insofar as reasonably applicable and

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[36] [1929] 2 D.L.R. 4, at p. 8; for detailed studies of invested capital see: *Ottawa* v. *Ottawa Electric Railway Co.*, *supra*, n. 31, *Re: Pipe Line Matters*, 50 C.R.T.C. 145; *Re: B.C. Telephone Co., Increase in Rates & Charges*, (1950), 66 C.R.T.C. 7.

[37] *Ottawa Electric Railway Co.* v. *City of Ottawa*, 41 C.R.T.C. 86; *Ottawa* v. *Ottawa Electric Railway Co.*, 59 C.R.T.C. 136.

[38] 56 B.T.C. 535.

[39] *Supra*, n. 4; where in searching for a justification of preserving the utility's right to a reasonable rate of return in an act which simply provided for "just and reasonable rates", the Court interpreted such provision as meaning that in addition to being so for the public, these rates should be so for the Company and that they should provide for a rate of return.

not inconsistent with this section or the Special Act". Amongst the sections of the Act so extended and applied to the Company are most, but not all, of the sections dealing with traffic, tolls and tariffs, and one of the most important sections in this group is section 328(5) which applies to the Company and confers on the Board powers to "fix, determine and enforce just and reasonable rates, and to change and alter rates as changing conditions or cost... may from time to time require..." Section 380(2) of the Act provides that all telephone tolls are subject to the approval of the Board; section 380(3) provides for the filing of tariffs and prohibits the Company from charging tolls which have not been approved by, and filed in a tariff with, the Board; and section 380(4) provides that the Board may deal with telephone tolls in the same manner as provided by the Act for freight tariffs, insofar as applicable and not inconsistent with the provisions of section 380.[40]

Since it had not the power to determine a rate base and to fix a rate of return, the Board did not see the determination of the latter as a goal in itself but as part of the rate-making process.

The Board in this case accepted capitalization as a rate base since all parties to the proceedings agreed to it: however, there was discussion as to which part of the capital should be considered, one of the parties favouring the equity only. The decision gives no reason for rejecting the latter consideration and accepts total average capitalization. It furthermore accepted the concept which we have discussed earlier of a "zone of reasonableness".

The Board, in that same decision, expressed some concern over the fact that it might be said that in fixing a rate of return, it was committing itself to adjusting the utility's charges to a level providing for that return. This would certainly be contrary to regulatory practice since it had often been repeated that the determination of a rate of return did not guarantee such return to the company.[41]

In the latest judgment regarding an application by Bell Canada for an increase in rates,[42] the Railways Transport Committee declined to consider the rate of return aspect in fixing the rates, although it had noted that the Company had been unable to raise the required additional capital on favourable terms and that the cost of its new debt capital was higher than the permissive rate of return fixed in the previous decision. In considering that the fixing of the rate of return was not the "sole test of the justness and reasonableness

[40] 56 B.T.C. 535, at pp. 715-716.

[41] In the *Hope* Case, *supra*, n. 1, at p. 603, the Supreme Court said: "Thus we stated in the *Natural Gas Pipeline Co.* case that 'regulation does not insure that the business shall produce net revenues.'"

[42] Decision rendered on September 25, 1969; R.T.C. File No. C-995, 178.

of rates", the Committee was right to a certain extent.[43] But if it is not the sole test, it certainly is an important one and in omitting to consider it, the Committee failed to fulfil its duty of "balancing the consumer's and the investor's interests." In a way, such finding does not even protect the consumer's interest, which is to pay the lowest possible price but also to get the best service and to be offered all the latest technological advancements. It is a fact that to meet these two last mentioned expectancies, the utility needs the additional capital. If the interest of the person who is providing this capital is not taken into account, he will not provide it and the consumer will resultingly suffer.

Provincial legislation

All provinces in Canada have legislation creating administrative tribunals of the nature of the Canadian Transport Commission, which are regulatory bodies for the public utilities under their jurisdiction. Provincial Acts (except those of Quebec, Ontario and Saskatchewan) contain special provisions concerning the rate base and the rate of return.

In the first category, all acts recognize the utility's right to a just and reasonable rate of return in very clear and specific language.[44] It follows that the Board acting thereunder cannot refuse to consider this aspect.

Determination of the rate base is generally left to the Board but certain guidelines are provided. Allowances for various items such as working capital, reasonable organization expenses and construction overhead are provided for in the Newfoundland,[45] Nova Scotia[46] and Manitoba[47] legislation.

The rate base itself is usually the cost of property: fair depreciated value and original cost less depreciation in Newfoundland; prudent original cost in Nova Scotia, Prince Edward Island,[48] Manitoba and

[43] In the *Permian Basin Area Case, supra,* n. 1, the Supreme Court of the United States said that investors' interest provide only one of the variables in the constitutional calculus of reasonableness."

[44] In most instances the Acts use the phraseology: "a just and reasonable rate of return" and in two cases, the words "in addition to operating expenses" are added, (Newfoundland and Nova Scotia).

[45] S.N. 1964, No. 39.

[46] R.S.N.S. 1967, c. 258 (note that all the list is exhaustive under this Act).

[47] S.M. 1959, c. 51.

[48] R.S.P.E.I. 1951, c. 133.

Alberta,[49] while legislation in British Columbia[50] is content with the general expression coined in *Smyth* v. *Ames*,[51] of value of the property of the public utility used in serving the customers.

In New Brunswick[52] the law merely states that the Board will fix a reasonable rate of return upon the investment of the utility. The Supreme Court of that province decided that since there were no provisions in the *Act* to determine the rate base, the Board or the Court had full discretion to choose whatever method of valuation it saw fit;[53] the Court heavily relied on American decisions, more especially on the *Bluefield*,[54] and *Hope*,[55] cases.

The Ontario and Quebec *Public Utilities Acts*[56] contain no special provision on the rate of return and rate base. However the Boards have always recognized the right of the utility to earn a fair rate of return.

The Ontario Energy Board statod in a 1961 decision:

> Historically it appears clear to the Board that in Ontario and in other jurisdictions in Canada and in the United States the fundamental matters to be considered in detormining whether ratos of a natural gas utility are just and reasonable are two-fold, firstly, from the standpoint of the consumers, the rates charged should be just and reasonable for the services furnished by the utility and secondly, from the standpoint of the utility, the rates charged should provide a just and reasonable return on its capital employed in the utility operations...
>
> Obviously, the Board must use certain tools or yardsticks in arriving at its decision in relation to these concepts. Again, in Ontario and in other jurisdictions in Canada and the United States, the yardstick which has been and is used almost without exception is the rate base — rate of return method, the rate base being the capital employed in the utility operation as referred to above, and the rate of return being the return earned by the utility on that amount. The return to the Applicant should be sufficient to provide revenue for the Applicant to pay for its cost of operation together with a fair return to the owners of the utility and further should be such as to enable the Applicant to attract on a reasonable basis the necessary capital for further extension and the proper maintenance of its services...[57]

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[49] S.A. 1960, c. 85.
[50] R.S.B.C. 1960, c. 323.
[51] *Supra*, n. 12.
[52] R.S.N.B. 1952, c. 186.
[53] *The King* v. *Rideout*, *supra*, n. 31.
[54] *Supra*, n. 16.
[55] *Supra*, n.1.
[56] R.S.O. 1960, c. 335; R.S.Q. 1964, c. 229.
[57] *In re: Consumer's Gas Company Rate Application*, decided August 15, 1961, at p. 9.

In Quebec, the *Public Utilities Board Act*[58] gives wide powers to the Board in fixing rates which are to be just, fair and reasonable: the interpretation of such a clause by the Supreme Court of Canada to the effect that rates must be fair and reasonable for the utility as well as the customer may be applied here.[59]

The right of the utility to a reasonable rate of return underlies the following pronouncements by the Board:

> ...l'expérience démontre que des taux d'abonnement insuffisants pour permettre au propriétaire de l'entreprise de s'acquitter convenablement de ses responsabilités comportent une déficience organique qui entraîne la confiscation lente de la propriété, ce qui est contraire à l'intérêt bien compris des abonnés et cause, en même temps, une injustice à l'endroit du propriétaire.[60]
>
> ...laissant un revenu disponible pour les intérêts et les dividendes de $35,968 représentant un pourcentage de 5% de la valeur dépréciée de l'actif immobilisé de l'entreprise.
>
> L'addition de ce revenu au revenu disponible pour intérêt et dividende mentionné précédemment fournirait un total de $49,434 représentant un pourcentage de 6.9% de la valeur dépréciée de l'actif immobilisé et de 5.8% de la valeur non-dépréciée de l'actif immobilisé de l'entreprise.
>
> ...il faut admettre que les pourcentages réalisés restent en deça des limites qui pourraient être considérées comme indispensables pour permettre à l'entreprise d'obtenir des capitaux requis de temps à autre pour défrayer le coût des améliorations et des agrandissements requis pour satisfaire aux exigences du service et de continuer à fournir le service le plus moderne possible.[61]

The *Electricity and Gas Board Act*,[62] like other provincial legislations, makes it a duty for the Board to allow a reasonable rate of return to the utility,[63] and specifies that this return shall be based upon the physical assets of a company. It then goes on to exhaustively enumerate what are to be comprised in these assets.

Conclusion

Public utility companies are in Canada and (though to a lesser extent) in the United States, one of the most important contributing factors to the national economy. In the United States, the American Telephone & Telegraph is, in terms of assets,[64] the largest corpo-

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58 R.S.Q. 1964, c. 229.

59 *B.C. Electric Railway Co. Ltd.* v. *Public Utilities of B.C.*, *supra*, n. 4.

60 *Re: Téléphone Lotbinière & Nicolet*, (1957) Ordonnance 6142.

61 *Re: Telephone Dorchester Inc.*, (1961) Ordonnance 7130.

62 R.S.Q. 1964, c. 87.

63 *Ibid.*, s. 12.

64 $40 B compared to General Motors' $23 B.

ration: this means that it attracts more investors, pays more wages[65] and pays more taxes. Bell Canada is to the Canadian scene what A. T. & T. is to the American. But this is not to say, however, that their economic performance will set the general trends or that it will be indicative. Over a ten year period, the growth rate of A. T. & T. has been slightly over 5%, a figure very rare indeed amongst the 500 largest industrials. Yet, although they are monopolies, they still are privately owned and there is no reason why, all factors considered, they should be at a disadvantage in terms of earnings. Simple business and common sense direct unregulated enterprises to offer the best possible service and goods adapted to modern science and technology so that they will meet competition and earn the best return. Utilities being legally obliged to offer the same thing should at least have equivalent rights. Competition is not altogether absent in the field of utilities. One has several choices of transportation. Even if there is but one choice of a utility, it does not mean that good financial results are automatic for the company offering it. This is why so much emphasis is and should be put by regulatory bodies on the comparable earnings test.

Unregulated business automatically reflects inflation, an important factor nowadays and one which definitely constitutes a risk for the investor. Regulated undertakings will not follow and immediately their level of earnings will be less than the former, even though they were comparable at one point. In surveying the financial position of the largest American corporations, the editors of Fortune stated,

> Probably no industry suffered more from inflation last year than the heavily regulated utilities. Rising demand for services boosted the operating revenues of every one of the 50 largest utilities... But the net income gain was only 1.9%, the smallest recorded since 1956.[66]

This is one example of the effectiveness of applying the "zone of reasonableness" concept in determining a rate of return: it would, moreover, call for a wider zone.

The independence of our judiciary towards the executive and legislative branches of government has always been considered one of the more attractive factors of our constitutional arrangement. Let not the regulatory bodies, which are not part of the judiciary, become agents of the financial policy of a government trying to control inflation. The utility is a privately owned company and there is no reason why its owners should be penalized separately from the ones of business in general. "It is, however, plain that power to

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65 Except for General Motors which has over 700,000 employees as compared to A.T. & T.s near 700,000.

66 Fortune Magazine, May 15, 1969 issue, Vol. LXXIX, No. 6, p. 199.

regulate is not a power to destroy", stated the Supreme Court of the United States in the *Permian Basin Area* case.

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. As numerous as are the regulation bodies in the United States, the methods are still changing and as recently as 1962, the New York Public Service Commission said:

> The question of fair rate of return continues to give regulatory agencies much concern. The issue is most important as well as highly controversial. There are no absolutes in arriving at a proper determination of what is a fair rate of return. Perhaps the one thing upon which all students of the subject would agree is that the determination of a fair return is, in the last analysis, a matter of judgment. This is not to say, however, that such determination is or can properly be an arbitrary one, devoid of any reference to and consideration of the relevant underlying factors.
>
> Another point upon which all should agree is that there is no one element, consideration, test, or criteria which can at all times and in all cases be singled out or given predominant emphasis. Sound judgment, as we see it, entails consideration of numerous factors.[67]

which proves that concepts are still changing and therefore remain adaptable.

Even if there are no definite rules to set a rate of return, at least the Constitution offers a safeguard to American utilities against regulatory decisions. We have no such thing in Canada and it is only through interpretation of texts, which otherwise exist in American legislation, that our courts have recognized the utilities' right to a return. True, we have been following American jurisprudence on that subject. However, the extent to which such following should go has at times been questioned.[68] However, our Canadian Constitution or Bill of Rights does not contain any provision similar to the XIVth Amendment of the American Constitution. The absence of this provision against confiscation makes the recourse to our common law tribunals more difficult. The ready-made remedial vehicle of the United States' system is latent but not specific under our system, inasmuch as our Canadian Courts have accepted the basic principles outlined in the United States decisions.

If, judicially, our regulatory bodies have seen fit to go to American decisions for principles which are after all, the product of a different system of law, it is even more natural that they should seek the

[67] *In re: Consolidated Edison Company of New York*, 41 P.U.R. (3d) 305.

[68] *Surrey Co-operative Association of B.C.* v. *C.N.R. & C.P.R.*, 54 C.R.T.C. 62; *In re: Telegraph Tolls*, 20 C.R.C. 1.

economic application of these principles from their American counterparts. Indeed, business conditions are strikingly similar in both countries, except that Canada is in need of more foreign capital. If its attraction is one of the more important factors in determining a rate of return, it follows that Canadian utilities' return should be as high, if not higher, than those fixed in the United States. However, in practice the contrary is true:[69] it is a fact that the rate of return allowed either directly as such or through the fixing of rates and charges by regulatory bodies in the United States is higher than that in Canada. There is no obvious reason for such, nowadays, when the absence of frontiers between the two countries makes it as easy for a Canadian to invest in American Telephone & Telegraph through his Montreal agent as for a New Yorker to find attractiveness in shares of Bell Canada.

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[69] Rate of return of A.T. & T. on total capital 8% — 8.5%; rate of return of Bell Canada on total capital 7-7.3%. Both cases decided in the Fall of 1969.