VIA RESS, EMAIL AND COURIER

April 8, 2008

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319, 27th Floor
2300 Yonge Street
Toronto, ON M4P 1E4

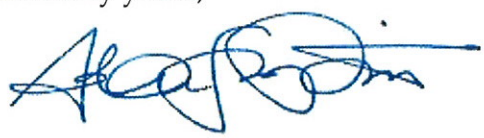
Dear Ms. Walli:

Re: Motion Record, Oshawa PUC Rates Decision
Board File No. EB-2007-0710

Attached please find AMPCO's motion record regarding the above proceeding.

Please contact me if you require additional information.

Sincerely yours,



Adam White
President

Copies to:
George Vegh, McCarthy Tetrault
Oshawa PUC and Intervenors in EB-2007-0710
Hydro One Networks Inc. and Intervenors in EB-2007-0681

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EB-2007-0710

ONTARIO ENERGY BOARD

IN THE MATTER OF the Ontario Energy Board Act, 1998 (the "*OEB Act*");

AND IN THE MATTER OF an Order by the Ontario Energy Board (the "Board" or the "OEB") dated March 19, 2008 which approved rates and other charges to be charged by Oshawa PUC for electricity distribution (Board File No. EB-2007-0710) (the "Oshawa PUC Rates Decision");

AND IN THE MATTER OF Rule 42 of the Board's *Rules of Practice and Procedure*;

AND IN THE MATTER OF Issue 7.1 of the Distribution Rates Application of Hydro One Networks Inc. (EB-2007-0681), addressing the appropriateness of cost allocation in that proceeding ("Hydro One Distribution Rates Application");

AND IN THE MATTER OF Subsection 21(5) of the *OEB Act* and s. 9.1 of the *Statutory Powers Procedure Act.*

MOTION RECORD

(AMPCO Motion for Review)

April 8, 2008

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INDEX

TAB **Contents (pages)**

1. The Notice of Motion for a rehearing in EB-2007-0710.
2. The PUC Rates Decision.
3. Rule 42 of the Board's *Rules of Practice and Procedure.*
4. Excerpts from OEB Decisions respecting Test for Motion to Review:
    - EB-2007-0797 (pp. 7-9)
    - EB-2006-0322/EB-2006-0338/EB-2006-0340) (pp. 17-18).
5. Board Report on *Application of Cost Allocation for Electricity Distributors.*
6. The Factum of the Ontario Energy Board dated September 12, 2007 filed with Divisional Court in Court File No. 273/07.
7. Excerpts from the following OEB Decisions respecting Rate Making Jurisdiction:
    - EB-2006-0034, (2006) (pp. 4-6)
    - RP-2003-0063 (2005) (p. 5)
    - EBRO 493 (1997) (p. 316-7)
    - RP- 1999-0017, paragraphs 2.458-2.459 (2001).
8. Richard Posner, "Taxation by Regulation", *Bell Journal of Economics and Management Science* 2 (Spring 1971) 22-50.
9. Pre-Filed Evidence of Hydro One Networks Inc. in EB-2007-0681 (G1, 3, 1).
10. *Statutory Power Procedure Act*, s. 9.1.
11. *OEB Act,* s. 21(5).

IN THE MATTER OF the Ontario Energy Board Act, 1998 (the "*OEB Act*");

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AND IN THE MATTER OF Subsection 21(5) of the *OEB Act* and s. 9.1 of the *Statutory Powers Procedure Act*.

NOTICE OF MOTION

The Moving Party, the Association of Power Consumers of Ontario ("AMPCO") will bring a motion to the Board at a time and place to be determined by the Board for an order:

(1) reviewing and directing a rehearing of the portion of the Oshawa PUC Rates Decision that allocates costs for distribution services between the customers of Oshawa PUC and specifically the Revenue to Cost Ratios approved by the Board;
(2) that the rehearing of the decision directed in accordance with (1) be combined with the revenue to cost ratios portion of the hearing respecting distribution rates proposed in s. 7.1 of the Issues List in the Hydro One Distribution Rates Application; and
(3) Such further and other order that the Moving Party requests and that the Board considers appropriate.

The grounds for the orders are:

(1) The Decision sets Oshawa PUC's distribution rates on the basis of revenue to cost ratios that systematically allows Oshawa PUC, at its discretion, to charge large volume general service and large user customer classes an amount greater than the cost of serving those classes. The Decision establishes two periods in which this over payment is allowed. The first period, ending in 2011, requires a reduction in this over payment from the range

up to 334% of the cost of service for the large volume general service class and from 257% for the Large User class. The second period, which starts in 2011, maintains the overpayment at up to the 180% and 115% ranges indefinitely. The result is that large volume customers must overpay for their services on an open-ended time frame. While these customers are over-paying, other customers are underpaying and receiving a subsidy. One of the beneficiaries of this subsidiary is Oshawa PUC's shareholder, who will contribute only 46% of the costs of serving street lighting.

(2) The Decision states that the Board may authorize Oshawa PUC to continue to overcharge large volume customers at its discretion as a result of the *Board Report on Application of Cost Allocation for Electricity Distributors,* November 28, 2007 (the "*Cost Allocation Report*").

(3) This Decision contains errors that are identifiable, material and relevant to the outcome of the proceeding. They are as follows:

i. The Decision misinterpreted the *Cost Allocation Report*. Specifically, the Decision stated that the policy expressed by that *Report* is that, to support just and reasonable rates, revenue to cost ratios need only fall within a range of permissible departures from unity. In fact, the *Cost Allocation Report* states that, "To the extent that distributors can address influencing factors that are within their control, (such as data quality), they should attempt to do so and to move revenue-to-cost ratios nearer to one [than contemplated in the ranges]". The *Report* thus sets a target of unity and requires justification of departures from that target up to a maximum allowable departure from unity – it does not allow utilities to have the option of whether or not to overcharge within an approved range. The Decision misinterpreted the *Cost Allocation Report* and erroneously relied upon that misinterpretation to both relieve Oshawa PUC from seeking to achieve a revenue to cost ratio of unity and to relieve the Board from the duty of setting rates based on unity. In doing so, the Board purported to give both Oshawa PUC and the Board a discretion to depart from cost causation within an approved range. This was not the intention or the direction of the *Cost Allocation Report*.

ii. In the alternative to (i), if the intention of the *Cost Allocation Report* is to effectively authorize either distributors or the Board to depart from cost causality and, instead, to achieve a range only, then the *Cost Allocation Report* contains an unlawful direction to depart from setting just and reasonable rates and cannot be followed by the Board in making orders that set rates. As a result, the Decision erred to the extent that it relied upon the *Report*, instead of evidence of cost causation, to set rates.

(4) The errors outlined above (and discussed in greater detail below) are material and relevant to the outcome of the Decision. If they are corrected, they would almost certainly change the outcome of the Decision in that a reviewing panel could decide that the Decision should be varied, cancelled or suspended. Specifically, a reviewing panel could produce a range of lawful orders with respect to revenue to cost ratios; for example, lawful orders could include:

i. That Oshawa PUC's revenue to cost ratio used for setting rates for 2008 be brought to unity or as close to unity as possible given current data;

ii. That, in the event that current data does not permit unity, then Oshawa PUC shall identify the data requirements necessary to achieve unity and collect and file such data in its next rates case so that the Board may rely upon it to set rates based on unity when adjusting rates for 2009; and

iii. If, for whatever reason and for whatever period, the Board determines that a revenue to cost ratio of unity should be transitioned for the benefit of customer classes that would otherwise experience "rate shock", then the Board can phase in any rate adjustments provided that any under-recovery from these customer classes is ultimately collected from these customers over time, and not from other classes of customers. The point here would be to track the cost of deferring the rate increase to those customer classes that benefit from deferring the rate increase.

(5) The issue of appropriate revenue to cost ratios for distribution rates is also being considered by the Board in the Hydro One Distribution Rates Application. It would therefore be appropriate for the Board to combine the hearing of this issue in both proceedings so that the results of the two cases are consistent.

The grounds for review are set out in further detail below.

The Rates Applied for and Approved

1. Oshawa PUC proposed distribution rates in this application that would have resulted in large customers over contributing to the cost of distribution services up to 334%. This would result in a collective subsidy from a small group of larger customers (less than 11) to other customers in the amount of over $1 million. Oshawa Hydro offered no reason why larger customers should be required to provide this subsidy.

2. Oshawa PUC's evidence was that the information from which these ratios were derived was "consistent with the cost data that supports the current approved distribution rates for OPUCN." (Pre-Filed Evidence Appendix E, p.2). Nothing in its evidence suggested that the data in relation to cost allocation was any less reliable than the data supporting the remainder of its evidence. In other words, the data in this case was sufficient for Oshawa PUC to have proposed, and for the Board to have set, a rate based on cost causality. However, the Board chose not to do so.

3. The Board's Decision in this case reduced, but did not eliminate the subsidy; a subsidy of approximately $750 thousand will be in place for 2008. Like Oshawa PUC, the Decision did not identify any deficiency in cost data that would necessitate a departure from cost causality. Further, the Decision did not even suggest that Oshawa PUC should be trying to achieve unity in allocating costs. It suggested that the only requirement was for Oshawa PUC to meet maximum allowable departures from unity as identified in the *Cost Allocation Report*. Further, it said that achieving these maximum allowable departures could be achieved over a three year period. At the end of the three year period, the rates charged by Oshawa PUC would not have to eliminate cross-subsidies; instead, they would only have to meet the maximum allowable departure. Oshawa PUC could continue to overcharge large customers by approximately $283 thousand for whatever

reason it wanted to in its discretion, provided that the overcharging did not exceed the permissible range.

4. Apart from stating that "cost causality is a fundamental principle in setting rates", the Decision did not propose any schedule or meaningful requirement that this principle would actually be met other than the statement that the maximum ranges would continue to be in place "until such time as data is refined and experience is gained." The Decision contained no further direction on:

- What data was to be refined;
- What steps Oshawa PUC is required to take to collect and refine this data;
- The level of refinement that was necessary;
- The schedule for this refinement;
- What experience was to be gained;
- What lessons would sought to be learned from this experience;
- Why the customer classes who benefitted from under paying during this period should not ultimately have to pay for the under collected costs; and
- When this experience would be completed.

5. The only clear direction from the Decision was that large customers would continue to subsidize other customers indefinitely, and at the discretion of Oshawa PUC.

The Reasons for the Decision

Misinterpreting the Cost Allocation Report

6. The Decision authorized Oshawa PUC to continue over charging large customers on the premise that revenue to cost ratios should seek to achieve a range of contributions to cost rather than unity. The rationale for this conclusion was said to be based on the *Cost Allocation Report*. The Decision addressed this as follows:

"As the Board has noted in its Cost Allocation Report regarding revenue to cost ratios, cost causality is a fundamental principle in setting rates, however, observed limitations in data affect the ability or desirability currently of moving immediately to revenue to cost framework around unity, which is considered ideal. The Board's ranges are a compromise until such time as data is refined and experience is gained." (p. 13)

7. With respect, this conclusion is both a misreading of the *Cost Allocation Report* and is inconsistent with the Board's rate setting jurisdiction.

8. It is a misreading of the *Cost Allocation Report* because the *Report* does *not* say that moving towards unity is an unattainable ideal. It says that the ranges are "minimum requirements" that do not replace the need to achieve unity if practical in light of data quality:

"To the extent that distributors can address influencing factors that are within their control, (such as data quality), they should attempt to do so and to move revenue-to-cost ratios nearer to one." (at p. 4, Emphasis Added)

9. Also:

"Distributors should endeavour to move their revenue-to-cost ratios closer to one if this is supported by improved cost allocations." (at p. 7, Emphasis Added)

10. The Decision thus erred to the extent that it treated the movement to revenue to cost ratios towards unity as some distant ideal; according to the *Cost Allocation Report*, unity is to be achieved if supported by data quality. There was no suggestion that data quality was lacking in this case.

11. The Decision also erred to the extent that it treated the *Cost Allocation Report* as relieving the Board from the duty to set rates based on cost allocation to the extent practical. In other words, even if the *Cost Allocation Report* did purport to authorize a range of ratios without reference to underlying cost information – which it did not – that goal would have been unlawful. The Board is still required to comply with the legal restrictions on its rate making authority – including the restrictions against undue discrimination between customer classes.

Inconsistency with the Legal Requirements for Just and Reasonable Rates

12. The Decision did not treat cost causation is a meaningful constraint on the discretion of the Board or of Oshawa PUC in charging rates to customers. The Decision thus departs from the Board's previous unequivocal statements respecting the fundamental legal requirements of cost causality as an inherent part of a just and reasonable rate. These statements are set out below; none of them were explicitly addressed by the Decision.

13. The Board recently had the opportunity to present its understanding of its jurisdiction respecting cost allocation to the Divisional Court as follows:

> "It has always been the Board's practice to allocate the revenue requirement to the different rate classes on the basis of how much of that cost the rate class actually causes. Put simply, rates are designed such that each rate class pays for the actual costs it imposes on the utility. To the greatest extent possible, the Board strives to avoid inter class subsidies." (Emphasis Added, Factum of the Ontario Energy Board dated September 12, 2007 filed with Divisional Court in Court File No. 273/07 "OEB Factum").

14. This representation to the Court was specifically based on limitations to the Board's jurisdiction to depart from principles of cost causality. The Board stated:

> "The Courts have specifically noted that treating customers equally includes charging consumers with similar cost profiles the same rate. Although the legislature is entitled to override the common law through statute if it chooses to do so, it must do so through clear and unambiguous language" (Emphasis Added, OEB Factum, paragraphs 23 and 24).

15. The Board also stated that cross-subsidies between customer classes would be inconsistent with its statutory objective to "protect the interests of consumers with respect to prices and the reliability and quality of ...service". According to the Board, that objective would be offended by a rate design that involved "conferring benefits of one set of consumers at the expense of another." (Emphasis Added, OEB Factum, paragraph 40).

16. Finally, the Board represented to the Divisional Court that, although it engages in balancing between consumer and utility shareholders, it cannot engage in "balancing of interests between groups of customers." (OEB Factum, paragraph 44).

17. As a result, the Board has made legal representations to the Divisional Court that it does not have the legal authority to approve rates that systematically contain subsidies imposed on one class of customers for the benefit of other customer classes. In light of the Board's legal responsibilities to the Court, those representations were not made lightly. If those representations are accurate, the Decision is incorrect.

18. Further, the representations by the Board to the Divisional Court are consistent with a long line of cases from the OEB. Specifically, the Board has made the following rulings with respect to undue discrimination between customer classes:

> "Economic regulation is rooted in the achievement of economic efficiencies, the establishment of fair returns for natural monopolies and the development of appropriate cost allocation methodologies...The Board's rate setting activities that currently have the effect of transferring benefits do so to accommodate either regulatory efficiency, the removal of financial barriers in support of government policy initiatives or so support a mitigation policy to overcome cost differential such as in rural rate subsidies...The Board also notes that to the extent that any of the current benefit transfers are material, such as in the rural rate subsidy and conservation initiatives, they are supported by the objectives of the Act, specific sections of the Act or by Ministerial Directives under section 27 of the Act." (Emphasis Added, EB-2006-0034, (2006) pp. 4-6).

Similarly:

> "Over the years, the Board has had many requests for special status for a customer group or a customer. The Board has been consistent in its response to such requests by adhering to its established principles in dealing with cost allocation and rate setting. Principled ratemaking involves the creation of a unified and theoretically consistent set of rates for all participants within the system. It begins with the establishment of a revenue requirement for the regulated utility and proceeds to design rates for the respective classes according to well-recognized and consistent theory respecting such elements as cost allocation. This is an objective and dispassionate process, which is driven by system integrity and consistent treatment between consumers on the system. Principled ratemaking typically does not involve a ranking of interests according to a subjective view of the societal value of any given

participant or group of participants. This approach is not unique to Ontario. A departure from these principles should only be undertaken where the evidence and all other circumstances outweigh the inherent virtue of an objective process. (RP-2003-0063 (2005), p. 5)

19. Another example:

"The Board is required by its legislation to "fix just and reasonable rates", and in doing so 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." (Emphasis Added, EBRO 493 (1997), p. 316-7)

20. Finally, the Board's commitment to cost causality as a component of just and reasonable rates is so firm that it would not allow a departure from that principle through incentive regulation. The Board dismissed a request by Union Gas to set rates based on a range of revenue to cost ratios between rates classes in its performance based regulation proposal:

"The Board is 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.

"The Board does not accept Union's arguments that "using a cost based measure, such as cross-subsidy is not meaningful in PBR because rates are judged just and reasonable by not being escalated beyond the restrictions approved by the Board" nor that "the approval by the Board of a level of pricing flexibility means that if Union makes rate changes anywhere within the boundaries of the flexibility constraints approved by the Board, then the result will be just and reasonable rates". The Board can not automatically assume that the resulting rates will remain just and reasonable among classes." (Emphasis Added, RP- 1999-0017, paragraphs 2.458-2.459 (2001).

21. As a result, the Board has identified cost causality as fundamental to its jurisdiction to set just and reasonable rates. This principle has been endorsed by many panels over many years. It is submitted that the Board cannot relieve itself from this duty by writing a Report.

Consequences of Departing From Principled Rate Making

22. The key consequence of a conclusion that the Board does not have to approve rates based on cost causality is that the Board is granting a discretionary authority to a distributor to impose costs on some customers for the benefit of others, for any reason that a distributor considers desirable. In other words, by taking this approach, the Board would be giving a utility a taxing power, that is, the power to redistribute among its customers. (for a demonstration of how the rate setting power may be distorted and used as a taxing power, see: Richard Posner, "Taxation by Regulation", *Bell Journal of Economics and Management Science* 2 (Spring 1971) 22-50).

23. This risk is not at all theoretical. In this case, the OEB did not seek, and Oshawa PUC did not offer, a principled or practical reason why large customers should be paying more than their costs.

24. As indicated, the Decision does not identify any deficiency in evidence that would prevent the attainment of unity in this case. Further, there was no basis in evidence for the Board to conclude that even the maximum ranges could not be achieved in this case. All it said was that bringing rates to within the range would have an "unacceptable impact for customers in the remaining classes." The decision offered no principled reason why it is unacceptable for customers to pay *their* cost of service but it was acceptable for larger customers to pay *more than* their cost of service.

25. This suggests a dangerous pattern where the Board or a utility can, at its discretion, determine who should be paying what based, not on cost causality, but on an explicit or implicit set of non-economic preferences. Signs of this pattern are already emerging. For example, in Hydro One's distribution rates case, Hydro One is proposing to change cost allocation to pursue various political goals. Thus, it is proposing that large customers continue to over-contribute to the cost of serving them, because to do otherwise "would result in either unacceptable bill impacts or the need for an excessively long impact mitigation period." (EB-2007-0681, G1, 3, 1, p.4). However, according to Hydro One,

distributed generation customers should no longer provide any subsidies "in support of Government policy to promote Distributed Generation in Ontario." (EB-2007-0681, G1, 3, 1, p.3).

26. In other words, under an approach which allows utilities to over and undercharge customers at their discretion, utilities are given the opportunity to allocate the cost of distribution services by reference to political objectives: they get to choose winners and losers. Although this approach has no basis in principled rate making, it is entirely consistent with the discretionary taxing policy approach allowed by the Decision.

Impact of Error

27. The Decision stands out as a departure from long history of principled and jurisdictional approaches to rate making. If the Decision was reconsidered, a reviewing panel would almost certainly not repeat this anomaly. Instead, it could, on the basis of evidence already provided, issue a range of orders that would comply with the Board's legal requirements. Examples of lawful orders could include:

    i. That Oshawa PUC's revenue to cost ratio used for setting rates for 2008 be brought to unity or as close to unity as possible given current data;
    ii. That, in the event that current data does not permit unity, then Oshawa PUC shall identify the data requirements necessary to achieve unity and collect and file such data in its next rates case so that the Board may rely upon it to set rates based on unity when adjusting rates for 2009; and
    iii. If, for whatever reason and for whatever period, the Board determines that a revenue to cost ratio of unity should be transitioned for the benefit of customer classes that would otherwise experience "rate shock", then the Board can phase in any rate adjustments provided that any under-recovery from these customer classes is ultimately collected from these customers over time, and not from other classes of customers. The point here would

be to track the cost of deferring the rate increase to those customer classes that benefit from deferring the rate increase.

Procedural Issues

28. This Motion has two procedural components that it is helpful to highlight. First, it requests that, if a review is held, that it be consolidated and heard together with the cost allocation issue in Hydro One's Distribution Rates Application. Second, it involves a request to have a hearing on the appropriate interpretation of a Board policy document -- the *Cost Allocation Report*. Both of these procedural components are consistent with previous approaches of the Board to address similar types of issues. They are addressed in turn.

Consolidating Hearings

29. The Board has the authority to consolidate proceedings, with or without the consent of parties, where two or more proceedings "involve the same or similar questions or fact, law or policy" (*Statutory Power Procedure Act*, s. 9.1; *OEB Act,* s. 21(5).

30. One example of where the Board has exercised this power is in the area of applications for mergers, amalgamations, acquisitions and divestitures under s. 86 of the OEB Act. In that area, three separate applications raised issues of what considerations should be in scope under a s. 86 application; the Board consolidated the proceedings so that it could produce a binding result. Given that similar issues are raised in this review as will be raised in the Hydro One Distribution Rates Case, combining the review with the treatment of the issue in that case is an efficient way to address the issues (RP-2005-0018; EB-2005-0234; EB-2005-0235; EB-2005-0257).

Applying the *Cost Allocation Report*

31. One of the issues in this review is how the Board should apply the *Cost Allocation Report*. As indicated, AMPCO's submission is that the panel in this Decision misinterpreted the *Report*. However, the *Report* itself is not legally binding. Further, the *Report*, because is it is not an order or rule of the Board, cannot be appealed to the Courts. As a result, it would be helpful to bring about greater legal certainty to hold a hearing on this matter. Holding a hearing to review the Decision provides an opportunity for the Board to make a clear legal ruling on how the *Report* should be applied.

32. One example of where the Board ordered a proceeding to determine how a non-binding report should be applied is in the area of Conservation and Demand Management ("CDM"; see: RP-2005-0020; EB-2005-0523). The Board's Report on CDM addressed a number of conservation issues on a generic non-binding manner. In order to provide certainty on some contested matters, the Board held a hearing to ensure that its resolution was both binding (i.e., through an order), and generic (i.e., would not just apply to the party before it). Similarly, in this case, it is helpful to have both a generic and binding ruling on the interpretation of the *Cost Allocation Report*.

Conclusion

33. AMPCO respectfully requests that the Board review and direct a rehearing of the Decision on the grounds that the Decision contains errors that are identifiable, material and relevant to the outcome of the proceeding.

34. Specifically, the Decision misinterpreted the *Cost Allocation Report* in concluding that, to support just and reasonable rates, revenue to cost ratios need only fall within a range of permissible departures from unity. The Decision erroneously relied upon that misinterpretation to both relieve Oshawa PUC from seeking to achieve a revenue to cost ratio of unity and to relieve the Board from the duty of setting rates based on unity. In doing so, the Board purported to give both Oshawa PUC and the Board a discretion to depart from cost causation within an approved range. This was not the intention or the direction of the *Cost Allocation Report*.

35. In the alternative, if the intention of the *Cost Allocation Report* is to effectively authorize either distributors or the Board to depart from cost causality and, instead, to achieve a range only, then the *Cost Allocation Report* contains an unlawful direction to depart from setting just and reasonable rates and cannot be followed by the Board in making orders that set rates. As a result, the Decision erred to the extent that it relied upon the *Report*, instead of evidence of cost causation, to set rates.
36. These errors are material and relevant to the outcome of the Decision. If they are corrected, they would almost certainly change the outcome of the Decision in that a reviewing panel could decide that the Decision should be varied, cancelled or suspended.

THE FOLLOWING DOCUMENTARY EVIDENCE will be used as the hearing of the motion:

1. The PUC Rates Decision.
2. Rule 42 of the Board's *Rules of Practice and Procedure.*
3. Excerpts from OEB Decisions respecting Test for Motion to Review:
   - EB-2007-0797 (pp. 7-9)
   - EB-2006-0322/EB-2006-0338/EB-2006-0340) (pp. 17-18).
4. Board Report on *Application of Cost Allocation for Electricity Distributors.*
5. The Factum of the Ontario Energy Board dated September 12, 2007 filed with Divisional Court in Court File No. 273/07.
6. Excerpts from the following OEB Decisions respecting Rate Making Jurisdiction:
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   - RP- 1999-0017, paragraphs 2.458-2.459 (2001).
7. Richard Posner, "Taxation by Regulation", *Bell Journal of Economics and Management Science* 2 (Spring 1971) 22-50.
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9. *Statutory Power Procedure Act*, s. 9.1.
10. *OEB Act,* s. 21(5).

Date: April 8, 2008

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AND TO: Oshawa PUC and Intervenors in EB-2007-0710

AND TO: Hydro One Networks Inc. and Intervenors in EB-2007-0681

Ontario Energy Board

Commission de l'énergie de l'Ontario

Ontario

EB-2007-0710

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, (Schedule B);

AND IN THE MATTER OF an application by Oshawa PUC Networks Inc. for an order approving just and reasonable rates and other charges for electricity distribution to be effective May 1, 2008.

BEFORE: Paul Vlahos
Presiding Member

Bill Rupert
Member

DECISION

Oshawa PUC Networks Inc. ("OPUCN" or the "Company") is a licensed distributor of electricity providing service within the City of Oshawa. OPUCN filed an application with the Ontario Energy Board, received on October 4, 2007 under section 78 of the *Ontario Energy Board Act, 1998*, seeking approval for changes to the rates that OPUCN charges for electricity distribution, to be effective May 1, 2008.

OPUCN is one of over 80 electricity distributors in Ontario that are regulated by the Board. In 2006, the Board announced the establishment of a multi-year electricity distribution rate-setting plan for the years 2007-2010. On May 4, 2007, as part of the plan, the Board identified which group of electricity distributors will have their rates rebased in 2008. OPUCN was included in the group for 2008. Accordingly, OPUCN filed a cost of service application based on 2008 as the forward test year.

The Board issued a Notice of Application and Hearing dated October 18, 2007. The evidence filed was made available to the public. The Vulnerable Energy Consumers Coalition ("VECC"), the School Energy Coalition ("SEC") and the Association of Major Power Consumers in Ontario ("AMPCO") intervened in the proceeding. The evidence in the application was tested through written interrogatories from Board staff and intervenors. Board staff, intervenors and OPUCN had an opportunity to file written submissions. Submissions by Board staff and intervenors were received by January 14, 2008 and the Company's reply submission was received on January 25, 2008.

In an effort to assist distributors in preparing their applications, the Board issued the Filing Requirements for Transmission and Distribution Applications on November 14, 2006. Chapter 2 of that document outlines the filing requirements for cost of service rate applications, based on a forward test year, by electricity distributors. The Board found that OPUCN's application, while generally complying with the filing requirements, was unclear in several areas and difficult to follow. The lack of quality and clarity of responses to interrogatories and the company's reply submission, and the errors and omissions, has caused the Board to spend a disproportionate amount of effort to understand the application and the company's positions on certain issues, as they kept changing. The Board expects the company to do a better job in its next cost of service application and to familiarize itself with the Board's regulatory processes for setting rates.

The full record is available at the Board's offices. The Board has chosen to summarize the record to the extent necessary to provide context to its findings.

RATE BASE

For a distributor, rate base consists of net fixed assets (gross fixed assets minus accumulated depreciation and any contributed capital) plus an allowance for cash working capital. Net fixed assets are determined as the average of the beginning and the end year values, and reflect capital additions for the test year. The Board's guidelines stipulate a level of cash working capital equal to 15% of the sum of OM&A expenses and the cost of power. The cost of power consists of the commodity cost of power and transmission charges.

In its filing, the Company had proposed a rate base of $64,758,238, consisting of $52,809,618 in net fixed assets and $15,247,548 in cash working capital, which was subsequently revised to reflect a change to the load forecast.
The Board deals below with the following issues: Capital Expenditures; and, Cash Working Capital.

Capital Expenditures
The Company's proposed rate base reflects the impact of $10.99 million in capital expenditures for 2008. The major drivers identified by OPUCN for its capital expenditures are customer growth and maintenance of its aging distribution system. With respect to maintenance, OPUCN produced an Asset Condition Assessment Study conducted by Kinectrics in 2006.

Board staff noted, and VECC concurred, that OPUCN did not submit any evidence on how capital investments were selected and how the improvement programs were prioritized, and that OPUCN may wish to address these in its reply submission.

In reply, the Company provided additional explanations in support of its argument that it has a comprehensive practice for establishing annual capital and maintenance programs.

Board Findings
On the basis of the additional information provided, the Board finds that the Company's "scoring matrix" of prioritizing capital needs is a reasonable approach and accepts the proposed level of capital additions for 2008. In so finding, the Board has noted the Company's relatively poor performance in the reported reliability indices, which is discussed elsewhere in this decision, and the capitals expenditures would improve reliability performance.

Cash Working Capital
OPUCN proposed a working capital allowance equal to 15% of the sum of: the Company's proposed OM&A, forecast cost of power based on a price of $0.0584 per kWh, and transmission costs based on pre-November 1, 2007 transmission charges.

AMPCO noted that the 15% ratio appears rooted in historic Board practice, but the Board has recently approved a ratio of 11.6% for Hydro One as a result of a lead/lag study and it should be this ratio that should apply for OPUCN.

VECC submitted that OPUCN failed to capture the material decrease in transmission charges approved by the Board, already in effect since November 1, 2007. VECC also submitted that OPUCN's assumed cost of power for 2008 ($0.0584) appears high when compared with the most recent Navigant forecast prepared for the OEB in October 2007 to support the November 1, 2007 RPP price.

In reply, OPUCN stated that there is no generally accepted method for forecasting the cost of power and declined to use Navigant's forecast prices. The Company also argued that the 15% ratio comes from the Board's own guidelines and in the absence of an OPUCN-specific lead/lag study, the use of Hydro One's 11.5% would be arbitrary. The Company indicated that its filing was made prior to Hydro One's announcement of the lower transmission charges and incorporation of the new charges would be appropriate.

Board Findings

AMPCO has suggested that OPUCN should compute its working capital allowance based on the results of the Hydro One study rather than use the Board's standard 15% factor. The Board notes that there have been two recent lead/lag studies, one by Hydro One and the other by Toronto Hydro. The results from both studies suggest that the historic 15% allowance may be high. The Board is not prepared to require OPUCN to apply the conclusions of those two lead/lag studies without first considering in some detail whether those studies are fully applicable to the circumstances of a wide range of distributors. Thus, the Board accepts OPUCN's use of the 15% ratio provided for in the Board's current guidelines.

Elsewhere in this decision, the Board directs the Company to reflect the updated costs for transmission. The Board directs the Company to adjust its cash working capital provision consistent with that finding. This will reduce the provision for cash working capital.

In Chapter 2 of the Board's filing requirements for distributors, the Board suggests that, when filing, the cost of power will be that available from the most recent Board-approved RPP. In the Board's view, there are benefits and no cost for the electricity distribution sector and for the Board to have one common cost of commodity power forecast. As long as the Board is required to produce a cost of power forecast in its responsibility to set RPP prices, and to the extent that the Board's forecast covers a period which can subsume in whole or in large part the test period for setting distribution

rates, it makes good sense to utilize that forecast. Applying individual efforts by each distributor can lead to inconsistencies among distributors, can be expensive and is unnecessary. The Navigant forecast used by the Board to set RPP prices for November 2007 onward covers most of the Company's test year filing. The Board finds the use of Navigant's forecast prices appropriate in this case. The Board directs the Company to reflect in its re-calculation of cash working capital an all-in supply cost of $0.054/kWh derived from Board's Price Report issued October 12, 2007. This will further reduce OPUCN's cash working capital provision.

OPERATING COSTS

Operating costs include OM&A expenses, depreciation and amortization expenses, payments in lieu of taxes (PILs taxes), and any transformer allowance payments to customers. PILs taxes are proxies for capital and income taxes that otherwise would have to be paid if the distributor was not owned by a municipality or the Ontario government.

The final PILs tax allowance for ratemaking purposes is determined after the Board makes its findings on other relevant parts of the Company's application.

Operating costs also include interest charges on the Company's debt. These are dealt with in the cost of capital section of the Decision.

The Board deals below with the following issues: OM&A Expenses; and, PILs Taxes.

OM&A Expenses

Table 1 shows the components of OPUCN's forecast OM&A expenses of $10,446,613 for 2008 (as shown in its initial filing). That amount is an increase of $2,209,597, or 26.8%%, over the Company's 2006 actual OM&A expenses.

Table 1: OM&A Expenses

	2006 Actual	2008 Forecast
Operations and maintenance	$ 1,009,058	$ 1,471,408
Billing and collections	2,053,343	2,248,345
Community relations	787,789	1,000,216
Administrative and general expenses	4,164,507	5,429,644
	8,014,697	10,149,613
CDM expenses (Note)	222,319	297,000
Total	**$ 8,237,016**	**$10,446,613**

Note: In OPUCN's application, the 2006 CDM expenses were included in the "Community relations" line item, and the 2008 forecast CDM expenses were include in the "Administrative and general expenses" line.

Board staff questioned whether OPUCN has provided sufficient evidence to support the substantial additional spending requested. In particular, Board staff identified an "unexplained difference" of $930,868 between the 2007 Bridge Year OM&A expenses and 2008 proposed OM&A, and pointed to a number of inconsistencies in the Company's responses to the interrogatories submitted by parties. Board staff also questioned the inclusion of a $297,000 amount for Conservation and Demand Management ("CDM").

VECC stated that it shares Board staff's concerns regarding the material increase in OM&A costs between 2006 and 2008, and the lack of comprehensive explanation for the overall change in costs. VECC also noted that there were inconsistencies between the total OM&A reported by OPUCN in its application and OPUCN's responses to VECC's interrogatories. VECC submitted that without any further explanations, the Board should reduce the Company's OM&A forecast by $1 million.

SEC noted that approximately $1.8 million of the proposed increase in OM&A from 2006 to 2008 appears to be related to wage and benefits for employees, which are not driven by changes in programs or work plans. SEC submitted that the proposed OM&A budget should be reduced by the amount of the $930,868 "unexplained difference" between 2006 and 2008 OM&A identified in Board Staff's submissions.

In reply, the Company reduced its forecast 2008 OM&A expense to $10,149,613 by removing the $297,000 amount related to CDM expenses. The Company maintained that its OM&A proposals are otherwise reasonable. OPUCN admitted that its evidence was not clear and that there were inconsistencies; however, it stated that the recasting of information provided in its reply submission rectified those problems and left no differences unexplained.

Board Findings

The Board notes that the Company is forecasting an expense of $150,600 for mounting this 2008 rates application but is also seeking a variance account. The Board does not accept the Company's proposal for a variance account. Deferral or variance accounts are reserved for situations where the risks of over or under recovery are greater than what is at risk here. Proliferation of variance accounts for these types of expenses would render the principle of a forward test year meaningless. The Board accepts the proposed expense of $150,600 as reasonable but does not accept expensing the total amount in the test year. In the Board's view, the more appropriate treatment is to amortize these expenses over three years, which is the expected duration of the benefit of this proceeding until the next rebasing. The Board will therefore allow one third of the expense. On the expectation that the 2008 approved revenue requirement will remain in place for three years, the Company will have recovered the full amount by the time it re-bases in 2011. To allow for the time value of money, the Board will allow an expense of $53,000 to be reflected in 2008 rates. The proposed regulatory expense for the test year shall be reduced by $97,600.

After deducting the regulatory expense ($97,600) and CDM ($297,000) adjustments referred to above, OPUCN's proposed 2008 OM&A expenses are $10,052,013, or 25% higher than the amount of 2006 actual OM&A expenses (after removing CDM expenses). That represents a 12% compound annual growth rate.

The Board found that the Company's OM&A presentation was not particularly helpful and understands the concerns expressed by Board staff and intervenors. In its reply submission, the Company presented an analysis that was intended to show there is no "unexplained difference" between 2006 and 2008 OM&A expenses. That analysis, although somewhat helpful to the Board, was submitted too late in the process to be tested by intervenors and Board staff. Accordingly, the Board was able to give only modest weight to the analysis. The Board concurs with the intervenors that the overall level of increase over 2006 is too high and finds that a further decrease of $500,000 is

warranted. The revised forecast 2008 OM&A expenses of $9,552,013 implies a more reasonable, although still significant, compound annual growth rate of 9% over 2006 actual spending.

PILs Taxes

It appeared to VECC that the Company has included capital taxes of $148,936 twice in calculating its 2008 revenue requirement - in total PILs and in account 6105 (Taxes other than Income Taxes). VECC also noted that it is not apparent that OPUCN has reflected in its PILs income tax calculations the new CCA class rate (at 55%) for computer equipment acquired on or after March 19, 2007 and the new CCA class (at 6%) related to buildings.

In its reply submission, OPUCN agreed to remove the duplicate $148,936 capital tax PILs amount, and agreed that the CCA rate to be used for computer purchases should be 55%.

Board Findings

In calculating the final PILS tax provision, the Board directs the Company to reflect in its Draft Rate Order the new federal income tax rate (reduced from 20.5% to 19.5%, yielding a combined federal and Ontario income tax rate for 2008 of 33.5%), the change in the Ontario capital tax exemption amount to $15 million from $12.5 million, and the new CCA class rates as applicable.

CAPITALIZATION/COST OF CAPITAL

Capitalization refers to the financing of total rate base through common equity, preference share capital (if applicable), long term debt and short term debt. Cost of capital refers to the cost rates for debt or preference share capital and the Board-authorized rate of return on common equity.

Table 2 below summarizes OPUCN's proposed capitalization and cost of capital.

Table 2: Proposed Capital Structure/Cost of Capital	
Parameter	**OPUCN Proposal**
Capital Structure	53.3% debt (composed of 49.3% long-term debt and 4.0% short-term debt) and 46.7% common equity
Short-Term Debt	4.77%, but to be updated
Long-Term Debt	6.70%, as a weighted average of 4.90% for third-party debt and 7.25% for a long-term debt with the municipal shareholder (affiliated debt).
Return on Common Equity	8.79%, but to be updated.

OPUCN's proposed rate of long-term debt for 2008 is comprised of existing third-party debt at 4.90% and a demand note to its parent of 7.25%, first arranged on November 1, 2000 (affiliated debt).

Both SEC and AMPCO submitted that the 7.25% cost rate for the affiliated debt should not be accepted for ratemaking purposes and that the Board's approach should be guided by the December 20, 2006 Board Report on cost of capital and 2nd generation IRM. AMPCO suggested that the allowed rate on the affiliated debt be reduced by at least 50 basis points, while SEC submitted that a rate of 6.25% be allowed.

OPUCN did not respond to the submissions of SEC and AMPCO.

Board Findings

The Board agrees with the comments of intervenors that OPUCN has provided limited information on the affiliated debt despite the fact that information was requested through interrogatories. What is ascertainable from the evidence is that it is a demand note with an affiliate and the interest rate is pegged at 7.25%.

As suggested by SEC, the Board is guided by the Board Report. In particular, the Board notes that section 2.2.1 of the Board Report states, in part:

> For all variable-rate debt and for all affiliate debt that is callable on demand the Board will use the current deemed long-term debt rate. When setting distribution rates at rebasing these debt rates will be adjusted regardless of whether the applicant makes a request for the change.

Notwithstanding the fixed rate of the instrument, based on the guidelines the Board finds that the allowed cost of debt on the affiliated and callable debt should be the deemed debt rate updated for 2008 in accordance with Appendix A of the Board Report. Based on Consensus Forecasts, Bank of Canada and TSX Inc. data for January 2008, this rate is 6.10%. OPUCN shall reflect this rate for the affiliated debt in determining its revenue requirement.

The Board deals with the updates of the other components of the cost of capital under the "Implementation Matters" section at the end of this Decision.

COST ALLOCATION AND RATE DESIGN

Once the total revenue requirement is determined, it is allocated through various steps to the various rate classes and is used to set rates for each class.

This section deals with Revenue to Cost Ratios, and Retail Transmission Service (RTS) Rates.

Revenue to Cost Ratios

In its original filing, the Company did not propose changing rates to reflect the results of its 2006 Informational Filing Run 2. The Company's rationale is that there was no definitive guidance from the Board on the application of the results of the 2006 cost allocation study. Since the application was filed, the Board has issued such guidance[1]. However, the Company is not proposing to apply the guidelines at this time.

In Table 3 below:

Column A shows the revenue to cost ratios[2] per the Company's Informational Filing based on data in its 2006 rates case;

Column B shows the ratios that flow from the Company's rate proposals;

Column C shows alternative ratios if proposals were to be within the Board-sanctioned ratios; and

[1] Application of Cost Allocation for Electricity Distributors, Report of the Board, Dated November 28, 2007
[2] Revenue to cost ratios are depicted in percentage terms or as factors around unity. For example a ratio of 120 can also be depicted as 1.2

Column D shows the target ranges as set out in the Board Report, *Application of Cost Allocation for Electricity Distributors*, issued November 28, 2007 ("Cost Allocation Report").

Table 3: Revenue to Cost Ratios				
Customer Class	**2006 Informational Filing Run 2** [A]	**Proposed Rates per Application** [B]	**Alternative Within Target Ranges** [C]	**Board Target Ranges** [D]
Residential	89	88	93	85 – 115
GS < 50 kW	130	134	120	80 – 120
GS > 50 kW to 1000 kW	158	102	108	80 – 180
GS > 1000 to 5000 kW	334	348	180	85 – 180
Large Use > 5000 kW	257	207	115	85 – 115
Street Lighting	23	33	70	70 – 120
Sentinel Lighting	55	60	70	70 – 120
Unmetered scattered load	132	109	109	80 – 120

Board staff noted that it is evident that OPUCN's rates for some rate classes would need to be changed substantially for the revenue to cost ratios to be within the target ranges. Board staff also noted that it is peculiar that the ratio in Column C for the GS > 1,000 to 5,000 kW rate class is further from 100 than the ratio in Column B.

VECC noted that the model used for the Informational Filing allocates the cost of transformers to the classes in proportion to the loads of the customers who do not own their own transformers only, however the total cost being allocated includes the "cost" of the transformer ownership allowance, resulting in an allocation of some of that cost to those classes where customer ownership of transformers is not found. VECC submits that there are two ways the model could have reflected a valid ratio of revenue to cost:

a. exclude the "cost" of the transformer ownership allowance from the revenue requirement and compare the class revenue requirements with actual revenues net of the allowance; or

b. allocate the "cost" of the allowance directly to the classes that receive the allowance and compare the class revenue requirements with revenues gross of the allowance.

VECC illustrates its point with the response to an interrogatory that shows, for example, that the revenue to cost ratio for OPUCN's Large User class in the Informational Filing is 2.57, but when recalculated using method a. would be only 2.14. VECC submits that, while an adjustment in rates for those classes with high ratios is appropriate, the adjustment should be more modest than the full-scale adherence to the Board's guidelines.

Also, it appeared to VECC that, in the case of the Residential class, the rates used inappropriately included the Smart Meter adder in the fixed monthly charge and the Regulatory Asset rider in the variable charge. In response to VECC's submission, OPUCN clarified that neither the Smart Meter nor the Regulatory Assets rate adders are used in the calculation of base revenues.

SEC submitted that the alternative ratios (shown in Column C) are a "good first step" at reducing the current cross subsidization except in the GS>50 rate class where the ratio moves further from unity.

AMPCO submitted that OPUCN should bring rates for the larger customer classes closer to unity than merely being within the Board-sanctioned ranges, based on the rationale that OPUCN's information is of better quality when compared to other electricity distributors. AMPCO suggested that for customer groups between 50 and 5000 kW, the data is of sufficient quality to support a tolerance band of 85 to 115. Regarding the issue of transformation allowance, AMPCO suggested that while the correct, principled approach is that customers should not be allocated cost for transformation assets they do not use, until a sound evidentiary basis can establish the underlying facts to implement this, the Board guidelines regarding transformer allowances should be followed.

The Company responded that if the Board were to move to different revenue to cost ratios than proposed by the Company (Column B), the Board should consider mitigating the effects over a period of three or more years.

Board Findings

As the Board has noted in its Cost Allocation Report regarding revenue to cost ratios, cost causality is a fundamental principle in setting rates, however observed limitations in data affect the ability or desirability currently of moving immediately to revenue to cost framework around unity, which is considered ideal. The Board's ranges are a compromise until such time as data is refined and experience is gained.

With respect to OPUCN's application, the Board is prepared to adopt the general principle that, where the proposed ratio for a given class (Column B) is above the Board's target range (Column D), there should be a move of 50% toward the top of the range from what was reported in the Informational Filing 2 (Column A). Under this approach, rates for three classes would be adjusted to achieve the following revenue to cost ratios:

GS < 50 kW	125
GS > 1,000 to 5,000kW	257
Large Use	186

Although the ratios for the GS > 1,000 and Large Use classes would continue to be high, the Board has concluded that an immediate move to the target ranges would result in unacceptable impacts for customers in some of the remaining classes, and some mitigation is warranted. Therefore, the rates for the two classes shall be set so that a move of 50% to the top of the Board's target ranges will be achieved for 2008. The Board expects the Company to achieve the remaining 50% by equal increments in years 2009 and 2010 when it makes applications for rate adjustments.

Where the revenue to cost ratios in the Informational Filing (Column A) are below the Board's ranges (Column D), the rates for 2008 shall be set so that the ratios for these classes shall move by 50% toward the bottom of the Board's target ranges.

Under this approach, rates for three classes would be adjusted to achieve the following revenue to cost ratios:

Streetlighting	46
Sentinel Lighting	62

The Board expects the Company to achieve the remaining 50% move by equal increments in years 2009 and 2010.

As a result of these findings, there will be a higher net revenue requirement that needs to be recovered from the other classes. Of these classes (Residential, GS > 50 kW to 1000 kW, and Unmetered Scattered Load), the Residential rate class will be under-contributing based on the Company's proposal. The Board finds that the higher net revenue requirement shall be recovered from the Residential class so that the under-contribution will be reduced.

The Board expects the Company to maintain this principle when it applies for rate adjustments in 2009 and 2010.

In filing its Draft Rate Order, the Company shall provide the information necessary to establish its compliance with the above directions for 2008 rates.

Retail Transmission Service (RTS) Rates

On October 17, 2007, the Board issued its EB-2007-0759 Rate Order, setting new Uniform Transmission Rates for Ontario transmitters, effective November 1, 2007. The Board approved a decrease of 18% to the wholesale transmission network rate, a decrease of 28% to the wholesale transmission line connection rate, and an increase of 7% to the wholesale transformation connection rate. The combined change in the wholesale transmission line connection and transformation connection rates amounts to a reduction of 5%.

On October 29, 2007, the Board issued a letter to all electricity distributors directing them to propose an adjustment to their retail transmission service (RTS) rates to reflect the new Uniform Transmission Rates for Ontario transmitters effective November 1, 2007. The objective of resetting the rates was to minimize the prospective balance in variance accounts 1584 and 1586 and also to mitigate inter-generational inequities.

The Company did not file a proposal to adjust its RTS rates.

Board staff noted that, in the GS > 50 to 1,000 kW class, OPUCN's existing Tariff contains separate and different RTS rates for interval-metered and non-interval-metered customers. However, the Company has dropped the metering distinction and used the higher RTS rates that applied for interval-metered customers. Board staff submitted

that OPUCN should clarify why it has proposed to continue with only one rate where currently there are two and why it is proposing only the higher of the two sets of rates.

Board staff submitted that the application should be updated to reflect the decrease in transmission rates, as recently approved by the Board for Ontario transmitters, and that this update would apply to all customer classes.

VECC agreed with Board staff's submission that OPUCN should update its application to reflect the decrease in transmission rates for 2008.

In reply, OPUCN agreed to continue the existing distinction between interval-metered and non-interval-metered customers in the GS > 50 to 1,000 kW class and to adjust its RTS rates for all rate classes.

Board Findings

The Board notes that there is a variance account mechanism for all distributors to capture differences between their transmission costs and the charges they levy on their customers. The issue is not whether the distributors or the customers would be financially harmed. Good ratemaking suggests that, to the extent possible and practical, rates and charges at a point in time should reflect the most current information so that any differences captured in variance accounts would be minimized. This would lead to smoother rate making and reduced concerns about inter-generational inequities.

Given the magnitude of the changes in wholesale transmission rates, the Board directs the Company to reduce its RTS – Network Service Rate by 18% and its RTS – Line and Transformation connection Service Rate by 5%.

The Board also directs the Company to continue the distinction that exists in its current rate schedules with respect to interval-metered and non-interval-metered customers. Some of the confusion about what the Company was proposing for these rates arose because the document "Existing Rate Schedules" included in OPUCN's application (Exhibit 9, Tab 1, Schedule 5) is incorrect and contrary to the current Board-approved RTS rates with respect to interval-metered and non-interval-metered customers. This is an example of why the Board had considerable difficulty ascertaining the facts when reviewing the Company's application.

The Board also notes that in Exhibit 9, Tab 1, Schedule 6, entitled "Proposed Rate Schedule", the Retail Transmission Charge - Network for the GS<50 kW class is shown as zero. This appears to be in error and should be corrected in accordance with the Board's findings above.

OPERATING REVENUE

For purposes of setting base distribution rates for the electricity sector, the Board determines the operating revenues from sales and subtracts certain revenues associated with certain charges by the distributor.

The Board deals below with the following issues: Load Forecast, and Revenue Offsets.

Load Forecast

The Company's load forecast was developed using a normalized average consumption ("NAC") estimate for a given rate class multiplied by a customer count forecast for that rate class. OPUCN's load forecast is based on a forecast customer count of 63,653 for 2008, an increase of 3.4% over 2006 or an annual average growth rate of 1.69%. The NAC value by class was based on 2004 consumption data and was weather-normalized using factors that had been developed by Hydro One.

In VECC's view the customer count for the residential customer class is understated and in SEC's view, the customer count forecasts for both the residential and GS<50 rate classes are understated. VECC noted that the 2006-2008 residential customer count growth rate is assumed by the Company at 1.2% per year but over the 2002-2006 period the average annual rate was approximately 1.7%, which VECC recommended be adopted by the Board. SEC noted that for the residential and GS<50 rate classes, OPUCN is forecasting 2008 customer count increases of just 1.4% and 1.5%, respectively, down from about 2.5% growth observed in 2006. SEC suggested a customer count growth rate of 2% for the residential and general service rate classes, the approximate mid-point between the historical average and the 2006 growth rate.

In reply, OPUCN argued that its customer count growth forecast is appropriate and noted that recent information indicates a customer count growth rate in the residential sector of only 1.5% for 2007, which is below recent historical trends.

Board Findings

The Board has noted the Company's comment in its reply argument that the residential growth rate for 2007 was recently announced at 1.5% over 2006. This would confirm the Company's position that past growth rates may not be sustainable. However, this is new untested information and the Board has given it little weight. On the basis of the Company's other evidence and argument, the Board accepts that past rates of customer growth in the Company's service territory should not be expected to be sustainable in the test year. The Board accepts the Company's customer count forecast for the 2008 test year.

The Board also accepts the Company's updated load forecast for 2008.

Revenue Offsets

In VECC's view, the forecast revenue from the SSS Administration charge is not reflected as an offset to OPUCN's distribution revenue requirement.

OPUCN did not respond to the submissions of VECC.

Board Findings

The Board notes that with respect to Account 4080B in the Uniform System of Accounts, the Accounting Procedures Handbook states that:

> "Distributors shall use this account to record revenues generated from the SSS Administration Charge. Distributors shall use a sub-account to separately track such revenues in light of Board expectations that each distributor will establish a specific utility charge for recovery of SSS administrations costs."

There is no indication OPUCN has done so. The Board directs OCUPN to follow the prescribed treatment outlined in the Uniform System of Accounts noted above and treat the forecast revenue from the SSS Administration charge as an offset to OPUCN's distribution revenue requirement. The Board expects OPUCN to explain how it has reflected this finding at the time it files its Draft Rate Order

DEFERRAL AND VARIANCE ACCOUNTS

OPUCN requested disposition of approximately $2.38 million of deferral and variance account balances as shown in Table 4. Positive balances are amounts due to OPUCN;

negative balances are amounts due to customers. The amounts in Table 3 are based on OPUCN's application, as modified and clarified in its reply to interrogatories and its final submission.

Table 4: Deferral and Variance Accounts – Disposition Requested by OPUCN				
Account	**Balance**	**Forecast Changes** (to April 30, 2008)		**OPUCN's Claim**
	Dec. 31, 2006	**Recoveries**	**Interest**	
	A	**B**	**C**	**A+B+C**
1508 Other Regulatory Assets	$ (21,501)	$ -	$ -	$ (21,501)
1562 Pre-May 2006 PILs	812,655	-	-	812,655
1580 RSVA – WMSC	(677,570)	-	(42,333)	(719,903)
1582 RSVA – One-time WMSC	63,405	-	3,636	67,041
1584 RSVA – Retail Transmission, Network	2,998,076	-	176,951	3,175,027
1586 RSVA – Retail Transmission, Connection	(1,605,640)	-	(98,127)	(1,703,767)
1588 RSVA – Power	115,716	-	12,885	128,602
1590 Recovery of Reg. Asset Balances	2,097,493	(1,523,352)	71,027	645,168
Total				**$ 2,383,322**

Account 1508 – "Other Regulatory Assets"

The balance in the 1508 account relates to an over-recovery by OPUCN under a Board-approved rate adjustment that was intended to cover lost revenue related to the closing of the facilities of one of the Company's large customers. In its final submission, OPUCN clarified that the balance represents revenues collected during January to March 2005 in excess of the Board-approved amount of $277,500.

Board Findings

The Board accepts clearance of this deferral account. As Table 3 indicates, OPUCN has not forecast interest on this account for the period January 1, 2007 to April 30, 2008. The Board's normal practice for deferral and variance accounts of electricity distributors is to order disposition of the most recent audited balance (December 31, 2006 in this case) together with interest from that date to the commencement of the related rate rider. The Board directs OPUCN to recalculate the balance for disposition by accruing interest at the appropriate rate on account 1508 to April 30, 2008.

Account 1562 – "Pre-May 2006 PILs Variance"

This account is used to capture certain variances between the amount of PILs taxes used to set rates up to April 30, 2006 and the amount of PILs taxes actually paid by a distributor.

Board Findings

Before approving disposition of account 1562 for any distributor, the Board has concluded it is necessary to ensure that distributors have been following a consistent approach to making entries to the account. As announced on March 3, 2008, the Board will initiate a combined proceeding to determine the accuracy of final balances in account 1562 for the seven distributors, including OPUCN, that have applied for clearance of the account in their 2008 cost-of-service filings. Thus, the Board does not approve clearance of account 1562 at this time.

Retail Settlement Variance Accounts (RSVAs)

Board staff noted that account 1588, RSVA – Power, is reviewed quarterly for disposition by the Board as part of the process required by Bill 23 (which is set out in section 78 (6.1) of the *Ontario Energy Board Act, 1998*). Staff suggested the Board consider how ordering the disposition of this account, as requested by OPUCN, might affect the Bill 23 process.

Board Findings

On February 19, 2008, which is after the completion of the argument phase, the Board announced an initiative for the review and disposition of commodity account 1588 (RSVA-Power). The Board noted that, as part of this initiative, it will also consider whether to extend this initiative to other accounts that are similar in nature, and named certain RSVA accounts. The Board finds that it would be best to wait for the outcome of

this initiative and therefore will not order disposition of the commodity or non-commodity RSVA accounts in this proceeding

The Board therefore does not approve clearance of accounts 1588, 1580, 1582, 1584, and 1586 at this time.

Account 1590 – "Recovery of Regulatory Asset Balances"
When the Board approved new rates for distributors for 2006, it also approved recovery of regulatory asset balances on a final basis. The Board approved rate riders to facilitate the recovery of the approved balances over the two remaining years of the four-year recovery period mandated by the Minister of Energy. The regulatory assets rate riders identified on OPUCN's current approved Tariff of Rates and Charges cease to be effective on May 1, 2008.

OPUCN is requesting disposition of its estimate of the forecast April 30, 2008 balance in account 1590 of $645,168 through the current disposition of regulatory deferral and variance accounts. OPUCN's proposed rate riders are constructed using this balance.

Board staff referred to the Board's Phase 2 decision for the Review and Recovery of Regulatory Assets for four large distributors (RP-2004-0117, RP-2004-0118, RP-2004-0100, RP-2004-0069, RP-2004-0064). The Phase 2 decision specified that rate riders associated with account 1590 be removed as of May 1, 2008. Once the residual balance in account 1590 is finalized, the residual balance is to be disposed at a future hearing. Staff noted that the final balance in account 1590 cannot be confirmed until after April 30, 2008.

VECC reiterated staff's concerns about OPUCN's proposal and submitted that the Phase 2 decision was clear about how and when residual balances in account 1590 are to be cleared.

In reply, OPUCN acknowledged the Board's earlier Phase 2 decision but submitted that "the request for disposition of the forecasted amount is made to relieve both the Board staff and OPUCN of the work involved in submitting an additional rate rider application at a later date."

Board Findings
The Phase 2 decision clearly contemplates final disposal of account 1590 once the actual final residual balance is verified after April 30, 2008. The Board will not approve clearance of the expected residual balance at this time.

Recovery Period
OPUCN originally proposed to recover balances in the deferral and variance accounts through two-year rate riders commencing May 1, 2008. Board staff submitted that recovery could be over a shorter period. SEC submitted that a faster recovery is not appropriate given the relatively large distribution rate impacts of OPUCN's application.

In response to staff's submission, OPUCN agreed there was merit to a shorter period of recovery and filed revised proposed rate riders based on a one-year recovery period. In its final submission, the Company stated that it would await guidance from the Board on the appropriate recovery period.

Board Findings
Based on the Board's earlier findings, the balances that the Board approves for recovery at this time total approximately $800,000, much less than OPUCN's request of $2.38 million. The Board approves recovery of the approved balances through class-specific rate riders over one year beginning May 1, 2008. The Board considers it reasonable for OPUCN to recover those balances quickly given that it is possible there might be larger rate riders required in later periods when the Board reviews and disposes of other accounts.

LOST REVENUE ADJUSTMENT MECHANISM ("LRAM") AND SHARED SAVINGS MECHANISM ("SSM")

In its December 10, 2004 decision in proceeding RP-2004-0203, the Board determined that an LRAM and an SSM were appropriate for electricity distributors, and that the mechanisms should apply to CDM expenditures relating to the third installment of distributors' market adjustment rate of return ("the third tranche"). As set out in the Board's Filing Requirements for Transmission and Distribution Applications ("Filing Requirements"), issued November 14, 2006, LRAM balances are determined by calculating the energy savings by customer class, and valuing those energy savings using the Board approved variable distribution charge appropriate to the class. SSM balances are determined as 5% of the net benefits of an approved CDM portfolio.

OPUCN is seeking in this application to recover an LRAM amount of $49,788, and an SSM amount of $97,237. Both amounts relate to fiscal year 2006.

As part of its application, OPUCN filed a report prepared by the EnerSpectrum Group which provided EnerSpectrum's assessment of OPUCN's LRAM and SSM amounts.

Through interrogatories, Board staff requested additional information from OPUCN regarding the calculation of the LRAM and SSM amounts.

In its submission, Board staff noted that having reviewed the EnerSpectrum Report, as invited by OPUCN in its response to Board staff interrogatories, it is unable to determine if the LRAM and SSM claims are calculated using appropriate input assumptions and data, as the EnerSpectrum Report did not contain the requested information. Staff submitted that the following information is needed to determine whether the amounts claimed are just and reasonable and invited OPUCN to respond to these in its reply submission:

- kW or kWh impacts, both net and gross of free riders, for each program and each class;
- Free rider rates for each program;
- TRC costs and TRC benefits for each program;
- Detailed explanation of how the proposed rate riders were determined;
- Duration of program delivery. OPUCN appears to have provided the equipment life in its response to the Board staff interrogatories, but not the duration of program delivery.

Board Staff also noted that OPUCN calculated energy savings using a rate of $0.0119 per kWh but a review of OPUCN's 2006 Board-approved tariff indicates that the volumetric rate for residential customers is $0.0107 per kWh. It also appeared to Board staff that the rate used by OPUCN to calculate the LRAM amount includes the Board-approved rate rider for Regulatory Asset Recovery of $0.0012 per kWh, which would be inappropriate.

VECC stated that it concurs with Board staff's submissions.

In reply, OPUCN provided certain additional information and adjusted the LRAM amounts by using the volumetric rate for residential customers of $0.0107 per kWh.

Board Findings

In reviewing the record, it is the Board's view that OPUCN has not satisfied the Board's procedural and evidentiary requirements, and for these reasons the Board is denying OPUCN's request for recovery of amounts relating to LRAM and SSM as part of this proceeding.

The onus is on an applicant to provide evidence to support all aspects of its application. An integral part of the hearing process is the examination, testing and challenging of that evidence by the intervenors and Board staff. To ensure that the intervenors and Board staff have that opportunity prior to the filing of written argument, an applicant is required to disclose and file all of the evidence on which it intends to rely by the time interrogatories are completed, and certainly before reply argument is submitted. Filing evidence as part of an applicant's reply submission circumvents an important step in the hearing process as it prevents the testing of the new evidence by the intervenors and Board staff. Short of resuming the hearing process, this cannot be rectified. The Board does not intend to resume the hearing and will not to rely upon untested evidence filed well beyond the appropriate timeline.

Moreover, OPUCN's evidence in this matter is still unclear and incomplete. The Board notes that the Company only provided detailed inputs and calculations for one of the four programs for which OPUCN is claiming LRAM amounts. Some information was provided for the other programs, but this information is less detailed, and it is not clear how it is used by OPUCN in the calculation of the proposed LRAM and SSM amounts. For example, the TRC costs and benefits, and a detailed explanation of how the proposed rate riders were determined has not been provided in relation to the LRAM amounts for the "Every Kilowatt Counts (Spring)", "Library Watt Reader", and the "Residential 155 Colborne Replace Bulk with Individual Meters" programs. Further, no information was provided as to which programs are included in OPUCN's SSM claim, as OPUCN provided only the total SSM amount and not the breakdown of how this amount was determined.

OPUCN may, if it wishes, bring forward an application for recovery of LRAM and SSM amounts at its next opportunity for a rate adjustment. The Board expects that any future application by OPUCN for recovery of LRAM and SSM will contain clear and complete information as to the calculations of the amounts proposed for recovery.

OTHER MATTERS

This section deals with issues that do not directly fit within the areas used by the Board to discuss the specific issues or are considered to be cutting across sections.

Service Reliability Indices

Board staff noted that the Board requires distribution companies to maintain service reliability within their three year historical performance. Board staff noted that the Company's performance in 2004 was poor compared to 2003 or 2005 and if continuous maintenance has been an ongoing practice for OPUCN, it is not clear why OPUCN has been unable to improve on its past reliability performance. Board staff further noted that it is not clear from the evidence that OPUCN has acted upon the Kinectrics report to develop a well-defined and comprehensive asset management plan to proactively address its poor reliability performance and effectively manage its facilities.

In reply, the Company corrected an error in its reliability indices it had previously reported and it noted that the higher outage time duration for 2006 was due to a lengthy outage caused by a substation breaker failure. The Company listed the programs that have been undertaken as a result of the Kinectrics study and noted that 70% of the Company's capital budget for 2008 relates to programs that would enhance the reliability of its distribution system.

Board Findings

The Board notes the Company's evidence regarding service reliability indices, which is reproduced in Table 5 below.

> SAIDI is the ratio of total customer hours interruption divided by total number of customers served.
>
> SAIFI is the ratio of total customer interruptions divided by total number of customers served.
>
> CAIDI is the ratio of total customer Hours of Interruption divided by total customer interruptions.

Table 5: Reliabilty Indices			
	SAIDI	SAIFI	CAIDI
2002	1.707	1.422	1.201
2003	1.505	1.221	1.233
2004	1.337	0.993	1.346
2005	1.122	1.142	0.982
2006	2.268	1.289	1.760
2007	1.782	1.158	1.539
Three-year average, 2005-2007	1.724	1.196	1.427
OPUCN Target	Less than 65 min	Less than 1	Less than 65 min

The Board finds that Board staff's concerns have merit. In all three categories of reliability, the Company's performance indicates a problematic trend generally and the achieved indices are substantially below the Company's own targets, particularly so in the case of SAIDI and CAIDI. The Board notes the Company's evidence that 70% of the proposed capital expenditures are related to programs that would enhance future reliability. As service reliability is most important to customers, the Board expects the Company to be vigilant about its service reliability performance going forward and to ensure that the capital expenditures authorized by the Board do result in substantial improvements in that regard.

Line Losses

Line losses are the difference between the Company's recorded energy purchases and recorded retail sales. The Board allows a loss factor to be included in rates. Differences between the losses reflected in rates and the actual losses are recorded in a variance account. The Company's proposed total loss factor (TLF") for 2008 is 1.0487. The underlying distribution loss factor ("DLF") for 2008 is 1.0440 and it is based on a three year average of the actual DLF for 2004 to 2006.

The actual DLF increased from 1.0402 in 2005 to 1.0474 in 2006. OPUCN stated that the increase was largely driven by theft in growhouses. Board staff and VECC expressed concern with the increase in actual losses in 2006.

In reply, OPUCN set out the following action it plans to take to decrease distribution losses:

- Perform a system optimization study in order to configure the distribution system in its most efficient state;
- Continue its practice to purchase transformers with optimum loss factors;
- Continue its program of working with local law enforcement agencies to identify and investigate theft of energy occurrences; and
- Upon implementation of smart metering, utilize a transformer metering device to compare transformer energy delivered with the summation of metering data for each service supplied, in order to identify theft of energy occurrences.

Board Findings

While the Board does not consider the reported loss factors to be that excessive compared with certain other electricity distributors and accepts the proposed loss factors, the Board is concerned with the increase in distribution losses in 2006 over 2005. The Board is encouraged by the Company's plan of action and expects the Company to be vigilant with respect to its losses, particularly those caused by theft.

IMPLEMENTATION MATTERS

Cost of Capital Update

In mid-2006, the Board initiated a consultative process to examine the cost of capital applicable to the Ontario electricity distribution sector. This process was conducted in conjunction with the development of the 2nd Generation Incentive Regulation plan. The product of these consultations was the Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors (the "Board Report"), issued December 20, 2006. The Board Report considered the extensive consultation record and established, in part, guidelines for setting and updating the cost of capital parameters for distribution rate-setting from 2007 onwards, including the return on common equity ("ROE"), the deemed short-term debt rate, and, as appropriate, the deemed long-term debt rate.

The Board Report established that the approved ROE to be used for rate-setting purposes should be calculated by application of the formula in Appendix B of the Board Report. In setting the ROE for the establishment of 2008 rates, the Board has used the Consensus Forecasts and published Bank of Canada data for January 2008, in accordance with the Board's guidelines. In fixing new rates and charges for the Company the Board has applied the policies described in the Board Report. Based on

the final 2007 data published by Consensus Forecasts and the Bank of Canada, the Board has established the ROE to be 8.57%.

The Board Report also established that the short-term debt rate should be updated using the methodology in section 2.2.2 of the Board Report. The Board has set the short-term debt rate at 4.47% using data from Consensus Forecasts and the Bank of Canada for January 2008.

Draft Rate Order

The Board has made numerous findings throughout this Decision. These are to be appropriately reflected in a Draft Rate Order incorporating an effective date of May 1, 2008 for the new rates and charges.

In filing its Draft Rate Order, it is the Board's expectation that the Company will not use a calculation of a revised revenue deficiency to reconcile the new distribution rates with the Board's findings in this Decision. Rather, the Board expects the Company to file detailed supporting material, including all relevant calculations showing the impact of this Decision on the Company's proposed revenue requirement, the allocation of the approved revenue requirement to the classes and the determination of the final rates. The Draft Rate Order shall also include customer rate impacts.

A Rate Order will be issued after the processes set out below are completed.

1. The Company shall file with the Board, and shall also forward to intervenors, a Draft Rate Order attaching a proposed Tariff of Rates and Charges reflecting the Board's findings in this Decision, within 14 days of the date of this Decision.

2. Intervenors may file with the Board and forward to the Company responses to the Company's Draft Rate Order within 20 days of the date of this Decision.

3. The Company shall file with the Board and forward to intervenors responses to any comments on its Draft Rate Order within 26 days of the date of this Decision.

A cost awards decision will be issued after the steps set out below are completed.

4. Intervenors eligible for cost awards shall file with the Board and forward to the Company their respective cost claims within 26 days from the date of this Decision.

5. The Company may file with the Board and forward to intervenors eligible for cost awards any objections to the claimed costs within 40 days from the date of this Decision.

6. Intervenors, whose cost claims have been objected to, may file with the Board and forward to the Company any responses to any objections for cost claims within 47 days of the date of this Decision.

The Company shall pay the Board's costs of, and incidental to, this proceeding upon receipt of the Board's invoice.

DATED at Toronto, March 19, 2008.

Original signed by

Paul Vlahos

Original signed by

Bill Rupert

ONTARIO ENERGY BOARD
Rules of Practice and Procedure, Rule 42

PART VII - REVIEW

42. Request

42.01 Subject to **Rule 42.02**, any person may bring a motion requesting the Board to review all or part of a final order or decision, and to vary, suspend or cancel the order or decision.

42.02 A person who was not a party to the proceeding must first obtain the leave of the Board by way of a motion before it may bring a motion under **Rule 42.01**.

42.03 The notice of motion for a motion under **Rule 42.01** shall include the information required under **Rule 44**, and shall be filed and served within 20 calendar days of the date of the order or decision.

42.04 Subject to **Rule 42.05**, a motion brought under **Rule 42.01** may also include a request to stay the order or decision pending the determination of the motion.

42.05 For greater certainty, a request to stay shall not be made where a stay is precluded by statute.

42.06 In respect of a request to stay made in accordance with **Rule 42.04**, the Board may order that the implementation of the order or decision be delayed, on conditions as it considers appropriate.

TAB 4:

Excerpts from OEB Decisions respecting

Test for Motion to Review

Ontario Energy Board

Commission de l'énergie de l'Ontario

Ontario

EB-2007-0797

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c.15 (Schedule B);

AND IN THE MATTER OF an application by Hydro One Networks Inc. for the review and approval of connection procedures;

AND IN THE MATTER OF an application by Great Lakes Power Limited for the review and approval of connection procedures;

AND IN THE MATTER OF Rules 42, 44.01 and 45.01 of the Board's *Rules of Practice and Procedure.*

BEFORE: Pamela Nowina
Vice Chair and Presiding Member

Paul Sommerville
Member

Ken Quesnelle
Member

DECISION AND ORDER

INTRODUCTION

On September 6, 2007, the Board (the "Connection Procedures panel") issued its Decision and Order in relation to applications by Hydro One Networks Inc. ("Hydro One") and Great Lakes Power Limited ("GLPL") under section 6.1.5 of the Transmission System Code (the "Code") for the review and approval of their respective connection procedures (the "Connection Procedures Decision"). The file number assigned to Hydro One's application was EB-2006-0189 and the file number assigned to the application by

The Connection Procedures Decision also discussed two further matters that have been raised by parties to this proceeding. The first is the regulatory treatment of capital contributions paid by distributors to transmitters. The second is adjustments to cost responsibility that can and should be made where a transmitter's plans call for the installation of unique system elements as part of the proposed reinforcement of connection facilities.

THE THRESHOLD QUESTION

1. Scope of the Power to Review

Under Rule 45.01 of the Rules, the Board may determine as a threshold question whether the matter should be reviewed before conducting any review on the merits.

The Notice and PO provided guidance in relation to this threshold question, based in part on the Board's May 22, 2007 Decision with Reasons on the NGEIR Motions (proceeding EB-2006-0322/EB-2006-0338/EB-2006-0340) (the "NGEIR Motions Decision"). Specifically, the Notice and PO indicated that the Board would wish to be satisfied that Hydro One's Motion to review raises a question as to the correctness of the Connection Procedures Decision, and is not being used as an opportunity to reargue the case.

The moving party must also satisfy the Board of the following:

- To the extent that an error in the Connection Procedures Decision is alleged:
    - that the error is identifiable, material and relevant to the outcome of the Connection Procedures Decision and that, if the error is corrected, the reviewing panel could change the outcome of the Connection Procedures Decision (in other words, there is enough substance to the issues raised that a review based on those issues could result in the reviewing panel deciding that the Connection Procedures Decision should be varied, cancelled or suspended); and
    - that the findings of the Connection Procedures panel are contrary to the evidence that was before that panel, the panel failed to address a material

issue, the panel made inconsistent findings, or another error of a similar nature was made by the panel.

- To the extent that the incompleteness of evidence is raised as a ground for review:

  - that the facts now sought to be brought to the attention of the Board could not have been discovered by reasonable diligence at the time; and

  - that those facts are material and relevant to the outcome of the Connection Procedures Decision and that, if considered by the reviewing panel, could change the outcome of the Connection Procedures Decision (in other words, the facts are such that a review based on a consideration of those facts could result in the reviewing panel deciding that the Connection Procedures Decision should be varied, cancelled or suspended).

With one exception, the parties did not expressly take issue with the threshold test as articulated above. In its written summary of submissions and at the oral hearing, the EDA argued that the Board cannot limit its substantive jurisdiction through its procedural rules, and that the issue of whether there is a "question as to the correctness of the order or decision" goes beyond whether there was a simple error. If the implications of a decision were not matters before the Board at the relevant time, and have only emerged subsequently, it is in the EDA's view appropriate for the Board to reconsider the conclusions that were reached in the decision.

During the oral hearing, the OPA submitted that while reviews initiated by motion are subject to the constraints identified in Rule 44 of the Rules, the Board has a broader power to review under Rule 43.01. That broader power can be exercised even if the Board finds that the moving party has not made a case for review under Rule 44.

During the oral hearing, Board staff agreed that the Board has wide latitude in relation to reviews, under both Rule 43 and Rule 44. However, in the case of an applicant-driven motion to review, it is not sufficient to simply reargue the case, or to argue that a different outcome might have been preferred. The moving party must show that the decision at issue is incorrect in an identifiable, relevant and material way.

This panel acknowledges that the scope of the Board's power to review is broad, but remains of the view that a motion to review must raise a question as to the correctness of the decision at issue. The Board has previously indicated, in the NGEIR Motions Decision and in the Notice and PO, that the grounds for review set out in Rule 44.01 are not exhaustive. It may be that the emergence of previously unknown or unforeseen implications of a decision could be considered a ground for review. However, in the circumstances of this case this panel does not need to decide that issue given the findings below.

2. The Section 71 Issue

a. Introduction

Hydro One's Notice of Motion raised the following grounds for review in relation to the Section 71 Issue:

i. the Connection Procedures panel erred in that there was incomplete evidence and information, which evidence and information could not have been discovered by reasonable diligence at the time or which were otherwise not brought to the attention of the Connection Procedures panel, thereby raising a question as to the correctness of the Connection Procedures Decision;

ii. the Connection Procedures panel erred in that, because of the absence of evidence and information referred to in (i), the Connection Procedures panel failed to protect the interests of consumers (third parties to whom Hydro One provides services and Hydro One's ratepayers), thereby raising a question as to the correctness of the Connection Procedures Decision; and

iii. the Connection Procedures panel's interpretation of section 71 of the Act occurred in the absence of relevant evidence before it, thereby raising a question as to the correctness of the Connection Procedures Decision.

Hydro One's Motion in relation to the Section 71 Issue was supported by OPG, Bruce Power, the OPA, PWU, the EDA, CLD and the IESO. ECAO and Board staff submitted that the threshold for review has not been met on the Section 71 Issue.

Ontario Energy Board
Commission de l'Énergie de l'Ontario

EB-2006-0322
EB-2006-0338
EB-2006-0340

MOTIONS TO REVIEW THE NATURAL GAS ELECTRICITY INTERFACE REVIEW DECISION

DECISION WITH REASONS

May 22, 2007

CCC and VECC argued that the moving parties are required to demonstrate, first, that the issues are serious and go to the correctness of the NGEIR decision, and , second, that they have an arguable case on one or more of these issues. They argued that the moving parties are not required to demonstrate, at the threshold stage, that they will be successful in persuading the Board of the correctness of their position on all the issues.

MHP argued that the threshold question relates to whether there are identifiable errors of fact or law on the face of the decision, which give rise to a substantial doubt as to the correctness of the decision, and that the issue is not whether a different panel might arrive at a different decision, but whether the hearing panel itself committed serious errors that cast doubt on the correctness of the decision. MHP submitted that a review panel should be loathe to interfere with the hearing panel's findings of fact and the conclusions drawn there from except in the clearest possible circumstances.

Kitchener argued that jurisdictional or other threshold questions should be addressed on the assumption that the record in NGEIR establishes the facts asserted.

School Energy Coalition argued that an application for reconsideration should only be denied a hearing on the merits in circumstances where the appeal is an abuse of the Board's process, is vexatious or otherwise lacking objectively reasonable grounds.

Findings

It appears to the Board that all the grounds for review raised by the various applicants allege errors of fact or law in the decision, and that there are no issues relating to new evidence or changes in circumstances. The parties' submissions addressed the matter of alleged error.

In determining the appropriate threshold test pursuant to Rule 45.01, it is useful to look at the wording of Rule 44. Rule 44.01(a) provides that:

> Every notice of motion... shall set out the grounds for the motion that raise a question as to the correctness of the order or decision...

Therefore, the grounds must "raise a question as to the correctness of the order or decision". In the panel's view, the purpose of the threshold test is to determine whether the grounds raise such a question. This panel must also decide whether there is enough substance to the issues raised such that a review based on those issues could result in the Board deciding that the decision should be varied, cancelled or suspended.

With respect to the question of the correctness of the decision, the Board agrees with the parties who argued that there must be an identifiable error in the decision and that a review is not an opportunity for a party to reargue the case.

In demonstrating that there is an error, the applicant must be able to show that the findings are contrary to the evidence that was before the panel, that the panel failed to address a material issue, that the panel made inconsistent findings, or something of a similar nature. It is not enough to argue that conflicting evidence should have been interpreted differently.

The applicant must also be able to demonstrate that the alleged error is material and relevant to the outcome of the decision, and that if the error is corrected, the reviewing panel would change the outcome of the decision.

In the Board's view, a motion to review cannot succeed in varying the outcome of the decision if the moving party cannot satisfy these tests, and in that case, there would be no useful purpose in proceeding with the motion to review.

Ontario Energy Board

Application of Cost Allocation for Electricity Distributors

Report of the Board

EB-2007-0667

November 28, 2007

Table of Contents

1 INTRODUCTION ..... - 1 -
1.1 Scope ..... - 1 -
1.2 Background ..... - 1 -
1.3 Approach to Cost Allocation ..... - 2 -
1.4 Organization of the Report ..... - 2 -

2 REVENUE-TO-COST RATIOS – A RANGE APPROACH ..... - 4 -
2.1 Policy Summary ..... - 4 -
2.2 The Underlying Analysis ..... - 4 -
2.3 Influencing Factors ..... - 5 -
2.3.1 Quality of the data: ..... - 5 -
2.3.2 Limited modelling experience: ..... - 6 -
2.3.3 Status of current rate classes: ..... - 6 -
2.3.4 Managing the movement of rates closer to allocated costs: ..... - 6 -

3 REVENUE-TO-COST RATIOS – RANGES BY RATE CLASS ..... - 8 -
3.1 Residential Class ..... - 8 -
3.2 General Service Less Than 50 kW Class ..... - 8 -
3.3 General Service 50 to 4,999 kW Class ..... - 9 -
3.4 General Service Unmetered Scattered Load Class ..... - 9 -
3.5 Large User Class ..... - 10 -
3.6 Street Lighting and Sentinel Lighting Classes ..... - 10 -

4 OTHER RATE MATTERS ..... - 12 -
4.1 Other Rate Matters ..... - 12 -
4.2 The Monthly Service Charge ..... - 12 -
4.2.1 Lower Bound for the Monthly Service Charge ..... - 12 -
4.2.2 Upper Bound for the Monthly Service Charge ..... - 12 -
4.3 Certain Specific Credits and Charges ..... - 13 -

5 IMPLEMENTATION ..... - 14 -

APPENDIX A ..... - 15 -

1 Introduction

1.1 Scope

This Report sets out the Board's policies in relation to specific cost allocation matters for electricity distributors, and represents the culmination of a consultation process that began several years ago. It addresses a number of issues, most significantly the relationship between the class revenue and the class total allocated costs (the "revenue-to-cost ratio"). This Report also discusses the treatment of the Monthly Service Charge, metering credits for the unmetered scattered load class, transformer credits for customer-owned transformers, and charges for the provision of standby power for customers with load displacement generation.

1.2 Background

While electricity rates have been unbundled for some time, the basic historical cost relationship among rate classes has remained largely unchanged for the past twenty years.

Consultations on cost allocation have been on-going since 2002, and have benefited from the significant involvement of, and collaboration by, stakeholders and Board staff. An important milestone in this process was the issuance, on September 29, 2006, of a report of the Board entitled *Cost Allocation: Board Directions on Cost Allocation Methodology for Electricity Distributors*,[1] which articulated a number of principles and established the cost allocation methodology to be used by distributors for the purpose of electricity rate design (the "Methodology"). To enable the Board to evaluate the Methodology, distributors were directed to use it in association with their respective approved 2006 revenue requirement for the purpose of making informational filings at the end of 2006 and through the spring of 2007.

The results of Board staff's analysis of the informational filings were set out in a staff Discussion Paper issued on June 28, 2007 and entitled *On the Implications Arising from a Review of the Electricity Distributors' Cost Allocation Filings*[2] (the "Discussion Paper"). Among other things, the Discussion Paper proposed an incremental approach for adjusting rates based on the Methodology. Interested parties were invited to comment on the Discussion Paper, and those that did so are listed in Appendix A.

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[1] Available on the Board's website at http://www.oeb.gov.on.ca/documents/cases/EB-2005-0317/report_directions_290906.pdf.
[2] Available on the Board's website at http://www.oeb.gov.on.ca/documents/cases/EB-2007-0667/staff-discussion-paper_20070628.pdf.

1.3 Approach to Cost Allocation

The establishment of specific revenue requirements through cost causality determinations is a fundamental rate-making principle. Cost allocation is key to implementing that principle. Cost allocation policies reasonably allocate the costs of providing service to various classes of consumers and, as such, provide an important reference for establishing rates that are just and reasonable.

The Board is cognizant of factors that currently limit or otherwise affect the ability or desirability of moving immediately to a cost allocation framework that might, from a theoretical perspective, be considered the ideal. These influencing factors include data quality issues and limited modelling experience, and are discussed in greater detail in section 2.3 of this Report. The Board also recognizes however, that cost allocation is, by its very nature, a matter that calls for the exercise of some judgment, both in terms of the cost allocation methodology itself and in terms of how and where cost allocation principles fit within the broader spectrum of rate setting principles that apply to – and the objectives sought to be achieved in – the setting of utility rates. The existence of the influencing factors does not outweigh the merit in moving forward on cost allocation. Rather, the Board considers that it is both important and appropriate to implement cost allocation policies at this time, and believes that the policies set out in this Report are directionally sound. With better quality data, greater experience with cost allocation modeling and further developments in relation to other rate design issues, the policies will be refined as required.

The policies set out in this Report have been informed by the Discussion Paper and the comments of interested parties on it. The Board is grateful to all that have participated in the consultations that have enabled the Board to complete this phase of its cost allocation work.

1.4 Organization of the Report

This Report is organized as follows:

- Section 2: **Revenue-to-cost Ratios – A Range Approach**, summarizes the Board's approach to revenue-to-cost ratios.
- Section 3: **Revenue-to-cost Ratios – Ranges by Rate Class**, sets out the class-specific revenue-to-cost ratio ranges that have been established for each customer class.
- Section 4: **Other Rate Matters**, discusses the treatment of the upper and lower bounds for the level of the Monthly Service Charges, metering credits for the unmetered scattered load class, transformer credits for customer-owned transformers, and charges for the provision of standby power for customers with load displacement generation.
- Section 5: **Implementation**, identifies how the policies set out in this Report are expected to be applied by distributors.

This Report includes, as applicable, descriptions of, the Board's rationale supporting its policies, relevant influencing factors and issues that require further examination.

2 Revenue-to-cost Ratios – A Range Approach

2.1 Policy Summary

This section sets out an overview of the Board's policy as it relates to revenue-to-cost ratios.

The Board has concluded that an incremental approach is appropriate in light of the influencing factors identified below, and that a range approach is preferable to implementation of a specific revenue-to-cost ratio. Influencing factors aside, a revenue-to-cost ratio of one may not be achievable or desirable for other reasons (for example, to accommodate different rate design objectives). In addition, as a practical matter there may be little difference between a revenue-to-cost ratio of near one and the theoretical ideal of one.

The Board has therefore adopted, with some modification, the proposal set out in the Discussion Paper of creating bands or ranges of tolerance around revenue-to-cost ratios of one. As the influencing factors are addressed over time, the Board expects that these bands will narrow and move closer to one.

The ranges established by the Board are set out in section 3, and are intended to be minimum requirements. To the extent that distributors can address influencing factors that are within their control (such as data quality), they should attempt to do so and to move revenue-to-cost ratios nearer to one. As indicated in the Report other issues such as addressing the fact that the Uniform System of Accounts is less detailed than required to accommodate the methodology and certain rate design matters are beyond the control of individual distributors. These exogenous issues also need to be addressed before moving to an appropriate specific revenue-to-cost ratio.

2.2 The Underlying Analysis

Board staff conducted an analysis of the informational cost allocation filings to evaluate the reasonableness of the results filed by each distributor. The analysis and the results are more fully described in the Discussion Paper. By way of summary, Board staff employed two different approaches to test for reasonableness, both of which used the ratio of the class revenue compared to the allocated costs to the class as a measure of reasonableness.

The first approach was a statistical cross-sectional analysis to determine if the results by rate class across distributors tended to cluster. The second examined whether the clustering or lack of clustering could be explained by the input assumptions or judgments in the Methodology. This second analysis tested the sensitivity of the results to the judgements used to categorize the most significant component of the revenue

requirement; namely, the total cost related to the shared distribution facilities (poles, lines and transformers).

2.3 Influencing Factors

In developing its policy on revenue-to-cost ratios, the Board has considered the impact of the following factors.

2.3.1 Quality of the data:

It is apparent that accounting and load data can be improved. Although the cost allocation review was conducted on the approved 2006 distribution rates and revenue requirements, many distributors did not have the details that would be needed to develop more robust cost allocations. More extensive internal accounting would improve accuracy of costs by reducing the frequency of prorating operating and depreciation expenses. Comments received from some of the distributors also suggested that the Uniform System of Accounts should be modified to capture the level of detail required for cost allocation.

In addition, load data and load analysis contribute to important cost allocators; namely, the coincident peak and the non-coincident peak. The Board recognizes the significant work done by distributors, and Hydro One Networks Inc. in particular, in obtaining a set of load data as part of the cost allocation informational filings. However, the Board acknowledges that some of the information is based on estimates from a statistical model and may not be completely representative of current loads due to sampling errors and current market characteristics.

Data improvements in the future: It is important that accounting and load data be available at the appropriate level of detail to address the need for and use of estimated or default allocations and to ensure the reasonableness of the cost allocation results. There is also a need to examine the current Uniform System of Accounts to see if there are modifications that could be made in order to provide for the level of detail required for cost allocation purposes. A general review of the Uniform System of Accounts is currently being undertaken by the Board's audit group. This work is expected to consider the need for both greater accounting detail and additional accounting guidance. In the interim, distributors should nonetheless endeavour to record accounting information at a level of detail that accommodates cost allocation data input requirements.

With respect to load data and load analysis, the Board anticipates that the installation of smart meters, with their more exact load data, will provide opportunities for better analysis in the future and, as a result, will provide better cost allocators for the cost allocation model.

2.3.2 Limited modelling experience:

The cost allocation model is complex, and the data required for the model was not always readily available for modelling. This created interpretation issues for the analysts using the model, including the appropriate aligning of costs for the different voltage levels in the model and the number of connections for street lighting. The informational filings were the first time most distributors performed a cost allocation. As distributors apply this model in subsequent filings they will develop greater expertise in the application of data to the model, which in turn will allow for a greater reliance on the outcomes.

Modelling improvements in the future: The Board anticipates that, as distributors become more familiar with cost allocation concepts, they will better understand the blending of operating statistics and practice with accounting data, and they will more effectively and consistently use the models in the preparation of their rate applications. The Board also expects distributors to review their allocation factors as better load data become available from smart meters.

2.3.3 Status of current rate classes:

The general customer classifications have been in existence for many decades and the rate structures have been in place since the early 2000s. The current cost allocation methodology and model are based on these classes and structures. The introduction of smart metering will provide additional data and new ways to examine class structures. Any changes in customer classification or load data could have a significant impact on future cost allocation studies.

Rate classes in the future: An initiative is currently under way to examine the rate design for electricity distributors (consultation process EB-2007-003) (the "Rate Review"). The Rate Review covers both customer classification and rate structure issues, and its results could affect the way in which rates are set in the future.

2.3.4 Managing the movement of rates closer to allocated costs:

A principle of rate making is that rate stability in most instances is desirable. Rates should not be constructed in a manner that leads to subsequent counter directional changes. The Board considers it appropriate to avoid premature movement of rates in circumstances where subsequent applications of the model or changes in circumstances could lead to a directionally different movement. Rate instability of this nature is confusing to consumers, frustrates their energy cost planning and undermines their confidence in the rate making process.

Another principle of rate making is the avoidance of rate shock. Proposed rate changes should consider the ability of consumers to react to their new costs. In aligning rate levels closer to costs, reducing a high revenue-to-cost ratio for any one class requires an offsetting increase to one or more other classes. Such

realignments could result in large rate increases, particularly when combined with other plans that affect the distributor's revenue requirement.

The Board expects to address these concerns as and when they arise in the context of individual rate applications. Distributors should endeavour to move their revenue-to-cost ratios closer to one if this is supported by improved cost allocations. However, if a large increase is required to move closer to one, rate mitigation plans should be proposed by the distributor. Distributors should not move their revenue-to-cost ratios further away from one.

3 Revenue-to-cost Ratios – Ranges by Rate Class

This section sets out the revenue-to-cost ratios established by the Board for different rate classes.

3.1 Residential Class

The Board has concluded that, for the Residential Class, the appropriate range within which the revenue-to-cost ratio should fall is +/- 15% of 1.00 (i.e., 0.85 to 1.15).

The Residential Class comprises customers that use electricity exclusively in a separate metered living accommodation, which is typically a detached home, town home or premises within a building such as a triplex. When viewed cross-sectionally, the revenue-to-cost ratios reflected in the informational filings clustered closely around a common value. The sensitivity analysis supported a narrow range for variances in allocated costs.

The Discussion Paper proposed a range of +/- 20% centred on revenue-to-cost ratios of 1.00. Some participants commented that the Residential Class range should be narrower. The Board notes that the analysis tends to support a greater statistical confidence in the outcomes of the Residential Class cost allocations. There is also greater homogeneity in this class, and less likelihood that changes to rate classifications would affect the overall costs assigned to this type of customer. The range established by the Board is therefore narrower than that proposed in the Discussion Paper.

3.2 General Service Less Than 50 kW Class

The Board has concluded that, for the General Service less than 50 kW Class (the "GS<50 Class"), the appropriate range within which the revenue-to-cost ratio should fall is +/- 20% of 1.00 (i.e., 0.80 to 1.20).

The GS<50 Class comprises non-residential customers whose monthly average peak demand is less than 50 kW. Typically, these accounts are for commercial, institutional, industrial and bulk-metered apartment buildings or condominiums. When viewed cross-sectionally, the revenue-to-cost ratios reflected in the informational filings clustered closely around a common value. The sensitivity analysis tended to support a relatively narrow range for variances in allocated costs.

The Discussion Paper proposed a range of +/- 20% centred on a revenue-to-cost ratio of 1.00. Most participants agreed with this range. However, some participants also commented that the GS<50 Class should have a narrower range. The Board notes that this Class is less homogenous than the Residential Class. In addition, the 50 kW boundary that separates this Class from the General Service 50 to 4,999 kW Class is

somewhat arbitrary. The widespread introduction of smart or interval metering for customers in both this class and the next larger class will provide a better basis on which to re-examine both class structures as part of the Rate Review. For these reasons, the Board believes that the +/- 20% band proposed in the Discussion Paper is appropriate.

3.3 General Service 50 to 4,999 kW Class

The Board has concluded that, for the General Service 50 to 4,999 kW Class (the "GS≥50 Class")the appropriate range within which the revenue-to-cost ratio should fall is -20% to +80% of 1.00 (i.e., 0.80 to 1.80).

The GS≥50 Class comprises all subclasses whose monthly average peak demand falls within the range of 50 kW to 4,999 kW. The customers are typically large industrial, commercial, multiple dwelling and institutional buildings. The cross-sectional analysis of the revenue-to-cost ratios reflected in the informational filings did not reveal any clustering. Distributors with such customers generally had revenue-to-cost ratios significantly above 120%. The sensitivity analysis also indicated large changes in the revenue-to-cost ratios as assumptions in the methodology changed.

The Discussion Paper proposed an asymmetrical range around 1.00 of -20% to +80%. A number of participants agreed with this proposal, noting concerns about the effects on other classes if the range were made too narrow too quickly. Given the heterogeneity of this Class it is difficult to assess the directional impact the intended abatement of the aforementioned influencing factors will have on its constituent's rates. Due to the potential for undesirable rate instability, for other classes as well as members of this class, the Board believes that the adoption of a narrower band than that proposed in the Disscussion Paper would be inappropriate at this time.

3.4 General Service Unmetered Scattered Load Class

The Board has concluded that, for the General Service Unmetered Scattered Load Class (the "USL Class"), the appropriate range within which the revenue-to-cost ratio should fall is +/ 20% of 1.00 (i.e., 0.80 to 1.20).

Unmetered scattered loads ("USL") are accounts for unmetered applications such as bus shelters, telecommunications and cable amplifiers, billboards and the like, where the billing determinant can be established by applying the operating hours to the operating loads. The majority of distributors charge USL customers on the basis of the GS<50 rate schedule (possibly with a modification of the Monthly Service Charge). A few distributors have a stand alone rate schedule for the USL Class. With few data points, the analysis for distributors with a stand alone USL Class was inconclusive.

The Discussion Paper proposed that the range for the USL Class not differ from that of the GS<50 Class. Most participants did not specifically comment on this staff proposal. While one participant submitted its own analysis, the resulting comments were primarily

related to rate design issues. The Board believes that, for cost allocation purposes, all USL customers should be treated the same regardless of whether they are in a separate rate class or are classified in the GS<50 Class. Given that the majority of distributors charge USL customers on the basis of the GS<50 Class rate schedule, the range is set to be the same as that for the GS<50 Class; namely, +/- 20% centred on a revenue-to-cost ratio of 1.00.

3.5 Large User Class

The Board has concluded that, for the Large User Class, the appropriate range within which the revenue-to-cost ratio should fall is +/- 15% of 1.00 (i.e., 0.85 to 1.15).

This Class comprises very large customers whose monthly average peak demand is equal to or greater than 5,000 kW. They are typically large industrial customers. The cross-sectional analysis of the revenue-to-cost ratios reflected in the information filings did not reveal any clustering. Distributors with such customers generally had revenue-to-cost ratios significantly above 120%. The sensitivity analysis also indicated large changes in the revenue-to-cost ratios as assumptions in the methodology changed.

The Discussion Paper proposed an asymmetrical range around 1.00 of -20% to +180%. Some participants proposed narrower bands than the one proposed in the Discussion Paper. The Board notes that customers within this Class have been interval metered for many years, which results in better load data. The relative size of customers in this class means that better operating and cost data are available. The Board therefore considers the results of the cost allocation model for the Large User Class more reliable than the results in the case of the GS≥50 Class. The Board has therefore adopted a narrower range for this Class than the one proposed in the Discussion Paper.

3.6 Street Lighting and Sentinel Lighting Classes

The Board has concluded that, for both the Street Lighting Class and the Sentinel Lighting Class, the appropriate range within which the revenue-to-cost ratio should fall is -30% to +20% of 1.00 (i.e., 0.70 to 1.20).

Staff's analysis treated these two Classes together due to their similarities; namely, there is no metering, and the load profiles are similar, responding to the lack of daylight. In the cross-sectional analysis of the revenue-to-cost ratios reflected in the informational filings, there was a strong tendency to cluster at a very low ratio around 30%. However, these Classes are sensitive to changes in the assumptions in the model.

The Discussion Paper proposed an asymmetrical range of -30% to +20% around 1.00. Comments from participants suggested that the model over-represents costs for street lighting. If this is correct, the resulting revenue-to-cost ratio would tend to be understated, probably with a value below 1.00.

The Board agrees with staff's analysis and with the comments of participants to the effect that the Street Lighting and Sentinel Lighting Classes present significant issues that need to be resolved in respect to the allocation of costs and the model's sensitivity to changes in assumptions. The Board has therefore adopted the range proposed in the Discussion Paper.

4 Other Rate Matters

4.1 Other Rate Matters

The review of the informational cost allocation filings considered other rate design matters. This section discusses the treatment of the fixed rate component (Monthly Service Charge ("MSC")) of the distribution rate as well as metering credits for the USL Class, transformer credits for customer-owned transformers, and charges for the provision of standby power for customers with load displacement generation.

4.2 The Monthly Service Charge

4.2.1 Lower Bound for the Monthly Service Charge

The Discussion Paper proposed that the floor for the MSC be the avoided costs. Staff's rationale for this proposal was that these costs are not subject to other cost allocation judgments (such as the minimum plant) and therefore there can be a higher level of confidence in the associated outcomes. These are costs defined as meter-related, billing, and collection costs. Many participants agreed with this proposal. One participant commented that the costs associated with a service drop should also be included in the avoided cost calculation. The Methodology was specific about the definition of avoided costs and the Board is not persuaded to depart from that definition at this time. The Board remains of the view that the use of avoided costs, as defined in the Methodology, is an appropriate basis for establishing the minimum or floor amount for the MSC at this time.

4.2.2 Upper Bound for the Monthly Service Charge

The Methodology set a ceiling for the MSC based on the avoided costs plus the allocated customer costs. The Discussion Paper proposed that the ceiling for the MSC be 120% of this level. Some participants believed that the results of the sensitivity analysis were not an appropriate basis for setting an upper bound.

The Board considers it to be inappropriate to make significant changes to the ceiling for the MSC at this time, given the number of issues that remain to be examined. The appropriateness of the methodologies cited above, used to set the MSC is an issue that will be examined within the scope of the Rate Review. The Rate Review will also examine the role of rate design in achieving various objectives, including conservation of energy. Both of these undertakings will have determinative impacts on the fixed/variable ratio policy.

In the interim, the Board does not expect distributors to make changes to the MSC that result in a charge that is greater than the ceiling as defined in the Methodology for the MSC. Distributors that are currently above this value are not

required to make changes to their current MSC to bring it to or below this level at this time.

4.3 Certain Specific Credits and Charges

The following were identified in the Methodology as questions to be addressed through the review of the informational filings:

1. Should one provincial rate be set for a metering credit for USL?
2. Should one province-wide rate be set for a transformer credit for customers that own their own transformers?
3. Should one province-wide rate be set for a load displacement generation standby charge?

The cost allocation model was designed to specifically determine these rate components on a distributor-specific basis, with the intent of being able to reflect each distributor's costs as opposed to having one standard credit or charge for all distributors.

The Discussion Paper indicated that the setting of an average province-wide value would not be appropriate, principally due to the variability in the results using the cost allocations. Most participants commented that these credits and charges should be determined on a distributor-by-distributor basis.

These credits and charges are expected to be the subject of review as part of the Rate Review. In addition, the standby charge for customers with load displacement generation facilities is also being considered as part of the current initiative regarding distributed generation rates, rate classification and the recovery of connection costs for distributed generation (consultation process EB-2007-0630).

Given the variability of the results and the fact that these credits and charges are the subject of either or both of the above-noted ongoing initiatives, the Board does not consider it appropriate to set a province-wide rate for any of these three items at this time. In the interim, these credits and charges will continue to be set on a case-by-case basis.

5 Implementation

The cost allocation policies reflected in this Report should be followed by distributors whenever they apply for rates on a cost of service basis. To the extent that the application of these cost allocation policies results in a significant shift in the rate burden amongst classes relative to the status quo, distributors should be prepared to address potential mitigation measures. Except as noted below, these cost allocation policies will not apply in relation to applications for rate adjustments based on the Board's incentive regulation mechanism ("IRM").

The Board recognizes that some distributors whose rates will be rebased for 2008 will have filed their rate applications prior to the issuance of this Report while others should be filing soon. However, the Board does not expect that there are significant practical impediments to applying the cost allocation policies to these cost of service applications. The policies do not affect a distributor's overall revenue requirement calculation. In addition, the Board's *Filing Requirements for Transmission and Distribution Applications*[3] already provide for the filing of a completed cost allocation study based on updated forecast year data, and distributors have for some time had a model that they can use for that purpose.

Updating and applying cost allocations in a manner that reflects the cost allocation policies set out in this Report should therefore not, in most cases, require a significant incremental effort by distributors. To the extent that it is determined by the Board that accommodation of these policies is impractical in any given case and can reasonably be deferred, the cost allocation issue may be addressed in the context of the distributor's 2009 IRM rate application.

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[3] Available on the Board's website at http://www.oeb.gov.on.ca/html/en/industryrelations/rulesguidesandforms_regulatory.htm#filreq

Appendix A

The following distributors and other interested parties filed comments on the Board staff Discussion Paper, issued on June 28, 2007. Their comments are available on the Board's website at www.oeb.gov.on.ca.[4]

Association of Major Power Consumers in Ontario
Coalition of Large Distributors
Electricity Distributors Association
Energy Cost Management Inc.
Energy Probe Research Foundation
EnWin Utilities Ltd.
Federation of Ontario Cottagers' Associations
Hydro One Networks Inc.
London Hydro
London Property Management Association
Power Workers' Union
Rogers Cable Communications Inc.
School Energy Coalition
Mr. William Harper

[4] http://www.oeb.gov.on.ca/html/en/industryrelations/ongoingprojects_costallocation_review.htm

Court File No. 273/07

ONTARIO
SUPERIOR COURT OF JUSTICE
DIVISIONAL COURT

B E T W E E N:

ADVOCACY CENTRE FOR TENANTS-ONTARIO
and INCOME SECURITY ADVOCACY CENTRE
on behalf of LOW-INCOME ENERGY NETWORK

Appellant

-and-

ONTARIO ENERGY BOARD

Respondent

APPEAL MADE UNDER
The Ontario Energy Board Act, 1998, S.O. 1998, c. 15, Sched. B, s. 33

FACTUM OF THE RESPONDENT ONTARIO ENERGY BOARD

PART I – OVERVIEW

1. The Respondent accepts as correct the facts as stated in Part II of the Appellant's factum.

Background

2. The Ontario Energy Board (the "Board") is the provincial regulator for the natural gas and electricity sectors.
3. The Board has been regulating the natural gas sector in Ontario for many years. The Board is empowered by section 36 of the *Ontario Energy Board Act, 1998* (the "Act") to set "just and reasonable" rates for the distribution of gas.

> ***Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Schedule B, section 36**

4. The Board has traditionally set rates through a "cost of service" assessment. At a very high level, a cost of service assessment seeks to

determine a utility's total cost of providing service to its customers over a one year period (the "test year"). These costs include the rate base (which is essentially the net book value of the utility's total capital investments), and the utility's operations and maintenance costs for the test year, amongst other things. The utility's total costs for the test year (usually including a rate of return on the rate base portion) forms the revenue requirement. The revenue requirement is then divided amongst the utility's ratepayers on a rate class basis (i.e. residential, small commercial, industrial, etc.).

5. It has always been the Board's practice to allocate the revenue requirement to the different rate classes on the basis of how much of that cost the rate class actually causes. Put simply, rates are designed such that each rate class pays for the actual costs it imposes on the utility. To the greatest extent possible, the Board strives to avoid inter class subsidies.

Decision with Reasons, EB-2006-0034, p. 5
[Appellant's Appeal Book and Compendium, Tab 2]

6. In a prior decision, the Board provided an explanation of the principles underlying its practice:

> Over the years, the Board has had many requests for special status for a customer group or a customer. The Board has been consistent in its response to such requests by adhering to its established principles in dealing with cost allocation and rate setting. Principled ratemaking involves the creation of a unified and theoretically consistent set of rates for all participants within the system. It begins with the establishment of a revenue requirement for the regulated utility and proceeds to design rates for the respective classes according to well-recognized and consistent theory respecting such elements as cost allocation. This is an objective and dispassionate process, which is driven by system integrity and consistent treatment between consumers on the system. Principled ratemaking typically does not involve a ranking of interests according to a subjective view of the societal value of any given participant or group of participants. This approach is not unique to Ontario. A departure from these

> principles should only be undertaken where the evidence and all other circumstances outweigh the inherent virtue of an objective process.
>
> **Decision with Reasons, RP-2003-0063 (2005), p. 5**
> **[Respondents' Joint Book of Authorities, Tab 10]**

7. Requests for special rates based on non-cost related factors have been made previously. In denying a request to establish a rate class for aboriginal peoples, the Board said the following:

> The Board is required by its legislation to "fix just and reasonable rates", and in doing so 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. While the Board recognizes ONA's concerns, the Board finds that the establishment of a special rate class to provide redress for aboriginal consumers of [the utility] does not meet the above criteria and it is not prepared to order the studies requested by ONA.
>
> ***Decision with Reasons*, EBRO 493 (1997), p. 316-7**
> **[Respondents' Joint Book of Authorities, Tab 11]**

The Issue LIEN sought to have added to the Issues List in the EB-2006-0034 Proceeding

8. The Appellant Low-Income Energy Network ("LIEN") was an intervenor in the Board's EB-2006-0034 proceeding. EB-2006-0034 was a "rate case" application by Enbridge Gas Distribution Inc. ("Enbridge") for an order of the Board pursuant to section 36 of the Act allowing it to charge a set of proposed rates for gas distribution. Enbridge sought to have its rates set on a "cost of service" basis.
9. It is the Board's practice to set an Issues List which serves to frame the proceeding. In order to set the Issues List, an Issues Day is held, where parties are invited to put forward issues that they believe should form a

part of the Issues List. The Issues Day for EB-2006-0034 was held on October 12, 2006.

10. At the Issues Day, LIEN sought to have the following issue added to the Issues List:

> Should the residential rate schedules for EGD include a rate affordability assistance program for low-income consumers? If so, how should a program be funded? How should eligibility criteria be determined? How should levels of assistance be determined?
>
> **Decision with Reasons, EB 2006-0034, p. 2 [Appellant's Appeal Book and Compendium, tab 2]**

11. Certain parties to the proceeding objected to the proposed issue on a variety of grounds, including the ground that the Board does not have the requisite jurisdiction to make orders relating to low income rate affordability programs.
12. The Board invited written submissions from interested parties, including LIEN, on the issue of the Board's jurisdiction to deal with the proposed issue.
13. In a decision dated April 26, 2007 (the "Decision"), the majority of the panellists (the "Majority") found that the Board does not have the jurisdiction to order the implementation of low income rate affordability programs. The Decision is the subject of the current appeal.
14. The Majority found that the Board did not have the jurisdiction to order a low income rate affordability program as it would require the creation of a customer rate class based upon the income characteristics of the members of the rate class rather than the costs the class imposes upon the utility. In addition, the lower rates paid by this new rate class would almost certainly have to be subsidized by other ratepayers. The Majority held that this amounted to an income redistribution scheme, which it viewed as outside of the Board's section 36 powers, its mandate as an economic regulator, and contrary to long standing Board practice.

Decision with Reasons, EB-2006-0034, at p. 4 and p. 13 [Appellant's Appeal Book and Compendium, Tab 2]

The Issue in this Appeal

15. The question before the court is whether the Ontario Energy Board has the jurisdiction to order the implementation of a low income rate affordability program?

PART II – RESPONDENT'S POSITION WITH REGARD TO ISSUES RAISED BY THE APPELLANT

A. The Standard of Review

16. The Respondent agrees that the standard of review should be correctness.

B. The Powers of the Ontario Energy Board

Principles of Statutory Interpretation

17. The question of whether or not section 36 grants the Board the jurisdiction to order low income rate affordability programs is one of statutory interpretation.
18. In its consideration of this issue, the Court must be guided by the overriding principles of statutory interpretation. In *Sullivan and Driedger on the Construction of Statutes*, the modern principles of statutory interpretation are described as follows:

> There is only one rule in modern interpretation, namely, courts are obliged to determine the meaning of legislation in its total context, having regard to the purpose of the legislation, the consequences of proposed interpretations,

> as well as admissible external aids. In other words, the courts must consider and take into account all relevant and admissible indicators of legislative meaning. After taking these into account, the court must then adopt an interpretation that is appropriate. An appropriate interpretation is one that can be justified in terms of (a) its plausibility, that is its compliance with the legislative text; (b) its efficacy, that is, its promotion of the legislative purpose; and (c) its acceptability, that is, the outcome is reasonable and just.
>
> **Ruth Sullivan, *Sullivan and Driedger on the Construction of Statutes* (3rd ed.), Butterworths (Toronto), 1994, p. 131 [Respondents' Joint Book of Authorities, Tab 40]**

19. The Supreme Court has also stated that the words of a statute are to be read in their entire context and in their grammatical and ordinary sense, harmoniously with the scheme of the act, the object of the act, and the intent of the Legislature.

> ***ATCO Gas & Pipelines Ltd. v. Alberta (Energy and Utilities Board),*[2006] 1 S.C.R. 140 at para. 37 [Appellant's Book of Authorities, Tab 1]**

20. In *ATCO Gas & Pipelines Ltd. v. Alberta (Energy and Utilities Board)*, the Supreme Court commented that a discretionary grant of authority to a tribunal cannot be viewed as conferring unlimited discretion, and that a regulatory tribunal must interpret its powers "within the confines of the statutory regime and principles generally applicable to regulatory matters, for which the legislature is assumed to have had regard in passing [the] legislation."

***ATCO*, para. 50 [Appellant's Book of Authorities, Tab 1]**

21. Of further note is the *Legislation Act*, which applies to all Ontario statutes. Section 64(1) of the *Legislation Act* states:

> An Act shall be interpreted as being remedial and shall be given such fair, large and liberal interpretation as best ensures the attainment of its objects.
>
> ***Legislation Act*, S.O 2006, Chapter 21, Schedule F, s. 64(1)**

Common Law regarding rate regulation

22. It has long been a regulatory common law principle that consumers are to be treated equally to the extent possible insofar as the rates they pay for a particular service is concerned. In *St. Lawrence Rendering Co. Ltd. v. Cornwall,* the court noted:

> That a public utility was at common law compelled to treat all consumers alike, to charge one no more that the others and to supply the utility as a matter of duty and not as a result of a contract, seems clear...
>
> ***St. Lawrence Rendering Co. Ltd. v. Cornwall*, [1951] O.R. 669, at p. 683 [Respondents' Joint Book of Authorities, Tab 13]**

23. The courts have specifically noted that treating customers equally includes charging consumers with similar cost profiles the same rate.

> ***Chastain et al v. British Columbia Hydro and Power Authority*** **(1972), 32 D.L.R. (3d) 443 (B.C. Supreme Ct.), at p. 454 [Respondents' Joint Book of Authorities, Tab 14]**
>
> ***Attorney General of Canada v. Toronto*** **(1893) 23 S.C.R. 514, at pp. 519-520 [Respondents' Joint Book of Authorities, Tab 15]**

24. Although the legislature is entitled to override the common law through statute if it chooses to do so, it must do so through clear and unambiguous language.

> ***Chastain et al v. British Columbia Hydro and Power Authority*** **(1972), 32 D.L.R. (3d) 443 (B.C. Supreme Ct.), at p. 457 [Respondents' Joint Book of Authorities, Tab 14]**
>
> ***Attorney General of Canada v. Toronto*** **(1893) 23 S.C.R. 514, at p. 523 [Respondents' Joint Book of Authorities, Tab 15]**

25. With the exception of section 79 (see below), the Legislature did not choose to insert clear language into the Act to confer on the Board the power to set different rates for consumers with similar cost profiles. The common law principle of treating all customers alike, therefore, is intact. For this reason, and the reasons described further below, the Board is not empowered to order a low income rate affordability program.

The Ontario Energy Board Act, 1998

26. The Board's powers to set rates for regulated gas utilities are derived from section 36 of the Act. The relevant subsections read as follows:

> **36.** (1) No gas transmitter, gas distributor or storage company shall sell gas or charge for the transmission, distribution or storage of gas except in accordance with an

order of the Board, which is not bound by the terms of any contract.

[...]

(2) The Board may make orders approving or fixing just and reasonable rates for the sale of gas by gas transmitters, gas distributors and storage companies, and for the transmission, distribution and storage of gas.

(3) In approving or fixing just and reasonable rates, the Board may adopt any method or technique that it considers appropriate.

[...]

***Ontario Energy Board Act, 1998*, section 36**

27. Any consideration of the scope of the Board's s. 36 powers must include a consideration of the Board's objectives with regard to natural gas regulation, as set out in section 2 of the Act:

2. The Board, in carrying out its responsibilities under this or any other Act in relation to gas, shall be guided by the following objectives:

1. To facilitate competition in the sale of gas to users.
2. To protect the interests of consumers with respect to prices and the reliability and quality of gas service.
3. To facilitate rational expansion of transmission and distribution systems.
4. To facilitate rational development and safe operation of gas storage.
5. To promote energy conservation and energy efficiency in a manner consistent with the policies of the Government of Ontario.

5.1 To facilitate the maintenance of a financially viable gas industry for the transmission, distribution and storage of gas.

6. To promote communication within the gas industry and the education of consumers.

***Ontario Energy Board Act, 1998*, section 2**

The Scope of the Board's Powers to set Just and Reasonable Rates

28. Section 36 of the Act grants the Board broad powers to determine and set "just and reasonable" rates.

29. The courts have found that setting rates is within the specific expertise of the Board. In *Garland v. Consumers' Gas Company*, the Ontario Superior Court of Justice stated:

> It is clear that the Ontario legislature intended that the Energy Board would have exclusive jurisdiction over all aspects of the gas distribution industry. In particular, the statute provides that part of the Board's role is to approve and set rates for the sale of gas-related products. ... The purpose behind the *Ontario Energy Board Act*, both in its current and past form, is clear. The Act provides a detailed and comprehensive scheme upon which the Energy Board relies in order for it to carry out its very specific objectives. **Rate setting is at the core of the Energy Board's jurisdiction. [emphasis added]** [...]
> In addition to providing the Energy Board with guidelines, the OEBA provides the Board with specific and broad ranging powers. Pursuant to section 36(2) of the current Act, the OEB may make orders approving or fixing just and reasonable rates for the sale, distribution and storage of gas. Subsection 36(7) authorizes the Board to fix or approve such rates of its own motion or upon the request of the Minister. In addition to the provisions outlining the Board's expansive rate making power, section 23 of the current Act is an expression of the provincial legislature's intention to bestow upon the OEB broad powers, which allow the Board to attach conditions to its orders as a means of fashioning effective and far reaching decisions.
>
> ***Garland v. Consumers' Gas Company* (2000), 185 D.L.R. (4th) 536 (Ont. Sup. Ct. Jus.), paras. 17, 45-46. (overturned on separate grounds) [Respondents' Joint Book of Authorities, Tab 17]**

30. The courts have long recognized that the legislature intended that the Board have wide powers to determine what makes up a just and

reasonable rate. In *Natural Resource Gas v. Ontario Energy Board*, the Divisional Court stated: "The Board's mandate to fix just and reasonable rates under section 36(3) of the Ontario Energy Board Act, 1998, is unconditioned by directed criteria and is broad; the Board is expressly allowed to adopt any method it considers appropriate."

[2005] O.J. No. 1520 (Ont. Div. Ct.), at para. 13 [Respondents' Joint Book of Authorities, Tab 18]

31. In *Union Gas Ltd. v. Ontario (Energy Board)*, the Ontario Supreme Court noted: "[t]hat in balancing these conflicting interests [between the shareholder and the ratepayer] and determining rates that are just and reasonable the O.E.B. has a wide discretion, is not in issue or in doubt."

(1983), 43 O.R. (2nd) 489 (Ont. Sup. Ct.), at p. 501 [Appellant's Book of Authorities, Tab 3]

32. Although the powers granted by section 36 are broad, they are not limitless. In interpreting its powers, the Board must act in a way that is harmonious with the purposes of the Act. In *Re Multi Malls Inc. et. al. v. Minister of Transportation and Communications* et. al., the Ontario Court of Appeal upheld the idea that powers granted to a regulatory authority "must be exercised reasonably and according to the law, and cannot be exercised for a collateral object or an extraneous and irrelevant purpose, however commendable."

***Re Multi Malls Inc. et. al. v. Minister of Transportation and Communications* (1977), 14 O.R. (2d) 49, p. 55 [Respondents' Joint Book of Authorities, tab 20]**

C. Respondent's Position Regarding issues raised by the Appellants

33. The Appellant's arguments are grouped under four broad categories: a) that the Board is expressly empowered to order a low income rate affordability program; b) in the alternative, that the Board is empowered to order a low income rate affordability program through the doctrine of necessary implication; c) that any ambiguity in the Board's empowering legislation should be resolved in favour of an interpretation that reflects Charter principles; and d) other errors of law and jurisdiction. The Respondent will reply to each of these arguments in turn.

Appellant's Arguments regarding Express Powers

34. The Supreme Court of Canada found in *ATCO Gas and Pipelines Ltd. v. Alberta (Energy and Utilities Board)*: "in the area of administrative law, tribunals and Boards obtain their jurisdiction over matters from two sources: (1) express grants of jurisdiction under various statutes (explicit powers); and (2) the common law, by application of the doctrine of jurisdiction by necessary implication (implicit powers)."

> ***ATCO Gas and Pipelines Ltd. v. Alberta (Energy and Utilities Board)*, [2006] 1 S.C.R. 140 at para. 38. [Appellant's Book of Authorities, Tab 1]**

35. The Appellant argues that the Act, specifically section 36 and section 2, expressly provides the Board with the jurisdiction to order a low income rate affordability program. The Appellant raises several arguments in support of this position.

> **Appellant's factum, para. 37**

36. The Respondent submits that a fair and reasonable reading of sections 36 and 2 of the Act does not support the interpretation that the Legislature intended to give the Board the power to order a low income rate affordability program.

Board's Objectives with respect to gas regulation

37. The objectives as set out in the Act are an important tool in interpreting the Board's jurisdiction. The *Legislation Act* states that legislation must be interpreted in such a way as "best ensures the attainment of its objects".

***Legislation Act*, s. 64(1)**

38. In support of its argument, the Appellant relies on one of the Board's statutory objectives under section 2 of the Act: "To protect the interests of consumers with respect to prices and the reliability and quality of gas service."

Appellant's factum, paras. 27-28

OEB Act, s. 2

39. It is the position of the Respondent that this objective argues for a contrary view, namely that the Board does **not** have the jurisdiction to order a low income rate affordability program.
40. The impugned objective clearly requires the Board to protect the interest of *consumers* as a whole, not any particular subset of consumers. Since any low income rate affordability program would almost certainly be funded through rates paid by other ratepayers, such a program would run counter to the stated objective by conferring benefits on one set of consumers at the expense of another.
41. A low income rate affordability program would almost certainly lead to higher prices for the majority of Enbridge's residential customers. As described above, the Board sets a revenue requirement for utilities before allocating those costs to the different rate classes. Creating a new rate class with lower rates for low income consumers would not reduce the revenue requirement. The only way the utility could recover its revenue requirement, therefore, would be to charge more to its other

rate classes. In no way can higher prices be construed as protecting the interests of consumers with respect to prices.

42. To implement a low income rate affordability program as proposed by the Appellant would therefore run counter to a clearly stated objective of the Act.

43. Both the *Legislation Act* and the case law cited above require that section 36 be interpreted in a way that accords with the objectives and is harmonious with the Act as a whole. It is the Respondent's position that a full and fair reading of the Act, including the objectives, leads to the unavoidable conclusion that the Board does not have the jurisdiction to order a low income rate affordability program.

"Balancing Act"

44. As the Appellant has stated in its factum, the courts have opined on the "balancing act" the Board must conduct in setting just and reasonable rates. Where the Appellant is mistaken, however, is in its assertion that this balancing act refers to a balancing of interests between groups of customers. The Board's responsibility, rather, is to balance the interests of consumers on one hand and the regulated utility on the other.

Appellant's factum, paras. 33-34

45. This principle was highlighted by the Ontario Supreme Court in *Union Gas Ltd. v. Ontario (Energy Board)*:

> 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. [...] Put another way, it is the function of the OEB to balance the interest of the appellants in earning the highest possible return on the operation of its enterprise, a

> monopoly, with the conflicting interest of its customers to be served as cheaply as possible.
>
> **(1983) 1 D.L.R. (4th) 698, at para. 41 [Appellant's Book of Authorities, Tab 3]**

46. There is no support in either the Act or any of the authorities cited by the Appellant for the argument that the Board is meant to balance the interests of one group of consumers against another.

47. Nothing relating to the Board's duty to balance the interests of consumers against the interests of the utility in any way suggests that the Board has the jurisdiction to order a low income rate affordability program.

Section 36(3) of the Act

48. The Appellant also relies on section 36(3) of the Act, which allows the Board to adopt any method or technique that it considers appropriate in setting just and reasonable rates, in support of its argument that the Board has the jurisdiction to order a low income rate affordability program.

> **Appellant's factum, para. 17**

49. Section 36(3) must be read in the context of the Act as a whole. It is the Respondent's position that the intention of section 36(3) was not to allow the Board to implement social policy through low income rate assistance programs; rather, it was to allow the Board to employ techniques other than traditional cost of service analyses in determining rates. By way of example, the Board is currently using its powers under section 36(3) to consider an Incentive Rate Mechanism model for the major gas utilities. Incentive Rate Mechanisms allow for automatic annual

adjustments to rates based on a set of assumptions about a utility's future performance, and thereby eliminate the need for time consuming and expensive annual cost of service hearings. Under Incentive Rate Mechanisms, the revenue requirement is still allocated to the rate classes based on the utility's actual cost in serving each class.

Decision with Reasons, EB-2006-0034, p. 10 [Appellant's Appeal Book and Compendium, Tab 2]

50. Like section 36(2), section 36(3) must be read within the context of the Act as a whole. For the reasons described above, a full and fair reading of section 36(3) and the Act cannot support the contention that this section was meant to empower the Board to order low income rate affordability programs.

Dictionary Definitions

51. The Appellants cite separate dictionary definitions of "just" and "reasonable" in support of its position that the Board's jurisdiction includes the power to order low income affordability programs.

Appellant's factum, paras. 22-24

52. It is the Respondent's position that "just and reasonable rates" has been defined by the case law and recourse to dictionary definitions is both unnecessary and unhelpful.

The Meaning of "Rates"

53. At paragraph 21 of its factum, the Appellant states that the use of the word "rates" in the plural in subsection 36(2) clearly

envisages more than one rate being approved or fixed by the Board. The Appellant cites this as evidence that the Board has the jurisdiction to fix a separate rate for those who cannot otherwise afford gas.

Appellant's factum, para. 21.

54. It is the Respondent's submission that the word "rates" is in plural to allow the Board to set different rates for different classes of customers based on the costs of serving those customers. By way of example, large industrial consumers are typically much more expensive to serve than residential consumers. For this reason, the Board sets separate rates for the residential rate class and the industrial rate class. Absent any indication in the Act to the contrary, it should not be presumed that the legislature intended to confer broad new powers on the Board simply by using the word "rates". Separate rate classes are a necessity to ensure that consumers pay the actual costs of the service that they receive.

Allstream

55. In support of its position, the appellant cites the Federal Court of Appeal case *Allstream v. Bell Canada*.

Appellant's factum, para. 35

56. The *Allstream* case deals with the powers conferred on the CRTC by the *Telecommunications Act*. The objectives of the CRTC listed in section 7 of the *Telecommunications Act* include enriching the "social and economic fabric", rendering "affordable" and "accessible" service, and responding to "the economic and social requirements of users." It is clear that the

objectives of the *Telecommunications Act* are much broader than those of the Board.

***Telecommunications Act*, section 7**

57. Similarly, the statutory mandate of the CRTC is broadly drawn when compared to that of the Board. It is the position of the Respondent that these differences render the *Allstream* case of little assistance in determining this appeal.

Respondent's Conclusion regarding Express Grant of Jurisdiction

58. A plain reading of the relevant sections and the Act as a whole does not support the Appellant's position that the Legislature intended to grant the Board the power to order a low income rate affordability program. It is the Respondent's position that a plain reading of the relevant sections, the Act and the case law makes it clear that the Board's jurisdiction does **not** encompass the power to order a low income rate affordability program.

Appellant's Arguments Regarding Doctrine of Necessary Implication

59. The Appellant submits that if the Board does not have the power to order the implementation of a low income affordability program through an express grant of jurisdiction, then the Board obtains that power through the doctrine of necessary implication.

Appellant's factum, para. 38

60. It is the Respondent's position that the doctrine of necessary implication cannot be said to empower the Board to order a low income rate affordability program. Put simply, this power is not necessary for the

Board to meet any of its statutory objectives. In fact, as argued above, the objectives suggest that the power to order such programs lies outside the Board's jurisdiction.

The Principle of Implied Exclusion

61. The related principle of implied exclusion also points to the conclusion that the Board does not have the jurisdiction to order a low income affordability program.

62. In *Sullivan and Driedger on the Construction of Statutes*, Professor Sullivan describes the doctrine of implied exclusion as follows:

> An implied exclusion argument lies whenever there is reason to believe that if the legislature had meant to include a particular thing within its legislation, it would have referred to that thing expressly. Because of this expectation, the legislature's failure to mention the thing becomes grounds for inferring that it was deliberately excluded. [...]
> When a provision specifically mentions one or more items but is silent with respect to other items that are comparable, it is presumed that the silence is deliberate and reflects an intention to exclude the items that are not mentioned. The reasoning goes as follows: if the legislature had intended to include comparable items, it would have mentioned them or described them using general terms; it would not have mentioned some while saying nothing of the others because to do so would violate a convention of communication.

Sullivan, pp. 186-187 [Respondents' Joint Book of Authorities, Tab 40]

63. Section 79 of the Act requires the Board to provide "rate protection" to certain rural and remote electricity consumers. This "rate protection" is a direct subsidy paid by the rest of the province's residential electricity consumers.

***OEB Act*, section 79**

64. Section 79 is a clear indication that the Legislature did turn its mind to the issue of providing subsidies (or rate assistance) for certain classes of consumers when it drafted the Act. By virtue of specifically singling out a single category of consumers to be eligible for a subsidy, it is reasonable to infer that the Legislature did not intend for this benefit to apply to other categories of consumers. Had the Legislature wished to provide a subsidy to other categories of consumers, it would have explicitly said so.

Respondent's Conclusion Regarding Doctrine of Necessary Implication

65. The doctrine of necessary implication cannot be said to empower the Board to order a low income rate affordability program, and the related principle of implied exclusion cited by the Appellant clearly points to the conclusion that the Board is not meant to have this power.

The Appellants Arguments regarding the Charter and the Rules Against Discrimination

66. The Appellant cites *R. v. Rogers* in support of the principle that, where there is genuine ambiguity in the interpretation of a statute, it is appropriate to prefer the interpretation that accords with Charter principles. The court in *Rogers* stated: "In other words, where the legislation permits two different, yet equally plausible, interpretations, each of which is equally consistent with the apparent purpose of the statute, it is appropriate to prefer the interpretation that accords with Charter principles."

> ***R. v. Rogers*, [2006] 1 S.C.R. 554 at para. 18**
> **[Appellant's Book of Authorities, Tab 6]**

67. *Rogers* does not apply to the issue on appeal. The Act does not offer two different, yet equally plausible interpretations, each of which is clearly consistent with the apparent purpose of the Act. As discussed above, a fair reading of the Act as a whole reveals that the Legislature did not

intend for the Board to have the powers which the Appellants seek to ascribe to it. Only where there are two equally plausible interpretations are Charter principles to be considered as an interpretive tool. In this case there are not two equally plausible interpretations.

68. Even if there were ambiguity in the legislation, Charter principles are of no application in this instance because economic disadvantage on its own is not an analogous ground and does not trigger section 15 protection.

> ***Falkiner v. Ontario (Ministry of Community and Social Services)* (2002), 212 D.L.R. (4th) 633 (O.C.A.) at para. 88 [Appellant's Book of Authorities, Tab 7]**
>
> ***R. v. Banks* (2007), 84 O.R. (3d) 1 (C.A.), at para. 104 [Respondents' Joint Book of Authorities, Tab 33]**

69. At tabs 10, 11 and 12 of their Appeal Book and Compendium, the Appellants reproduce three reports from Statistics Canada. The Appellants argue that these reports support their arguments relating to the Charter. None of these reports were filed with the Board in the proceeding giving rise to this appeal. These reports constitute new evidence, and should not be considered by the court on this appeal.

> **Appellant's Appeal Book and Compendium, Tabs 10-12**

The Appellant's arguments regarding Other Issues

Contention that the Board Misapprehended the Question that was before it

70. The Appellant states that the Board erred in not considering the question that it claims was before the Board, namely the Board's jurisdiction to consider and implement a low income rate affordability program. The Appellant states that the Board erred in assuming that proposed issue that

LIEN sought to add to the issues list would require the implementation of a rate class based on an income level determinant.

Appellant's factum, paras. 55-56

71. The jurisdictional issue for which the Board sought submissions and made a decision relates to the Board's jurisdiction to consider the issue that the Appellant sought to place on the Issues List at the hearing. That issue reads as follows:

> Should the residential rate schedules for EGD include a rate affordability assistance program for low-income consumers? If so, how should a program be funded? How should eligibility criteria be determined? How should levels of assistance be determined?

Decision with reasons, p. 2 [Appellant's Appeal Book, tab 2]

72. The proposed issue clearly envisions that any rate affordability program would be a part of residential rate schedules. Absent a special and separate rate specifically for low income earners, it is difficult to imagine by what other means such a program could exist in a rate schedule. This is exactly what the Majority assumed.

73. The proposed issue also asks how such a program would be funded. The only mechanism by which the Board could "fund" such a program would be through rates, specifically the rates of ratepayers not in the new low income class. There are no other means by which the Board could order a low income rate affordability program to be funded.

74. The Board did recognize that there was no specific proposal before it. However, it acted reasonably in assuming that such a program would be funded through rates. This is exactly what the issue proposed by the Appellant suggests, and is in fact the only possible mechanism the Board would have to support such a program. The Board's assumption regarding the basic nature of any proposed low income rate assistance program was entirely appropriate.

Contention that the Board Improperly Applied the Dalhousie Decision

75. The Respondent does not dispute that there are differences between the legislative regulatory scheme of Nova Scotia and Ontario. In particular, the Nova Scotia Public Utilities Act requires that rates shall "always be charged equally to all persons under the same rate in substantially similar circumstances and conditions irrespective of service of the same description." There is no comparable section in the Act.

> ***Dalhousie Legal Aid Service v. Nova Scotia Power Inc.*, [2006] N.S.J. No. 243 (C.A.), at para. 24 [Appellant's Book of Authorities, Tab 11]**
>
> **Nova Scotia *Public Utilities Act*, section 67**

76. The Nova Scotia Court of Appeal's decision, however, did not rest solely on this point. The Court also noted that the Board's regulatory power was designed to act as a proxy for competition in view of a utility's monopoly, and that it was not meant to act as an instrument of social policy.

> ***Dalhousie Legal Aid Service v. Nova Scotia Power Inc.*, at para. 33 [Appellant's Book of Authorities, Tab 11]**

77. Moreover, even if the Appellant is correct that the Board misapplied the *Dalhousie* decision, this was a minor point in the Decision. The absence of the *Dalhousie* precedent would not have altered the outcome.

PART III – ADDITIONAL ISSUES RAISED BY THE RESPONDENT

78. The Respondent is not raising any issues not described above.

PART IV – ORDER REQUESTED

79. The Respondent asks that the appeal be dismissed.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 12th day of September, 2007.

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Solicitor for the Respondent

CERTIFICATE

I, Michael Millar, solicitor for the Respondent Ontario Energy Board, certify that, pursuant to Rule 61.12(1)(f):

1. An order under subrule 61.09(2) (original records and exhibits) is not required for the hearing the appeal; and
2. I estimate 1 hour will be required for the oral argument of the Respondent.

September 12, 2007

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SCHEDULE A
LIST OF AUTHORITIES

Case Law

1. Ontario Energy Board Decision with Reasons, RP-2003-0063 (2005)
2. Ontario Energy Board Decision with Reasons, EBRO 493 (1997)
3. *ATCO Gas & Pipelines Ltd. v. Alberta (Energy and Utilities Board)*, [2006] 1 S.C.R. 140
4. *St. Lawrence Rendering Co. Ltd. v. Cornwall*, [1951] O.R. 669 (Ont. High Court)
5. *Chastain et al v. British Columbia Hydro and Power Authority* (1972), 32 D.L.R. (3d) 443 (B.C. Supreme Court)
6. *Attorney General of Canada v. Toronto* (1893), 23 S.C.R. 514
7. *City of Hamilton v. The Hamilton Distillery Company*, [1907] 38 S.C.R. 239
8. *Garland v. Consumers' Gas Company*, [2000] O.J. No. 1354 (Sup. Ct. Jus.)
9. *Natural Resource Gas v. Ontario Energy Board*, [2005] O.J. No 1520 (Ont. Div. Ct.)
10. *Union Gas Ltd. v. Ontario (Energy Board)* (1983), 43 O.R. (2^{nd}) 489 (Ont. Sup. Ct.)
11. *Re Multi Malls Inc. et. al. v. Minister of Transportation and Communications* (1977), 14 O.R. (2^{nd}) 49
12. *Allstream Corp. v. Bell Canada*, [2005] F.C.J. No. 1237 (F.C.A.)
13. *R. v. Rogers*, [2006] 1 S.C.R. 554
14. *Falkiner v. Ontario (Ministry of Community and Social Services)* (2002), 212 D.L.R. (4^{th}) 633 (O.C.A.)
15. *R. v. Banks*, [2007] O.J. No. 99 (C.A.)

16. *Dalhousie Legal Aid Service v. Nova Scotia Power Inc.*, [2006] N.S.J. No. 243 (C.A.)

Texts

17. Ruth Sullivan, *Sullivan and Driedger on the Construction of Statutes* (3rd ed.), Butterworths (Toronto), 1994, p. 131

SCHEDULE B

TEXT OF STATUTES, REGULATIONS & BY-LAWS

Legislation Act, S.O. 2006, c. 21, Schedule F, s. 64(1)

Telecommunications Act, S.C. 1993, c. 38, s. 7

Public Utilities Act, R.S.N.S. 1989, c. 380, s. 67

Legislation Act

S.O. 2006 c. 21
Schedule F

64. (1) An Act shall be interpreted as being remedial and shall be given such fair, large and liberal interpretation as best ensures the attainment of its objects. 2006, c. 21, Sched. F, s. 64 (1)

Telecommunications Act

S.C. 1993
c. 38

Objectives

7. It is hereby affirmed that telecommunications performs an essential role in the maintenance of Canada's identity and sovereignty and that the Canadian telecommunications policy has as its objectives

(*a*) to facilitate the orderly development throughout Canada of a telecommunications system that serves to safeguard, enrich and strengthen the social and economic fabric of Canada and its regions;

(*b*) to render reliable and affordable telecommunications services of high quality accessible to Canadians in both urban and rural areas in all regions of Canada;

(*c*) to enhance the efficiency and competitiveness, at the national and international levels, of Canadian telecommunications;

(*d*) to promote the ownership and control of Canadian carriers by Canadians;

(*e*) to promote the use of Canadian transmission facilities for telecommunications within Canada and between Canada and points outside Canada;

(*f*) to foster increased reliance on market forces for the provision of telecommunications services and to ensure that regulation, where required, is efficient and effective;

(*g*) to stimulate research and development in Canada in the field of telecommunications and to encourage innovation in the provision of telecommunications services;

(*h*) to respond to the economic and social requirements of users of telecommunications services; and

(*i*) to contribute to the protection of the privacy of persons.

Public Utilities Act

R.S.N.S 1989
c. 380

67 (1) All tolls, rates and charges shall always, under substantially similar circumstances and conditions in respect of service of the same description, be charged equally to all persons and at the same rate, and the Board may by regulation declare what shall constitute substantially similar circumstances and conditions.

TAB 7:

Excerpts from OEB Decisions respecting

Rate Making Jurisdiction

Ontario Energy Board

Commission de l'énergie de l'Ontario

Ontario

EB-2006-0034

IN THE MATTER OF the *Ontario Energy Board Act, 1998,* S.O. 1998, c.15

AND IN THE MATTER OF an Application by Enbridge Gas Distribution Inc. for an order or orders approving or fixing just and reasonable rates and other charges for the sale, distribution, transmission and storage of gas commencing January 1, 2007.

BEFORE: Gordon Kaiser
Presiding Member and Vice Chair

Paul Vlahos
Member

Ken Quesnelle
Member

DECISION - RATE AFFORDABILITY PROGRAMS

This is the decision of Board Member Vlahos and Board Member Quesnelle. The dissenting opinion with reasons of Vice Chair Kaiser follows the majority decision.

Enbridge Gas Distribution Inc. ("EGD") filed an application dated August 25, 2006 with the Ontario Energy Board under section 36 of the *Ontario Energy Board Act, 1998 ("*the *Act")*, requesting a rate increase effective January 1, 2007. On October 4, 2006, the Board issued Procedural Order No. 1 establishing an oral hearing on October 12, 2006 to hear submissions regarding the issues the Board should consider in this proceeding. This decision relates to one specific issue: rate affordability programs.

The Board considers this matter to be one of clear importance and is of the view that clarity of its position on jurisdiction is required to instruct those who are advocating on behalf of a low-income constituency. This Decision therefore is predicated on the following understanding: That the proposal is to establish a rate group for low income consumers. The defining characteristic of the rate group would be income-level and the program would be funded by general rates. It is in this context that the Board has considered the question of jurisdiction.

The Board agrees with the Parties that argued that the Act does not provide the Board with the authority, either explicitly or implicitly, to approve rates using income level as a criterion. The implementation difficulties referred to by parties are not, in the Board's view, pivotal to the issue at hand. Concerns that may arise related to implementation of new processes or the need to expand Board expertise are not threshold considerations related to the determination of jurisdiction. Where jurisdiction is found to exist, the Board structures itself accordingly.

The Board exercises its jurisdiction within the legislative framework established by Government. The *Ontario Energy Board Act, 1998* provides the objectives that govern the Board in its activities. The objectives and the statute as a whole are the sole reference for the determination of jurisdiction. The Board also derives certain powers from other statutes, but none of these powers are relevant to this particular issue.

Economic regulation is rooted in the achievement of economic efficiencies, the establishment of fair returns for natural monopolies and the development of appropriate cost allocation methodologies. Also, when appropriately authorized, economic regulation can be utilized in the pursuit of broad social goals such as conserving natural resources or in the provision of incentives for certain behaviours that are seen by the legislature to be in the public interest. An example of this can be seen in the Government's direction to the Board, authorized by the statute to enable certain approaches to conservation and demand management.

Through statute, governments authorize bodies such as the Ontario Energy Board to administer the economic regulation of specific sectors of society. At its core, the Board is an economic regulator, and that is where its expertise lies. The Board is engaged in many of the typical economic regulation activities mentioned above and makes determinations as to the appropriateness of the financial consequences of the regulated activities it authorizes.

The manner in which the Board makes its determinations is firmly grounded in the economic regulatory principles associated with rate setting. As submitted by Board Staff, while the term "economic regulator" is not precise, there is a widely accepted and practiced convention related to the setting of rates. Examples of these principles are more fully articulated later in this decision in the analysis of various submissions. The Government has a clear understanding of how the Board operates and the economic regulation principles that it utilizes as an economic regulator and has witnessed the Board's practices in that regard.

The Board was created and made operational through legislation. The Board has a responsibility to operate to the full depth and breadth of the authority granted in its governing statute. The limits or boundaries of its authority need not, nor should, be a bright line. This would require near unachievable foresight by the legislators to consider all of the possible eventualities. The objectives provided in the Act are intended to be broad enough to allow the Board to operate with discretion in an ever changing environment and focused enough to ensure that the Board operates within the government's policy framework. Determinations on jurisdiction should be guided solely by the question of what can reasonably be considered to have been intended by the legislators in the scoping and crafting of the Board's mandate. There should be no pre-destining bias based on a desire by the regulator to include or exclude any particular issue.

As described by section 36(3) of the Act, the Board has broad authority to utilize whatever methods or techniques it deems appropriate to set just and reasonable rates. LIEN has argued that this be interpreted as the Board having authority to establish a low-income rate class, using income level as a determinant. The Board does not agree. Significant departure from its current practices and principles would be required to institute a rate making process based on income level. The Board considers LIEN's proposal both in the intent and on the basis on which the transfer of benefits would take place to be a significant departure from the traditional rate setting principles applied currently by the Board. The Board's rate setting activities that currently have the effect of transferring benefits do so to accommodate either regulatory efficiency, the removal of financial barriers in support of government policy initiatives or to support a mitigation policy to overcome cost differential such as in rural rate subsidies. None of these activities are based on an income level determinant. The Board also notes that to the extent that any of the current benefit transfers are material, such as in the rural rate

subsidy and conservation initiatives, they are supported by the objectives of the Act, specific sections of the Act or by Ministerial Directives under section 27 of the Act.

The use of income level as a determinate in establishing utility rates has broad public policy implications. The interplay that this type of income redistribution program would have with other income redistribution programs that would reside outside of the Board's purview could be significant. The consideration of income redistribution should not be done in isolation of the broader government policy environment. The management of the interplay would necessitate a prescriptive statute or directive.

Income redistribution policies are at the core of the work done by democratically elected governments. The Board is of the opinion that had the Government wanted the Board to engage in such a fundamentally important function it would have specifically stated as such.

The Board is of the view that there is no compelling evidence to suggest that the objectives contained in the Act encompass, explicitly or implicitly, any accommodation for such a fundamental departure from the manner in which the Board currently regulates. For these reasons and for the reasons stated below the Board finds that it does not have jurisdiction to develop a rate class with an income level determinant as depicted earlier in this decision.

Analysis of Submissions

The Board is a statutory tribunal. In the *ATCO Gas and Pipelines Ltd. v. Alberta (Energy and Utilities Board)*, [2006] SCC 4 decision, the Supreme Court described the sources from which statutory tribunals obtain their powers:

> In the area of administrative law, tribunals and Boards obtain their jurisdiction under various statutes (express jurisdiction); and (2) the common law, by application of the doctrine of jurisdiction by necessary implication (implied powers).

A statutory Board has no powers other than those given to it by statute, either expressly or impliedly. If the Board's jurisdiction to order a low income affordability program cannot be found either expressly or impliedly in a statute, then it does not exist.

RP-2003-0063
EB-2004-0542

IN THE MATTER OF the *Ontario Energy Board Act, 1998,* S.O. 1998, C.15 (Schedule B);

AND IN THE MATTER OF an Application by Union Gas Limited for an order or orders amending or varying the rate or rates charged to customers under the M16 rate schedule.

BEFORE: Paul Vlahos
Presiding Member

Paul Sommerville
Member

Pamela Nowina
Member

DECISION WITH REASONS

May 19, 2005

focused on the firm transportation component east of Dawn, as Tribute's prospective Tipperary storage pool would be served under this part of the proposed revised M16 rate schedule.

The thrust of the evidence of Messrs. Knecht and Fisher sponsored by Tribute and Tribute's submissions is that independent embedded storage is the new frontier in the natural gas market in Ontario and, as such, it should be supported by cost allocation and rate setting principles or arrangements that may depart from those applicable to other users of Union's transmission system. According to Tribute, independent embedded storage providers should not be viewed in the same manner as any other customer classification; rather they should be viewed and treated as competitors to Union's own storage activities and as an enterprise that enhances the reliability of the natural gas system in Ontario. Tribute also grounds its position on the Board's recently released report entitled *Natural Gas Regulation in Ontario: A Renewed Policy Framework* resulting from the Natural Gas Forum.

What Tribute in effect is seeking from this Panel is special status. Union and other Intervenors opposed such treatment for Tribute. True Oil, a potential storage developer, adopted Tribute's position.

Over the years, the Board has had many requests for special status for a customer group or a customer. The Board has been consistent in its response to such requests by adhering to its established principles in dealing with cost allocation and rate setting. Principled ratemaking involves the creation of a unified and theoretically consistent set of rates for all participants within the system. It begins with the establishment of a revenue requirement for the regulated utility and proceeds to design rates for the respective classes according to well-recognized and consistent theory respecting such elements as cost allocation. This is an objective and dispassionate process, which is driven by system integrity and consistent treatment between consumers on the system. Principled ratemaking typically does not involve a ranking of interests according to a subjective view of the societal value of any given participant or group of participants. This approach is not unique to Ontario. A departure from these principles should only be undertaken where the evidence and all other circumstances outweigh the inherent virtue of an objective process.

In the above referenced report resulting from the Natural Gas Forum, the Board raises a number of matters regarding storage. The Board intends to proceed to explore the

687

2.455 With respect to Union's objective of creating and maintaining reasonable price relationships among rate classes and equivalency amongcomparable service options, the Board would be concerned if existing rates do not reflect such relationships. The Board expects Union to identify any relationships which are inappropriate and bring forward proposals on a timely basis to correct any deficiencies.

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2.456 Accordingly, the Board does not approve Union's proposed pricing flexibility scheme.

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2.457 The Board is 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.

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2.458 TheBoard does not acceptUnion's arguments that "using a cost basedmeasure, such as cross-subsidy is not meaningful in PBR because rates are judged just and reasonable by not being escalated beyond the restrictions approved by theBoard" nor that "the approval by the Board of a level of pricing flexibility means that if Union makes rate changes anywhere within the boundaries of the flexibility constraints approved by the Board, then the result will be just and reasonable rates". The Board can not automatically assume that the resulting rates will remain just and reasonable among classes.

Was page 131 691

2.459 In the Board's view there will be a continuing need to monitor changes in rate relationships to ensure that rates continue to be just and reasonable. The Board therefore directs Union to file with the Board and provide in the customer review process appropriate cost information, including rate class revenue-to-cost impacts.

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2.7.2 Treatment of Long-term Fixed Prices / Negotiated Rates

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2.460 Union proposed that customers, such as large industrials, retail marketers, and exfranchise customers, as an alternative to receiving service under a rate schedule, should have the option of negotiating fixed rates for periods in excess of one year. Union's billing system is not currently capable of billing residential customers at rates other than by class rate; therefore, the option of negotiated long-term fixed prices would be available from the Company only "to large industrial customers, retail energy marketers, and ex-franchise storage and transmission customers." Union noted that residential customers "could access [longer term fixed prices] through a retail energy marketer."

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2.461 The Company proposed to deem all volumes sold at negotiated prices to be billed at the posted rate for the purpose of proving that the annual rate changes comply with the price cap constraints. Any variance in the revenues from differences between negotiated rates and posted rates would be "managed" by the Company. Unless specifically excluded in the negotiated terms, the negotiated prices would be subject to pass-throughs and non-routine adjustments.

Was page 132 695

Positions of the Intervenors - Treatment of Long-term Fixed Prices / Negotiated Rates

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Table of contents

ARTICLES

3 **The theory of economic regulation**
GEORGE J. STIGLER

22 **Taxation by regulation**
RICHARD A. POSNER

51 **The FPC staff's econometric model of natural gas supply in the United States**
J. DANIEL KHAZZOOM

94 **Supply response in a regulated industry: the case of natural gas**
EDWARD W. ERICKSON AND ROBERT M. SPANN

122 **The "optimal" fair rate of return**
ALVIN K. KLEVORICK

154 **Cable television and the impact of regulation**
WILLIAM S. COMANOR AND BRIDGER M. MITCHELL

213 **Investment behavior in U.S. regulated industries**
DALE W. JORGENSON AND SIDNEY S. HANDEL

265 **Estimates of the marginal rate of time preference and average risk aversion of investors in electric utility shares: 1960-66**
ROBERT H. LITZENBERGER AND CHERUKURI U. RAO

278 **The effect of lagged regulation in an Averch-Johnson model**
ELIZABETH E. BAILEY AND ROGER D. COLEMAN

293 **An evaluation of tax incentives for on-the-job training of the disadvantaged**
DANIEL M. HOLLAND

Taxation by regulation

Richard A. Posner

Professor of Law
The University of Chicago

Spokesmen of the regulated industries often assume that regulation is designed either to approximate the results of competition or to protect the regulated firms from competition. But neither view explains adequately a number of important phenomena of regulation and regulated industries. Foremost among them is the prevalence of "internal subsidies," whereby unremunerative services are provided, sometimes indefinitely, out of the profits from other services. To understand this and other phenomena, we must assign another important purpose to regulation: we can call it "taxation by regulation." The purpose of this paper is to explore this dimension of the regulatory process, to demonstrate that it explains some otherwise perplexing features of the process and the industries subject to it, and to compare it with other methods of public finance.

■ Two views of the purpose in fact of public utility and common carrier regulation[1] vie in current scholarly debate. One, the more familiar, holds that regulation is a device for protecting the public against the adverse effects of monopoly[2]; the other holds that regulation is procured by politically effective groups, assumed to be composed of the members of the regulated industry itself, for their own protection.[3] In my opinion neither view, at least as thus far formulated, explains an important phenomenon of regulated industries: the deliberate and continued provision of many services at lower rates and in larger quantities than would be offered in an unregulated competitive market or, *a fortiori*, an unregulated monopolistic one.

Richard A. Posner, who received the A.B. degree from Yale University and the LL.B. from Harvard, is Professor of Law at the University of Chicago Law School. Among his major interests is the application of economic theory to law, and he also is the editor of a new journal to be published under the auspices of the University of Chicago. It is entitled *The Journal of Legal Studies*, and its first appearance will be in January 1972. The author would like to thank Edmund W. Kitch and George J. Stigler for their helpful comments on an earlier draft.

[1] By the awkward term "purpose in fact" I mean to distinguish sharply between the reasons ascribed to regulatory laws and decisions by the legislators and regulators themselves and the reasons, whether or not anywhere avowed, that provide a consistent explanation of the actual course and consequences of regulation. It is with the latter that I am concerned here.

Although the emphasis throughout this paper is on the full panoply of rate and entry controls characteristic of public utility and common carrier statutes, where the analysis can be extended to markets having somewhat different regulatory arrangements I have not hesitated to do so.

[2] For example, see Bonbright [3], p. 23.

[3] A rigorous statement of this theory appears in the article by G. J. Stigler in this issue of *The Bell Journal* [59]. The "capture" of regulation by the regulatees is, of course, an old theme in the literature of regulation. Professor Stigler's theory allows for capture by effective political groups other than the regulated firms themselves, and there is accordingly no necessary inconsistency between it and the analysis in this paper.

This phenomenon can be explained, I believe, only if we modify existing views by admitting that one of the functions of regulation is to perform distributive and allocative chores usually associated with the taxing or financial branch of government. And we shall see that an analysis of taxation by regulation explains other perplexing phenomena. But it would be error to think that the analysis compels rejection, as distinct from modification, of the existing views of regulation. I hope to show that any theory that conceives the function of regulation to be to approximate the results of competition, or to enrich the regulated firms, or to do sometimes the one and sometimes the other, is incomplete. But it does not follow that a broadened public-interest approach (one that accommodated certain subsidy elements) or a broadened effective-political-group approach (one that viewed certain customer classes as effective political groups) might not be tenable.

1. Internal subsidies

■ The best known example of a regulated service that an unregulated competitive market would not provide on the same scale is railroad passenger service,[4] but it is far from being an isolated example.[5] Like railroad passenger service, domestic telegraph service would be declining even more rapidly than it is, were it not for the Federal Communications Commission's stubborn rearguard action against further rate increases and service degradation by Western Union.[6] Local airline service provides another example,[7] complicated though by the presence of direct as well as internal subsidies.

The phenomenon is by no means limited to declining industries. The American Telephone and Telegraph Company may soon be required to provide electronic interconnection free of charge (or nearly so) to the National Educational Television network.[8] Broadcasters are required to provide at least some nonremunerative news and public-affairs programming.[9] Liability insurance for high-risk automobile drivers in many states is written at a loss.[10] Producers of natural gas are constrained to sell at a price that does not include scarcity rents, thereby benefiting present consumers of natural gas at the expense of future consumers, who may encounter shortages.[11] Uniform rates, based on averaging together the costs of services whose cost characteristics are in fact very different, are a conspicuous feature of regulated rate structures. Examples are statewide telephone rates, the uniform long-distance rate for telephone calls of the same distance and duration regardless of route, the pegging of airline and rail passenger rates to distance with little or no consideration for cost differences over different routes, and the flat rates characteristic of

[4] See Conant [10], p. 132, Hilton [23], p. 136, and Nelson [40], pp. 286–301.

[5] In at least one respect, we shall see, it is atypical of the general class. See p. 43 and fn 69 *infra*.

[6] See President's Task Force on Communications Policy [50], and U. S. Federal Communications Commission [75].

[7] See Eads [14], pp. 1, 13–14.

[8] See The Communications Act of 1934 [78], sec. 396(h), Interconnection Service [73].

[9] See Public Service Responsibility of Broadcast Licensees [74].

[10] See Keeton and O'Connell [30], pp. 93–94; cf [67], Price Variability in the Automobile Insurance Market.

[11] See MacAvoy [35], p. 271.

urban transit systems.[12] Electrical companies grant discounts, unrelated to any cost savings, to hospitals and other worthy groups,[13] while water companies are often required to furnish water for household use at rates below marginal cost—and to fire departments and schools for nothing.[14]

These practices are very old. In 1827, the State of Illinois required by statute that every keeper of a ferry, toll bridge, or turnpike road "give passage to all public messengers and expresses; to all grand and petit jurors, when going to and returning from court, without any fee or reward whatever" [26].

In all of these examples, as in many others one could cite (including some to be discussed later), a service is provided that does not pay its way in the market. Someone must pay its way, however. Normally it is other customers of the firm rendering the service, who pay a price higher than the cost of serving them. Sometimes it is future generations of consumers (as in the gas example) or the stockholders or creditors of the firm (as, perhaps, in the railroad and telegraph examples). Examples of internal or cross-subsidization, as we may call the practice, lie everywhere at hand in the regulated industries.[15] They are also commonly found among public enterprises here and abroad,[16] the structure of postal rates providing a conspicuous example.[17] They seem much less common in unregulated private markets. The contrast is instructive: it suggests that the provision of internal subsidies is associated with distinctively governmental purposes and functions. We shall return to this point.

Before proceeding, I should caution the reader that identification of our phenomenon—internal subsidization—is often difficult.[18] In practice an internal subsidy is not always easy to distinguish from certain familiar profit-maximizing practices. A monopolist may be able to maximize profit by setting different markups on different sales, depending on the elasticities of demand of particular customers or groups of customers. Like the internal subsidy, this practice involves a departure from cost-based pricing. But it does not involve any unremunerative services. Were the lower-priced services unprofitable, the monopolist could increase his profits still further by terminating them. To take another example, a firm that has a monopoly in some markets can, under certain restricted conditions, increase its profits by selling below cost in other markets where it still faces competition. Unlike internal subsidization, however, such "predatory price discrimination" is strictly a temporary tactic to

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[12] See Caves [5], p. 369; Davidson [12], p. 217; Johnson [27]; Garfield and Lovejoy [18], pp. 200–203, 243; Meyer, Kain and Wohl [37], pp. 354, 357; Meyer Peck, Stenason and Zwick [38], pp. 166–67; Watkins [82], p. 623.

[13] See Bonbright [3] p. 111.

[14] Hirshleifer, DeHaven & Milliman [24], pp. 109–11; Garfield and Lovejoy [18], p. 225; cf. Keig, Fristoe and Goddard [31].

[15] For additional examples see Bonbright [3], pp. 111–12; Friedlaender [15], pp. 66–68; Meyer, Peck, Stenason and Zwick [38], pp. 194–95; Nelson [40], p. 331; Hearings on Transportation Acts Amendments [66].

[16] See, for example, Coase [8], pp. 1, 13–14; Crew [11], p. 258; Peltzman [44]; Sargent [51], p. 248; Sharp [52], p. 53; Shepherd [53], p. 132. Sargent and Shepherd analyze internal subsidization in the context of public enterprises in terms somewhat parallel to mine in this paper.

[17] See Baratz [2], p. 305; Coase [9], p. 25; Kennedy [29], pp. 93–94.

[18] As emphasized by Nove [42], p. 847.

drive out competitors; prolonging it indefinitely would make no business sense.

Peak-load pricing also involves different prices for the same service, and is also different. One observes resort hotels charging, for identical accommodations, higher prices in peak seasons than in off-seasons. But the reason for the off-season discount is that it attracts customers who would otherwise not buy the service. So long as the price they pay covers the marginal or additional cost of serving them, the discount is profitable. It is therefore not a case of internal subsidization as I use the term.

Temporary below-cost selling might of course stem from errors of various kinds. And even persistent departures from a proper matching of price and cost could reflect simply the difficulty and expense of determining which costs were incurred in making which sales; some averaging of costs over different services is certainly applicable on this ground. Other cases of apparent below-cost selling evaporate on examination. Professor Bonbright gives as an instance of internal subsidization (he calls it "social principles of rate making," but it is the same concept) the granting of special rail fares to clergymen[19]; but one suspects that such a discount is simply a public-relations gesture. In view of the low income of clergymen, which may make their demand for some services relatively elastic, the discount might even be an example of price discrimination.

Finally, some services may appear unremunerative only because an inappropriate conception of cost is employed. As the resort example shows, a price below average cost, but equal to or above marginal cost, may still be remunerative. On the other hand, a price above even long-term marginal cost may be unremunerative.

The last point requires some explanation. In the case of an industry in which average cost decreases with output, a firm that charged a uniform price equal to its marginal cost would not recover its total costs. It could recover them by setting a uniform price equal to average cost. This would force customers willing to pay a price equal to or slightly above marginal cost but not the higher price equal to average cost to turn to more costly substitutes. Neither result is optimal, and the proper solution to the dilemma is a matter of fair debate. One attractive possibility is to charge a price equal to marginal cost for marginal purchases and a sufficiently higher price for inframarginal purchases to cover total costs without losing those sales. Although the proper design of the rate structure is not easy, this approach seems preferable to either the uniform marginal-cost price, which necessitates a government subsidy to make up the deficit in covering total costs, or the uniform average-cost price, which excludes the marginal sale.[20]

It is implicit in this solution, however, that some customers may end up paying a higher price than under average-cost pricing. A simple arithmetical example will illustrate. Suppose the fixed costs of providing a service are $1000 and marginal cost is $1, and suppose further that when price is made equal to average cost 500 units are demanded and supplied at a price of $3 per unit. Therefore, Buyer

[19] See Bonbright [3], p. 61.

[20] See Coase [7]; Henderson [22], p. 223; Hirshleifer, DeHaven and Milliman [24], pp. 91–92.

X, who purchases 20 units, pays a total price of $60. Now suppose the industry adopts a two-part pricing system (one version of the preferred solution to the dilemma of proper pricing under conditions of decreasing average cost) under which anyone wishing to purchase service must pay (a) a share of the fixed costs (ideally, the shares should vary inversely with the elasticity of the buyers' demands) plus (b) the marginal cost of each unit he buys. And suppose that *X*'s share of the fixed costs is set at $100. He must now pay $120 for the same 20 units.

To the extent that regulatory agencies are unwilling to visit such consequences upon particular customers of the firms they regulate, output is not carried to the efficient point. The subsidy is indirect but inescapable: the additional price that the rejected marginal customers must pay for substitute products is a cost imposed on them in order to enable inframarginal customers to buy at a cheaper price than if an efficient pricing system were employed. Profit-maximizing price discrimination would also result in the inframarginal customer paying a higher price. The pricing actually employed in decreasing-cost industries appears often to be neither efficient nor profitable.

"Value-of-service" pricing in the railroad industry provides good examples of this point. Before the development of truck transportation, the practice of proportioning rail rates to the price of the commodity transported may have been a roughly adequate method of concentrating the fixed costs of railroad service on those customers whose demands for rail transportation were least elastic. But once there was a good substitute service, the method ceased to have a rational basis, at least under the usual views of regulation, since the price of the commodity shipped bears no necessary relation to the adequacy of trucking as a substitute for transportation by rail. Wristwatches are more expensive per unit of weight than grain, but it does not follow that the demand of the wristwatch shipper for rail service is less elastic; it is probably more elastic, because trucking is a more feasible alternative for the shipper of wristwatches than for the shipper of grain.

Value-of-service pricing may have persisted because it is a convenient method of subsidizing some shippers regardless of the elasticity of demands for rail transportation. The favorable rates at which agricultural commodities continue to be transported seem a case in point.[21] Considering the broad range of subsidies that farmers have managed to obtain for themselves, it is perhaps not surprising that they have obtained internal subsidies as well. And they are not the only group, or railroading the only industry, where we find value-of-service pricing used as a method of internal subsidization.[22] Notice that keeping rates low to customers so favored is not only inefficient but can destroy a decreasing-cost industry.[23] These consequences only underscore the limitations of existing theories of regulation.

A final problem of characterization, one that also arises from the phenomenon of decreasing average costs in some regulated industries, requires brief mention. A pricing system for a decreasing-cost in-

[21] See Friedlaender [15], pp. 18–20; The Hoch-Smith Resolution [80], p. 801; cf Meyer, Peck, Stenason and Zwick [38] pp. 175, 187–88.

[22] See, for example, Johnson [27], pp. 42, 67; Wilson [83], p. 337.

[23] Stigler [60], pp. 213–14.

dustry, to be efficient, must satisfy three criteria: (1) it must enable the total costs of the enterprise to be recovered; (2) it must be so designed that no customer willing to pay at least the marginal cost of serving him is turned away; (3) there should be no sales below marginal cost. Now there are many different formulae for allocating overhead costs consistently with these criteria and the choice of one inescapably affects the distribution of wealth as between various customers. For example, suppose the fixed costs of an enterprise are $100; there are 10 customers who can be made to contribute to those costs; and each of them would pay $20 rather than do without service. The regulatory agency can insist on a pricing scheme under which each pays $10, or on one under which some pay $20 and some less (perhaps zero). Whichever choice is made makes some customers worse off and some better off than they would be under an alternative arrangement.

Because this type of "subsidization" does not involve the maintenance of any uneconomic service, and thereby avoids most of the problems with which this paper is concerned, I exclude it (perhaps arbitrarily) from the category of internal subsidies. That regulation unavoidably involves issues of wealth distribution as between customer classes does, however, emphasize the relevance of notions of taxation and public finance to the theory of public regulation—but on this, more shortly.

2. Internal subsidization and the received views of regulation

The existence of the internal subsidy is an embarrassment to proponents of the first view of regulation (at least as usually formulated) mentioned at the beginning of this paper—the view that regulation is imposed in order to bring about results approximating those of competition. As we have seen, the internal subsidy brings about results unthinkable in a competitive market, which is perhaps why a distinguished proponent of the first view, Professor Bonbright, who believes that "public utility services are designed to be sold at cost, or at cost plus a fair profit"[24], considers the internal subsidy aberrational.[25]

Nor is it explicable if regulation is conceived purely as a service demanded by and supplied to the regulated firms themselves, although here the demonstration is more complicated. While an unregulated firm, whether monopolist or competitive, would not profit from engaging in internal subsidization, regulation alters normal business incentives. Under certain conditions, a regulated firm can increase its profits by expanding the size of its plant even if some of the output of the enlarged plant must be sold at a loss.[26] In addition, a regulated firm might provide some unremunerative services as an unintended byproduct of a policy of deliberately not keeping detailed cost information. The purpose of such a policy would be to prevent the regulatory agency, which is normally dependent on the regulated firm for information about the firm and its markets, from acquiring sufficiently detailed knowledge of the firm's operations to enable more stringent regulation. Such a strategy is less risky than it may seem. A regulated monopolist can get by with less information about

[24] See Bonbright [3], p. 23.
[25] *Id.*, Ch. 8.
[26] Averch and Johnson [1], p. 1052.

the costs of particular sales than a nonregulated firm. It may be able to earn the overall profit permitted by the agency, even though many of its sales are unprofitable, by charging supracompetitive prices in markets where its monopoly is secure.

Furthermore, a firm that engages in internal subsidization can argue forcefully to the regulatory agency that the agency should not permit, or at least should strictly limit, the entry of competitors into those markets where the firm makes large profits, because those profits—which new entrants would erode—are necessary in order to cover the losses in the subsidized markets. Finally, regulated monopolists may believe that differential rates, even where cost justified, strike the public as discriminatory and may in consequence invite sterner regulation of the firm's profits.

These considerations do not explain, however, those instances, such as railroad passenger service and natural gas production, where the regulated industry does not appear to be benefiting, directly or indirectly, from internal subsidization. Nor do they explain very convincingly why the practice is ever instituted in the first place. If regulated firms dominate an agency, as the view under examination posits, they can use their position to increase profits directly by getting the agency to fix a high permitted level of profits and forbid the entry of new competitors. A program of internal subsidies seems a needlessly roundabout method for achieving these ends, and also a costly one: it entails smaller profits for the regulated firms since, as mentioned earlier, a profit-maximizing firm is always better off terminating a losing service. If firms do not yet dominate a regulatory agency but seek to do so, a program of internal subsidies is not likely to help them to reach their goal. A regulatory agency that is not a creature of the firms being regulated will not permit plant used for rendering unremunerative services to be figured in the rate base. It will not reason from the fact that the regulated firms are losing money in some markets to the conclusion that it should forbid the entry of new firms into others; rather, it will invite the firms to terminate the losing services. It will insist that the regulated firm adopt accounting procedures that reveal the true costs of serving various classes of customers. These regulatory checks may be far from entirely effective in practice, but it does seem unlikely that, if regulatory agencies had no independent reasons for encouraging internal subsidization, regulated firms could nonetheless engage in the practice on the scale they do.

In sum, existing views of regulation do not explain well the important phenomenon of internal subsidization. A new approach is needed and, in the next part, proposed.

3. Internal subsidization as a branch of public finance

Regulation and public finance are ordinarily considered unrelated activities. Occasionally the language of one laps over to the other, and we speak of a monopolist "taxing" his customers, redistributing wealth from them to him, by charging a price above cost. The internal subsidy, it seems to me, is an aspect of public finance in what is at once a more exact and a more natural sense. 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 or public finance. The basic mechanism is the internal subsidy. A firm provides 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. A firm would not institute a losing service. If by mistake it did, it would terminate the service rather than subsidize the losses from profits in other markets. If it foolishly persisted, firms not burdened with the costs of losing services would enter the high-profit markets and their competition would drive down the price; deprived of the necessary supernormal profits, the firm would finally be compelled to terminate the unprofitable service.

Internal subsidization may thus be viewed as an exertion of state power whose purpose, like that of other taxes, is to compel members of the public to support a service that the market would provide at a reduced level, or not at all. It is in fact a form of excise tax, with the burden falling on purchasers of certain goods or services, and the proceeds earmarked for specific uses. As a form of excise tax, it invites comparison with other methods and objects of taxation.

4. Two case studies

■ It may be helpful at this point to illustrate the thesis that regulation is a method of public taxation and expenditure by some cases. I confine myself to two: the wall of protection thrown up around the international telegraph carriers by the Federal Communications Commission, and the methods of regulation used in the cable television industry. These case histories are no more than suggestive, but I believe a broader study of regulated markets would confirm the picture they present.

□ **International telegraph service.** Since this is one of the less well known regulated industries, it may be well to begin with some background.[27] U. S. companies providing international telegraph service (which includes telegrams, teletype, and transmission of computer data) are regulated by the FCC and known as "record carriers," because they transmit communications in the form of a written or otherwise stored record, as distinct from voice-only telephone transmission. There are three principal record carriers: ITT World Com, RCA Global Communications, and Western Union International. Until the 1950's they owned and operated submarine telegraph cables and high-frequency radio transmitting and receiving equipment. AT&T owned high-frequency radio equipment too, with which it supplied overseas telephone service (underwater cables lacked sufficient capacity for such service). AT&T did not offer record services. It seems to have been understood that the FCC would not permit the telephone company to enter the record market in competition with the record carriers.

A technological revolution in the provision of international telecommunication service occurred in the 1950's with the perfection of

[27] A more detailed description of the industry is given by the President's Task Force on Communications Policy in [49] and [50].

the voice-grade submarine cable, developed and installed by AT&
These cables had sufficient capacity not only to enable telepho
communication but also to permit the derivation of telegraph circu
at much lower cost than was possible to the record carriers usi
their existing, and now largely obsolete, equipment. Overseas te
phone calls were cheaper and of much better quality than befo
and since a telephone call is a substitute for a telegram or oth
record service, the new development placed a good deal of pressu
on the record carriers. In addition, AT&T began to offer a new s
vice, called "AVD" (alternative voice-data), under which the cu
tomer leased a circuit in the AT&T cable which he could use for vo
or record service or both. Leased lines represented the most lucrati
portion of the record carriers' services, and AT&T's new offeri
posed a serious threat to those carriers' continued profitability a
even to their survival.[28]

They complained to the FCC. The Commission forbade AT&
to offer further AVD service (although AT&T was permitted to co
tinue serving a few markets where the service had already been
stituted) and granted the record carriers rights of co-ownership
AT&T's cable.[29]

The record carriers thus weathered this storm, but another v
brewing. In 1962 the Communications Satellite Corporation v
created to exploit the newly developed communications satell
The enabling legislation[30] was ambiguous as to whether Comsat v
free to deal directly with communications customers in addition
leasing circuits to the record carriers and AT&T. The issue came
a head when Comsat and the Department of Defense negotiated
the lease of thirty circuits in Comsat's Pacific satellite to the Depa
ment directly. Comsat offered a rate that was 32-to-40 percent
the rates offered by the record carriers.[31] The disparity was puzzli
since on leased circuits the record carriers do little more than arra
for obtaining a circuit either in one of AT&T's submarine cables,
in the present case, in one of Comsat's satellites. After the rec
carriers agreed on a general rate reduction, although not to the le
offered by Comsat, the Commission held that as a matter of pol
(not law) it would forbid Comsat to deal directly with the commu
cations user.[32]

Bare as this summary is, it indicates the salient fact of regulat
in the international communications industry: the insulation of
record carriers from direct competition. AT&T could have co
peted directly with the record carriers before the invention of
modern submarine cable and especially afterward, as could Com
but the regulatory agency prevented such competition. The recei
views of regulation do not explain well this persistent, indeed dogg
policy of regulatory protection.

If regulation is imposed in order to prevent monopolistic dist
tions, one must find reasonable grounds for thinking that the en
of AT&T or Comsat into the record business would have redu

[28] See FCC proceedings re the American Telephone and Telegraph Comp
[68], p. 1159 and [70], p. 433, n 9.

[29] Re The American Telephone & Telegraph Co. [68].

[30] Communications Satellite Act of 1962 [79].

[31] President's Task Force on Communications Policy [49], p. 19.

[32] *Authorized Entities and Authorized Users* [72].

rather than increased competition in that industry. Only if one attributes simplistic, although admittedly common, notions of competition to the FCC is it possible to construct a competitively based rationale for the denial of entry. The argument would be that AT&T controls the domestic leg of most international record traffic, and if permitted to offer international service as well would use its domestic position to monopolize the international service by routing all traffic to itself.

The fallacy in this reasoning lies in the assumption that a monopolist of one stage in the distribution of a good can increase his monopoly return by annexing successive stages as well. The assumption is in general false.[33] The successive stages of distribution are exactly analogous to the sale of complementary products, for example the head and shaft of a hammer. A monopolist of hammer heads could not increase his profits by getting control of the production and sale of the shafts as well. Any monopoly profits to be earned from controlling the manufacture of hammers could be captured by control of one essential component of hammers such as the heads. A monopolist's interests are ordinarily best served by minimizing the cost of complementary products, which will usually require the encouragement of competition in their provision. Thus, if AT&T indeed enjoys an effective monopoly of the domestic leg of international telegraph service, it should be able to extract all possible monopoly profits by means of appropriate charges for that leg. It would have an incentive to enter the international end of the business only if its costs in providing that service would be less than the rates charged by the existing carriers, in which event permitting it to enter would further the ends of competition.

Even if fear of AT&T's monopolizing the international business were plausible, it would not explain why the Commission also forbade Comsat to enter, or why the record carriers' rates at the time of Comsat's attempted entry were more than twice their costs.

The interest of the record carriers in repelling new entry is of course evident, but it seems unlikely that the protective measures taken by the Commission were merely in response to their demand. Although the determinants of political power are unfortunately not clearly understood, one is skeptical that the record carriers by themselves could have induced the Commission to subordinate to their protection the interests of AT&T and the Department of Defense, two of the nation's largest institutions, and of Comsat. The record carriers appear to lack the most important constituents of political influence. Their total revenues in 1968 were $173 million, in contrast to the Bell System's total earnings of $2.4 billion.[34] The record carriers have few employees[35] to go to bat on their behalf,

[33] See Bowman [4], p. 19. This statement and the analysis that follows in the text do not hold in a few special cases. Forward integration might facilitate price discrimination, enable the transfer of profits to an unregulated affiliate, forestall new entry, or simply complicate regulation of the primary market. None of these seem likely factors in the case under discussion.

[34] See Federal Communications Commission Annual Report [71].

[35] I am informed by the FCC that as of October 31, 1969, the international record carrier industry (the three major record carriers plus four smaller ones) had a total of 5623 employees in the United States and another 2432 abroad, of whom an undisclosed number are foreigners.

and the carriers' operations are confined to a handful of major cities—principally New York, San Francisco, and Washington[36]—in whose economies they play an insignificant role. One can challenge the comparison with Bell. Since two of the record carriers are parts of very large firms,[37] perhaps the proper comparison is between the parents' revenues (employees, etc.) and Bell's, or between the record carriers' revenues and those revenues of the Bell System that are earned in the international market alone. What this point ignores, however, is that virtually all of the Bell System's operations (even those regulated by state agencies) are directly or indirectly subject to control or influence by the FCC. The entire system, therefore, has a stake in decisions affecting a part. A decision limiting competition by AT&T in the international market could have precedential force in cases involving its right to compete in other markets. The common carrier interests of RCA and ITT, in contrast, are limited to the international telegraph industry.[38] The impact of regulatory decisions in that industry on the parent companies of the record carriers is consequently much smaller than the impact on the Bell System, so one would not expect them to devote comparable efforts to prevailing before the Commission.

A public finance view of regulation provides a clue to the curious success of the international telegraph industry in insulating itself from competition. The record carriers have long provided telegram service at a loss which they recoup by charging supracompetitive prices for other services, principally leased lines, where their costs, as mentioned, are small.[39] As a result, there is a class of customers who receive a service for which they would have to pay much higher prices were it provided in a free market; possibly the service would not be offered at all. These customers would be injured by any policies, such as free entry, which jeopardized the continued provision of international telegram service at the present attractive rates. They constitute allies of the record carriers in seeking the protection of the Commission against new entry and help to explain why such protection has been obtained in the face of strong opposition.

One would like to have a clearer idea of who the class of benefited customers is and how important cheap international telegraph service is to them. We can speculate that they are mostly small firms and individuals—travel agents, some importers, many tourists and their families—rather than large firms: a large user of international telecommunications service would lease circuits or at least subscribe to teletype service. But we know from other industries, notably the retail-drug industry, that small firms (when many in number) are frequently an effective political group in obtaining protective legislation for themselves. And even if the favored telegraph customers do not constitute an effective political group, perhaps they are viewed for one reason or another as particularly deserving, and on that ground favored. A careful empirical study might refute the suggestion that the interests of this customer class are a significant factor in the

[36] In re American Telephone & Telegraph Company [68], p. 1158.

[37] Western Union International is not affiliated with the domestic Western Union Company.

[38] ITT owns some South American telephone companies, but they are, of course, not regulated by the FCC.

[39] See *Authorized Entities and Authorized Users* [72], pp. 432–35.

actions of the Commission, but the important point is that such a study seems clearly indicated.

□ **Cable television.** The cable television industry,[40] in both its economic and its regulatory characteristics, resembles the public utility industries of the late nineteenth century. The industry is in its promotional phase. The systems already installed may be only a small fraction of what we can expect when it is mature. As with the earlier public utility industries, it appears that the returns to scale are large, and it may be inefficient for more than one cable television system to serve any given local area. There is a growing momentum of regulation. All municipalities now require providers of cable television service to obtain a municipal franchise; the franchises are becoming more elaborate; and some states are beginning to regulate the rates charged by cable firms.

On the basis of the received views of regulation, one might hypothesize that regulation had been imposed because the service was thought to be a natural monopoly, or had been demanded by the cable companies themselves in order to create or entrench a monopoly position. But neither hypothesis, separately or in combination, explains the specific types of regulation that have been imposed. On the one hand, the rates charged by the cable companies to their subscribers are rarely regulated (although, as mentioned, there is some movement in that direction); the thrust of regulation thus far has not been to eliminate monopoly pricing. On the other hand, municipal authorities have required cable franchisees to pay substantial fees, in money and kind, to the municipal government. These commonly take the form of the franchisee's agreeing to pay a percentage, sometimes as high as six percent, of gross revenues, coupled with his assuming an obligation to provide several channels in the cable system, without charge, to various municipal bodies such as the schools and the fire department. These exactions both reduce the value of the franchise to the cable firm and raise the price to the subscriber above what it would be if the service were an unregulated monopoly.[41]

Thus neither the subscribers nor the cable companies are clear gainers from the current regulatory policies. But they do generate municipal revenues. A tax is imposed on cable subscribers for the benefit of whoever watches the dedicated channels or partakes (either in reduced other taxes or greater municipal services) of the revenues generated by the franchise. In the latter case, indeed, internal subsidization has become conventional taxation in all but name.[42]

Possibly these burdens have been placed on the cable television industry at the behest of competitors, such as theater owners or local television stations (a hypothesis more plausible in the case of the percentage-of-receipts fee than in the case of the dedicated

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[40] The discussion that follows draws heavily on Posner [45].

[41] See *id.* at pp. 16–19.

[42] Another interesting example of the interplay of explicit taxation and internal subsidies is found in *Student Educational Group Fares* [62], a decision of the Civil Aeronautics Board dealing with a recent Hawaiian statute that granted a tax rebate to airlines establishing a special group rate for students.

channels). In that event, the analogy would be to a tariff—another exercise of the public finance power.

5. Some general characteristics of regulation and the regulated industries that a public finance approach illuminates

■ We have seen that viewing regulation as a method of taxation c public finance appears to account, better than alternative views, fo a major phenomenon found in regulated industries—internal sul sidization. But beyond that, the view provides a consistent explana tion of many other features of regulation and regulated industrie some of which fit poorly the received views.

□ **Regulatory control over entry.** Control of entry is an essenti feature of regulation under the view advanced here because th adoption of a system of internal subsidies creates false pricing si nals. Prices in certain markets must exceed costs if the losses su tained in providing the subsidized services are to be recouped. Th price-cost spread in the subsidizing markets will naturally attra new entrants. But their costs may actually be higher than those the existing firms, in which event their entry would produce a mi allocation of resources. Entry would also impair or destroy the sy tem of internal subsidies. With free entry, then, both efficiency a the subsidy scheme would be gravely endangered, so the regulato agency must control entry.

To be sure, were regulation imposed for the sole benefit of th firms regulated, control over entry would also be necessary to preve the dissipation through competition of the advantages secured the incumbent firms by regulation. But not all important instances entry control can be explained on this ground. The Post Office is n a profit-maximizing enterprise—it is in fact run at a deficit—but n entry into postal service is, and must be, barred, in order to preser the uniform-rate structure and interclass subsidies that are a pron nent feature of the Post Office's operation. Given the financial po tion of the railroads, it is doubtful that the control of entry in th industry is to be explained in terms of the interests of the regulat firms either.

The theory that regulation seeks to approximate the results competition cannot explain the control of entry at all. If the re lated firm is constrained to sell at a price approximating cost, th will be no incentive for an inefficient firm to enter. If, despite regu tion, the firm is charging a higher price, the matter is more compl In general, however, assuming that differential pricing is feasible, seems generally the case in decreasing-cost industries, a new entr will not be attracted into such an industry by monopoly profits unl it is more efficient than the existing seller. The latter can repel en by fixing a price near marginal cost to any customer solicited by new entrant and will, because such a policy will not reduce profits on any other sales (we have assumed he can maintain differ prices) and the alternative is to lose a customer whom it is profitable to serve even at the reduced price. Unless it is a m efficient firm, the new entrant will have higher costs and will not able to meet the low price. Thus, in the case where public uti regulation is most plausibly explained in terms of an efficie rationale—where the industry regulated is a decreasing-cost dustry—the rationale still will not explain an important feature

that regulation, the control of entry, because there is no reason to anticipate inefficient or excessive entry in the absence of public control.

□ **Regulatory review of new construction.** Firms subject to public utility or common carrier regulation are commonly required to obtain the permission of the regulatory agency for any major new construction.[43] This control is to be distinguished from control over entry: it applies whether the purpose of the construction is to enable the firm to enter a new market or to serve an existing market. In arguing that regulation is for the exclusive benefit of the regulated firms, one could point out that such control enables an agency to prevent the firms from expanding production in a way that might undermine cartel pricing. Although the provisions of regulatory statutes giving the agencies authority to fix prices and levels of service, requiring the regulated firms to embody all offerings in published tariffs, and forbidding under severe penalty any deviation from the tariff filings, already give an agency broad authority to enforce cartel pricing,[44] control of new construction makes the agency an even more effective enforcer of the cartel.

A consumer-interest view of regulation also provides an explanation, although not a very satisfactory one, of the control of new construction. While there is little solid basis for fear that an unregulated firm, even if a monopolist, would adopt an extravagant construction program,[45] there are, as noted earlier, some reasons for concern that regulated firms would not minimize costs. But it is unlikely that recognition of the side effects of regulation provides a general explanation of the power over new construction. Many regulated firms subject to the power are not monopolists, and the earlier analysis would not apply. If simply a fear of poor management was in the minds of those who framed the various public utility and common carrier statutes, one wonders why such statutes do not give the regulators more direct authority over management.

I suspect that the framers may have been motivated by a somewhat different concern from those previously mentioned—one that arises from the public finance function of regulation. An illustration, again drawn from the international communications industry, will help explain. In 1967, AT&T, acting this time in concert with the record carriers (and several foreign carriers), applied to the FCC for permission to build a fifth voice-grade cable across the Atlantic Ocean ("TAT 5").[46] The cost of constructing the facility was estimated to be $70 million and the planned capacity was 720 voice circuits. Comsat opposed the application. It pointed out that by the time TAT 5 was installed, very large satellites (5000 circuits each) would be in service above the Atlantic and these satellites would provide sufficient capacity to meet all reasonably foreseeable increments of demand for transatlantic telecommunications service at

[43] See, for example, the Communications Act of 1934 [78], sec. 214(a); the Natural Gas Act [81]; and the Transportation Act of 1920 [65].

[44] MacAvoy [36] is a case study of the role of regulatory controls in effectuating cartel pricing.

[45] See Posner [47], pp. 573–77.

[46] The incident is discussed by the staff of the President's Task Force on Communications Policy in [49], pp. 35–49.

a cost per circuit that would be only a small fraction of TAT 5
AT&T, in reply, noted that the satellites in question might not be
service in time to avoid a shortage. But in that event, judging fro
subsequent filings and analysis in the proceeding, the economic
solution would be to permit queuing, or use peak-load pricing,
launch an additional satellite of an older model. The staff of Preside
Johnson's Task Force on Communications Policy, which analyz
AT&T's application in some depth, concluded that TAT 5 was t
least economical alternative.[47]

The cost questions were in fact quite complex and the correctne
of the staff's analysis perhaps debatable. The opinions in the ca
suggest, however, that the FCC itself doubted whether TAT 5 w
cost justified. The Commission expressly refused to compare the cos
of the cable with those of alternative satellite facilities,[48] adhering
this position in the face of a strong dissenting opinion in which
was urged that the cable was indeed more costly.[49] The majori
cannot have been optimistic as to what an analysis of costs wou
have shown.

In approving the application, the Commission appears to ha
been strongly influenced by considerations that cannot be understoc
save in terms of a public finance approach to regulation, such
AT&T's representation that if TAT 5 were approved, it would
able to reduce its transatlantic telephone rates by 27 percent. It
at first glance surprising that the FCC should have been impresse
by this offer. If satellites were a cheaper means of meeting demar
than the cable, then rates could be reduced by even more than
percent if AT&T, rather than building a new cable, leased circui
from Comsat: so why did the Commission refuse to compare cab
and alternative satellite costs? The probable explanation lies
Comsat's rate structure. Comsat is wedded, largely it appears f
reasons of foreign relations, to a system of uniform global pricin
under which the price of a circuit in a Comsat Pacific satellite
roughly the same as the price of a circuit in one of its Atlant
satellites. Because the Atlantic routes are busier, the Atlantic satellite
are more fully utilized and the cost per circuit accordingly lower tha
in the Pacific. But this cost difference is not reflected in the rate
which, as noted, are roughly the same in both markets. Consequentl
when AT&T leases circuits from Comsat for transatlantic service,
is forced to pay a considerable premium above the actual cost of th
circuits to Comsat, so much so that the price to AT&T (after correct
ing for certain quality differences) is not clearly lower than the cos
to it of circuits in a new cable. It is thus understandable why AT&
should have pushed for approval of TAT 5. But while from its stand
point cable costs may not have been higher than satellite costs, fro
the broader social standpoint they were (assuming that the sta
analysis referred to earlier was correct). It is to prevent unwarrante

[47] See *id.*, pp. 36–41a.

[48] Re American Telephone & Telegraph Company [70], pp. 242–43 and n.

[49] Re American Telephone & Telegraph Company [69], pp. 962–63 and [70
pp. 261–62.

[50] The staff of the President's Task Force on Communications Policy est
mated that if the price per circuit in an Atlantic satellite had been determined o
the basis of the costs of that satellite (and its associated ground facilities),
would have been $22,400 per half circuit per year in 1970, rather than the actu
price of $31,300 set by Comsat.

investments based on divergences between private and social cost calculations caused by internal subsidization that regulatory agencies must have authority over the construction programs of regulated firms even when entry into a new market is not contemplated.

In this case, to be sure, the agency's exercise of its duty was perfunctory at best. Given the circumstances, however, that is not surprising. First of all, the program of internal subsidies that was jeopardized by the grant of the application—Comsat's policy of uniform global pricing of satellite circuits—is not one that the Commission has particularly encouraged. The motives behind it are rooted, as mentioned, in foreign-policy considerations that are the responsibility of other agencies. By granting the application the Commission was able to obtain immediate rate reductions for one of its constituencies, users of transatlantic telecommunications service, and the costs to the Commission cannot have seemed large.

Secondly, the Department of Defense made strong representations to the Commission[51] that the construction of TAT 5 would promote national security—another example of internal subsidization at work. The Department could have requested an appropriation from Congress to contribute to the cost of building a cable not justified by purely civilian demands; prevailing upon the FCC to authorize such a facility was an alternative mode of financing this defense project. The method of obtaining the "appropriation" and the class of "taxpayers" were different, but the object was the same. The subsidization of defense needs appears to be a rather general feature of regulation.[52]

☐ **The duty of the regulated firm to serve and regulatory power over the abandonment of service.** Two long-established and complementary features of the regulatory process are the duty of regulated firms to serve all who demand service and the prohibition against such firms' discontinuing a service without the authorization of the regulatory agency. Although the prohibition of arbitrary refusals of service lies close to the heart of the traditional common-law concept of a public utility or common carrier (as the very name, common carrier, suggests) and is a settled feature of regulatory law,[53] it is difficult to explain under existing views of the purpose in fact of regulation. It is not apparent why regulated firms would want to be placed under such a duty or how they might benefit from it; it is only a little less difficult to see why, from the standpoint of consumer interests, the imposition of such a duty would be thought an appropriate part of the regulatory system. To be sure, a monopolist, if he has his way, will establish a schedule of prices under which fewer customers are served than if a competitive price were set; but once the schedule is adopted there is no reason to expect him to refuse service, on any

[51] Alluded to in [69], p. 961, the dissenting opinion of Commissioner Johnson.

[52] See, for example, Bonbright [3], p. 113, and National Transportation Policy in [64].

[53] A typical statement of the duty appears in the Interstate Commerce Act [63]: "It shall be the duty of every common carrier subject to this part to provide and furnish transportation upon reasonable request therefor . . . ." Other examples are given in Jones [28], pp. 376–85. See also *id.* at pp. 26–27. The subject is treated exhaustively by Wyman in [84].

but good business grounds, to any customer willing to pay the price.[54] Arbitrary refusals do not make good business sense. There is similarly no reason to expect a commercial enterprise to abandon a profitable service. Yet regulated firms are forbidden to abandon any route without obtaining the permission of the regulatory agency,[55] and bitterly contested abandonment proceedings are a commonplace occurrence, especially in the railroad industry.

Perhaps these controls are designed in many instances to reinforce regulatory control over the profits of the regulated firms: a firm might refuse or terminate service in order to coerce a higher rate from the customer, or as part of a scheme for enhancing its profits by reducing the level of service on which the rates it was permitted to charge had been based. Possibly they were intended to reinforce ordinary contractual remedies for nonperformance of services considered "essential." But these considerations do not provide a complete explanation. They do not explain why regulatory agencies are empowered to require the extension of utility services to new areas and to prevent the discontinuance of manifestly unremunerative services such as long-distance passenger transportation in the railroad industry. These cases can only be explained, I believe, in terms of a public finance view of regulation. Regulated firms, were they not subject to the duty to institute and not to terminate service, could not be relied upon to implement policies of internal subsidization. For reasons to be noted later, they might still offer some unremunerative services and they might still not always discontinue services when they ceased to be remunerative. But there would be no assurance of their cooperation.

☐ **Competitive market structures.** The public finance hypothesis also illuminates some of the important characteristics of the regulated industries themselves (as distinct from characteristics of the regulatory schemes). It suggests, for example, why so many regulated industries do not have a monopolistic structure. A program of internal subsidies does not depend on the regulated industry's being a monopoly. So long as the demand for the industry's product is not perfectly elastic, and so long as the obligation to provide internal subsidies is imposed on all the firms in the industry, such a program is feasible just as it is feasible to impose an excise tax on a competitive industry. It is therefore not surprising, under the view advanced here, that many regulated industries are not monopolistic in structure. To be sure, were regulation imposed solely at the behest of regulated firms, one would also expect many regulated industries to be competitive in structure. But one would not expect so many regulated markets (especially in the communications, power, and water-supply industries) to exhibit pronounced characteristics of natural monopoly. These are the least likely settings for firms to seek governmental protection from competition since the existence of a natural monopoly substantially reduces the danger of competition.

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[54] See Posner [47], p. 584. I except refusals to serve based upon widespread racial prejudice in a community and refusals to serve business customers for monopolistic reasons. These are special cases, and the scope of the duty to serve is considerably broader.

[55] See Jones [28], pp. 385–95.

☐ **Regulated industries produce services.** It is a curiosity that public utility and common carrier industries invariably provide services (in the sense of a good that is difficult or impossible to store or transfer) rather than commodities. The public finance view supplies an answer. A subsidized good or service will not in fact be used by those for whom it is intended if they are free to resell it on the free market, which is why direct subsidies are commonly of services rather than commodities.[56]

☐ **Regulated industries provide "infrastructure" services.** The specific complex of controls over entry and over the level and structure of rates that is characteristic of public utility and common carrier regulation is confined, for the most part, to the transportation, telecommunication, and power (electricity and gas) industries. Neither of the received views of regulation explains adequately why these particular industries have been singled out. The consumer-interest view of regulation would suggest that these were industries in which monopolistic misallocations of resources were most likely to occur, yet, as mentioned, many of the industries are naturally competitive rather than monopolistic, while a number of important industries, such as computers, drugs, newspapers, and certain nonferrous metals, which appear to have monopoly problems, sometimes quite serious ones, have escaped regulation. On the other hand, if we assume that regulation is imposed primarily for the benefit of the regulated firms, it must be shown why other industries have not obtained the same kind of regulation as public utilities and common carriers.

A partial explanation of the identity of the regulated industries may be that society frequently subjects to the public utility type of control services that it wants provided on the broadest possible basis (in a sense to be defined). The regulated industries are part of the "infrastructure" of economic growth. Adequate transportation, communications, and power (especially electrical) must be in place before the development of modern industry is possible, and most countries, including this one at various periods, have undertaken to subsidize these services or provide them directly in the hope thereby of attracting industrial developers.[57] One can deny the necessity or appropriateness of this state promotional role but hardly its prevalence. And internal subsidization is one method whereby the expansion of the infrastructure services can be promoted.

To be sure, it is not "expansion" in any simple or obvious sense that is involved. In the case of a naturally competitive industry, internal subsidies expand the provision of service to one class of customers, the beneficiaries of the program, but contract it to another: those who must pay a higher price to defray the subsidy and who consequently demand (and are supplied) a smaller quantity. The overall output of the industry is not necessarily larger, and may (as we saw in discussing value-of-service pricing) be smaller. If the industry is monopolistic in structure and it is not feasible to control its monopoly profits directly, a program of internal subsidies may well

[56] Shoup [55], p. 160; Stigler [58], p. 5.

[57] See, for example, Locklin [34], pp. 101–11, and Smead [56]. The theory of social overhead capital (as investment in infrastructure is often called by economists) is discussed by Hirschman [25], pp. 83–97.

bring about a larger output than otherwise. But in either case it would appear that the primary effect of such a program is not to increase the amount of transportation, communication, or power produced but rather to extend the service to classes of customers and geographical areas that might not be served in a free market.

Such a result is nonetheless consistent with the thinking that underlies the desire to force the creation of an adequate infrastructure rather than let the market take its course. The basic assumption, correct or incorrect, is that private enterprise, due to lack of foresight, or imperfections in the capital market, or external economies, will forgo many investments in infrastructure that would be socially profitable.[58] One can argue from this that it is the role of the state to encourage precisely those infrastructure services that are unremunerative.

This view may be reinforced in some cases by another: concern with geographical concentration of population and economic activity. A program of internal subsidies that denies the cost advantages of proximity and density, as is often the case, encourages greater geographic dispersion. Cost advantages based on location, it need hardly be said, are no less real than those based on other factors. But governments, including our own, have frequently followed policies aimed at denying those advantages. Utility regulation is perhaps one of them.

The industries in which we find internal subsidies are commonly also recipients of at least some direct subsidies.[59] This correlation supports the view of regulation as a method of public finance, especially where, as in the case of the electrical and telephone subsidies doled out by the Rural Electrification Administration, the recipients of direct subsidies are not members of the industry at all (in the REA case, they are consumer cooperatives). In such a case the established firms in the industry benefit only insofar as the existence of the direct subsidy reduces the pressure on them to provide an internal subsidy, and the subsidy scheme is more convincingly interpreted as a method of obtaining greater service than as a device for enriching corporate treasuries.

To suggest that regulation is a method of promoting the expansion of infrastructure services is not, of course, to explain why it is chosen in preference to alternative methods, such as direct subsidies, or why, with respect to some infrastructure services, such as education, the public utility approach plays a very subordinate role.[60] A framework for answering this question is sketched in part 6, where we look at some of the advantages and disadvantages of regulation in comparison with other methods of taxation, and a highly tentative answer is suggested.

The infrastructure explanation for the identity of the regulated industries is far from being completely satisfactory. It hardly seems applicable when an internal subsidy is used to retard the decline of an old industry, such as railroad passenger service or telegraph service. In addition, the economic case for subsidizing infrastructure

[58] See, for example, Hagen [19], pp. 126–29, and Kindleberger [32].

[59] Cf. Harriss [21], p. 270.

[60] Although not an entirely negligible one, as attested by free cable-television channels for schools, the public-affairs programming obligations of broadcast licensees, and the proposed free interconnection for educational television.

services is often dubious. And internal subsidization seems a somewhat curious way to encourage the expansion of an industry since, as mentioned, the cost of the subsidy is borne by customers of the industry. Indeed, the obligation to provide service to all at a uniform price may retard the undertaking of new extensions of service.[61]

At the least, these considerations suggest that a thoroughgoing justification of internal subsidies on efficiency grounds is impossible. One can easily find examples where an internal subsidy works directly contrary to the dictates of efficient resource allocation. Thus, the subsidization of commuter railroad service aggravates an existing imbalance between private and social costs caused by the fact that individuals who are employed in cities and utilize urban public services can escape the costs of those services by living in a suburb and commuting. It would appear, therefore, that internal subsidies are frequently designed to redistribute wealth rather than to correct imperfections in the market.

6. Internal subsidization compared with other methods of public finance

Limitations of the device. To summarize the discussion at this point, there is persuasive evidence that an important purpose in fact of public utility and common carrier regulation is to compel, by the device of the internal subsidy, the provision of certain services in quantities and at prices that a free market would not offer, much as the conventional taxing-spending power is used to the same end. Serious discussion of the public finance component of regulation has been retarded, however, by a tendency to dismiss it out of hand as an implausible and inappropriate alternative to more conventional exertions of the taxing power. Two objections are usually advanced as conclusive. The first is that internal subsidization distorts the efficient allocation of resources; the second, that it tends to be arbitrary and inequitable. One sometimes hears it said, too, that taxation is the proper business of the legislature and not of regulatory agencies.

1) *Delegation.* To take the last point first, it is difficult to understand why the delegation of a part of the taxing power to appointive agencies, the regulatory commissions, should be thought to offend the principles on which our government is organized. Congress, acting from imperative reasons of practicality, has delegated much of its lawmaking power to appointive agencies. The Federal courts provide a conspicuous example, and the Internal Revenue Service one that is directly in point.

2) *Efficiency.* It is true that internal subsidization, by forcing prices in some markets above cost and prices in others below, distorts the allocation of resources. It creates a secondary inefficiency as well: the entry of new competitors into the high-price markets must be prevented by the regulatory agency lest the source of the internal subsidy be wiped out.[62] Where the high-price market is

[61] Coase [6], p. 139. The effect of uniform price systems with which Professor Coase was concerned—denial of service to high-cost customers willing to pay the full cost of serving them—can be avoided by combining a uniform price system for most customers with a system of surcharges for those who would not be served at the uniform price. This appears on casual observation to be the practice of the telephone industry in this country.

[62] For a good example, see Caves [5], p. 314.

a natural monopoly, this is not an acute problem, but of course not all markets subject to regulation are naturally monopolistic.

The criticism of internal subsidization as inefficient points to a real characteristic of the device; but as a criticism it is superficial. It measures the device against an ideal standard, and of course finds it wanting. The proper comparison is to other exercises of the taxing power. All methods of taxation distort the "optimum" allocation of resources—optimum, that is, without regard to any need or demand to provide certain services publicly—and there are no *a priori* grounds for assuming that excise taxes, such as the internal-subsidy programs imposed by regulatory agencies, produce worse misallocations than income or other taxes.[63] To consider an important example, the exemption from income taxation of the real but not pecuniary income generated by housewives must cause a significant misallocation of resources by inducing many women to stay at home who would be more productive in other employments. The administrative costs of implementing a broader income concept would be so great, however, that this exemption is probably a permanent feature of income taxation. Because of pervasive and ineradicable distortions of this kind, it is not obvious that raising income tax rates would be a more efficient method of providing particular services at below-market prices than internal subsidization.[64] Indeed, insofar as the burden of internal subsidies tends to be borne by customers whose demands are highly inelastic, the allocative effects may be less adverse than those of alternative taxation methods.[65] And in those cases where the regulated firms are obtaining monopoly profits, the adverse allocative effects of the tax will be even fewer.[66]

Internal subsidies are also criticized on the ground that a subsidy in kind is inefficient compared to an unrestricted cash subsidy, because different people have different needs and wants. This is a valid and important point but it is not a criticism of internal subsidies as such, since it applies with equal force to most direct subsidies.

3) *Equity*. Because the determination of the incidence of particular taxes is immensely complex, it is very difficult to gauge the effect of internal subsidies on the distribution of income. At a rough guess, internal subsidization may sometimes benefit the poor[67] but has no general tendency to do so; and as our commuter example shows it may sometimes work in the opposite direction. But poverty is not the only possible justification for the redistribution of income. It is notable that internal subsidization is frequently employed to bolster declining services or sectors; perhaps in these cases it is felt that there are important reliance interests (for example, in location proximate to a railroad line) that deserve protection. And even if no consistent equity justification is possible, that is no special criticism

[63] See Friedman [16], pp. 56–67, and Little [33], p. 608.

[64] Cf. Harberger [20], p. 58.

[65] Cf. Musgrave [39], p. 157.

[66] Cf. Shilling [54], p. 224; Shoup [55], p. 276; Dirlam and Kahn [13], p. 494.

[67] Some rather dubious examples are given in Bonbright [3], pp. 111–12. Lower prices to the poor could in some cases be explained as profit-maximizing price discrimination, and his examples may well be of this type. A better example is provided by the low rail rates for agricultural commodities (see p. 26 and fn. 21 *supra*), but it is possible that the benefits are largely captured by farmers (who may or may not be poor) rather than by consumers. Staudinger [57], p. 259, argues for using public utility pricing to redistribute income to the poor.

of internal subsidies: the redistributive effects of tax-cum-direct-subsidy programs appear in a surprising range of cases to be perverse.[68] If one is to oppose internal subsidies on equity grounds, it must be as part of a broader objection to the redistributive policies of the state.

I turn now to some other, less frequently discussed attributes of regulation as a method of public finance.

4) *Enforcement.* An important characteristic of taxation by regulation is difficulty (and expense) of enforcement. A firm that finds the provision of an unremunerative service irksome may try to terminate it by drastically reducing the quality of the service and then citing the resulting fall in demand as evidence that the public no longer wants the service. This is not so transparent a gambit as it may seem. Since the public is not paying the full cost of the service, it has a natural tendency to demand a very high (and correspondingly costly) level of service. The specification of an appropriate level involves an essentially arbitrary judgment and accordingly gives the firm some room for maneuver. Evidently degradation of service has played an important role in the termination of railroad passenger operations.[69]

The tendency of regulated firms to cheat in providing unremunerative services is probably quite general since, unless regulation is more effective than anyone thinks, a penny saved in skimping on an unremunerative service will not result immediately in a full penny reduction in the rates paid by customers of the firm's lucrative services. The finding in a recent study that the rates set by publicly owned electric utilities[70] are more uniform than those set by privately owned electric utilities supports this suggestion. Uniform rates, we saw, are a common method of internal subsidization; and one would expect a privately owned company to resist providing unremunerative services more energetically than a publicly owned one.

The tendency to cheat is not entirely a bad thing. It may result in a smaller subsidy than if direct subsidization were used, and given the forceful objections to many subsidies, this may be distinctly to the good.

5) *Public scrutiny.* A troubling characteristic of the internal subsidy is its low visibility, which impedes responsible review. The amounts and recipients of direct subsidies are ordinarily specifically stated, but this is not the case with internal subsidies. Since information is not a free good, a subsidy program whose magnitude requires computation is less apt to be challenged than one whose magnitude is patent.

This is a general criticism of hidden subsidies, of which internal subsidies in the regulated industries are only one variety. And it is easily overstated: extravagant subsidy programs sail through Congress with monotonous regularity. Full disclosure is a far from dependable test of whether legislation in the public interest will be adopted, because the public does not vote on specific pieces of legislation, but on representatives, and it is demonstrable that in a repre-

[68] Stigler [58], p. 1.

[69] Doubtless encouraged by the ICC's recent holding that it has no authority over the quality of rail passenger service [76].

[70] Peltzman [44].

sentative system much legislation benefiting special interests at the expense of the larger public will be enacted.[71] This is a basic insight of the effective-political-group theory of regulation. Furthermore, given the size of the Federal budget, the disclosure in an appropriation hearing of the amount of a subsidy may not always be an effective method of assuring a responsible review of the proposal's merits. Suppose that buried in the Defense Department's appropriation request there had been a small item for a contribution to the cost of building a transatlantic cable: can one be confident that it would have received the careful scrutiny of Congress?

Despite the last point, the concern about adequacy of scrutiny has greatest force, I believe, precisely with regard to internal subsidies for national defense. The Defense Department's role in the TAT 5 matter affords a good illustration. Had the Department been forced to include the item in its budgetary request to Congress, it would have had to weigh its importance against that of other national-defense programs. The defense budget is not limitless. The inclusion of the cable item might have compelled the Department to modify some other request. In the context of a regulatory proceeding, however, the cable represented a free good to the Department. The Department had no incentive to evaluate the benefits of TAT 5 to the national defense objectively; indeed, it had an incentive to exaggerate those benefits. The FCC could not exercise a critical scrutiny because it has no competence to deal with military questions. The competent agencies—Congress and the Bureau of the Budget (which reviews all Federal budgetary proposals before submission to Congress)—were bypassed.

6) *Manageability of regulation.* Another problem with internal subsidization is that it complicates an already barely manageable regulatory process. Because there is no objective basis for balancing off distributive benefits against allocative costs,[72] an agency concerned with subsidizing worthy groups is deprived of a clear-cut standard for resolving controversies over pricing and entry. Clear and definite standards are necessary to tolerable regulation.[73] Without a definite standard at the agency level, moreover, judicial review, a potentially

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[71] See Stigler [59].

[72] In his recent study of the Federal Power Commission [35], pp. 288–89, Paul MacAvoy makes a valiant but, I believe, unsuccessful effort to do so. His position on determining the dollar value of an income redistribution is "that the government should decide, and it indicates value by the amount that consumer X can keep after taxes . . . ." The difficulty with such an approach is that the scheme of Federal taxation does not reflect any consistent or intelligible policy toward the equity of income redistribution—unless we are to assume, for example, that because some dividend income is exempt from tax, stockholders are to be deemed a favored class for purposes of evaluating the redistributions brought about by a monopolist or a regulatory agency. See Pechman [43] for a lively recent discussion. And many of the apparently distributive features of Federal income taxation, including the progressive principle itself, have been justified on grounds (such as benefits received) that have nothing to do with the equity of redistributing income, while other features (such as the nontaxability of real income received in the form of reductions in the prices of consumer goods) reflect purely administrative considerations.

[73] Friendly [17]. For a somewhat different path to the same conclusion, see Posner [46], pp. 84–85.

important check on regulatory excesses,[74] is likely to be ineffectual; the agency can give a plausible justification for any result. Multiple and conflicting standards also breed corruption.[75]

7) *Private demand.* Taxation by regulation, to be feasible, requires that there be sufficient demand in the private market to justify the imposition of the burden of the subsidy on the regulated firms. Where there is not, as in the railroad industry, the results can be disastrous for the industry. One may hazard the guess that regulation has frequently been the principal means of subsidizing infrastructure services for which there is a strong private demand, while in areas like national defense and education, where the market demand is probably small in relation to the amount of service that the state wishes to provide, other methods of subsidization have predominated.

□ **And some advantages.** The balance of advantages is not wholly against the choice of the internal subsidy as a method of public finance. We have indicated several respects in which it may be preferable to other methods, and there are others.

1) *Administrative expense.* Although enforcement of internal subsidization can, as mentioned, be quite costly (railroad abandonment proceedings are a case in point), there are certain offsetting factors. Since no cash transfers are involved in internal subsidization, it is possible to dispense with the frequently elaborate apparatus of a formal transfer program—application forms, disbursement machinery, and the like. Often, too, a program of internal subsidies is implemented simply by the regulated firms' averaging the costs of many customers in setting a rate, and where this is done the firms avoid the expenses that would be incurred in identifying the costs of finer groups of customers and adopting a more complex rate structure tailored to the different costs. This is not to suggest that expenses incurred in implementing the price system are normally wasted; but once it is decided not to allow the price system to control the allocation of resources, a choice implicit in the decision to subsidize, the elimination of some of those expenses may represent a real saving.

2) *Legislative capacity.* By shifting taxing power from Congress (or state legislative bodies) to administrative agencies, internal subsidization economizes on the legislature's time. This is an especially important consideration where the subsidy is of a kind that requires frequent adjustment or review. The ability of a legislature to transact business is obviously limited. Among the ways in which it can be conserved, perhaps the delegation of minor taxing functions to regulatory agencies is relatively efficient.

3) *Protection of expectations.* At least when imposed on a service from the outset, internal subsidies may be less disruptive of public and

[74] An expanded role for the courts in the review of regulatory action is urged in Turner [61], p. 386. His position can be defended on the ground that judges are more insulated from political-group pressures than regulatory agencies. Cf. Posner [46], p. 89.

[75] The classic instance is the corruption that beset the FCC, at the highest levels, in the 1950's. The problem revolved around the initial grant of broadcast licenses, where the Commission applied no standard but used a check-list of criteria, enabling any preconceived result to be rationalized. Jones [28], pp. 1081–84, lists 15 criteria.

commercial expectations than other new taxes. An example will illustrate. Suppose a community has pending before it several applications for a cable television franchise and would like to use a few channels in any cable television system that is constructed for municipal functions such as education. And suppose further that the feasible alternative methods of obtaining this service have been narrowed to two: a tax on the gross receipts of the barbers in the community, the proceeds to be used to purchase the channels from the cable franchisee, and a condition in the franchise requiring the franchisee to provide the channels to the school system at no charge. If the first alternative is chosen, the result will be a rise in the cost (and hence presumably price) of barbering, which will lead to a fall in the amount of barbering demanded and supplied. As a result, some of the resources used in barbering in the community will be idle during the period in which they are being redeployed. And there will be an outcry from the barbers. These economic and political costs, incurred by virtue of the change in the economic conditions of the business brought about by a new tax, can be avoided if the second alternative, an internal subsidy by the cable industry, is selected. Since the costs of the cable system are now higher, a smaller system will be built. But the efficient scale (consistent with the obligation to provide free channels to the franchising authority) will be known in advance; there will be no waste in achieving it, as in the barbering example. In fact one observes that public utility and common carrier regulation has typically been imposed upon new services, where it was possible by a system of internal subsidies to finance desired extensions of the service without disturbing settled activities. And perhaps these considerations explain why municipalities have latched onto cable television as an important new source of revenue.[76]

Nonetheless, the explanation is severely limited. The alternatives in our example were too narrow: the municipality could also have placed a gross-receipts or other tax on cable service and raised the money for the free channels that way. It did not have to use internal subsidization, although we have previously discussed some reasons why internal subsidization might sometimes be preferred to alternative forms of excise taxation.

4) *Justice.* There may be some appeal to the notion that it is more "just" for other customers of the same industry to bear the cost of a subsidy of the industry's service than to distribute that cost among the taxpaying public at large. The notion is a little peculiar, however. It is one thing to say that those who benefit from a service should bear its costs, and quite another to impute the cost of a subsidy to those customers who are quite prepared to pay the full cost of serving them.

A final reason for the choice of internal subsidization over alternative methods of public finance has nothing to do with its relative merits. The regulated firms may cast their weight on the side of the internal subsidy, viewing customers who enjoy subsidized rates as useful allies in the maintenance of regulatory barriers to entry. Subsidizing some customers may be the "price" that the franchised monopolist pays for his monopoly. Perhaps careful study would disclose that most regulation is demanded by and supplied to a coalition

[76] See, for example, the Mayor's Advisory Committee [41].

of regulated firms and those of their customers who receive services below cost as a consequence of regulation.

7. Some practical suggestions

I trust that the foregoing remarks will not be construed as a "defense" of taxation (and subsidization) by regulation. They may, however, help explain the prevalence and tenacity of the practice, and they do suggest that, short of a thorough overhauling of government subsidy policy, it is less easy to condemn the practice out of hand as inefficient and inequitable than has usually been assumed. Perhaps few subsidies are in the public interest; there may still be cases where, given a decision to subsidize, regulation is the cheapest means of doing so.

But if we are stuck with taxation by regulation, perhaps we are not stuck with its worst features. I propose two modest reforms. The first is that agencies and reviewing courts insist, in proceedings where the maintenance of an internal subsidy is an issue, that the amount and cost of the subsidy, together with the identity of the recipients and of the payors, be calculated and placed in the public record. Perhaps this would eliminate some of the more captious instances of the phenomenon; at least it would bring an important issue of public policy into the open.

Second, more consideration should be given to the most efficient method of attaining the ends of internal subsidization. Accepting the decision to subsidize a specific service and to impose the cost of the subsidy on other customers of the firm providing the service, there may be better ways of achieving this end than control of prices, entry, abandonments, and the like by a regulatory agency. In particular, an explicit excise tax (such as the percentage-of-gross-receipts fee in many cable television franchises), with the proceeds earmarked for the service that the state wants to subsidize, may be preferable to the internal subsidy proper because it entails no limitation on entry into the high-price market; lump-sum fees may be preferable to either.[77] A likely reason why such alternatives are rarely considered is that the usual regulatory agency lacks authority to impose an explicit tax or other fee. In franchise regulation, as the case of cable television suggests, this option is open. Perhaps, therefore, a modest enlargement of the taxing power of regulatory agencies, to permit them to exact a uniform and limited fee from any firm desiring to enter a regulated market in lieu of other regulatory controls, would foster the more efficient use of what appears to be a settled device of public finance.

8. Conclusion

This paper merely scratches the surface of an interesting and important question of public policy. I have tried to show that certain views of the purpose in fact of public utility and common carrier regulation—that it is to approximate competitive results, or that it is to benefit the regulated firms—fail to account for a number of significant observed features of the regulatory process and the regulated industries. And I have argued that a consistent and comprehensive explanation of those features requires that we assign an important place to taxation and subsidization among the purposes that regula-

[77] See Posner [45] pp. 19–20.

tion in fact serves. I have attempted further to compare taxation by regulation with other methods of taxation and subsidization, in the hope of assisting evaluation of the pros and cons of alternative methods in particular cases. What I have not attempted to do is explain why some groups are subsidized and others not, or why the same group will receive some internal subsidies but not others (in the case of fire departments, for example, free water but not free telephone service). These fascinating and important questions, which require a better understanding of the magnitude and incidence of taxation by regulation than existing information permits, constitute the agenda for further research into a heretofore rather neglected aspect of public regulation.

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COST ALLOCATION OF REVENUE REQUIREMENT

This exhibit presents an overview of the process to allocate Hydro One Distribution related revenue requirement costs to Legacy, Acquired, and Sub-Transmission customer groups (including current Embedded LV customers).

1.0 INTRODUCTION

The 2008 revenue requirement of $1,067 million for Hydro One Distribution was derived in Exhibit E1, Tab 1, Schedule 1, and is attributed to the Retail, (Legacy and Acquired), and Sub-Transmission customers.

This revenue requirement is allocated to the proposed customer groups using the Cost Allocation methodology issued by the OEB on September 29, 2006 in the RP-2005-0317 proceeding. Hydro One modified the OEB methodology to reflect its unique circumstances related to the provision of an LV system and a very large number of rates. The modifications are detailed in Exhibit G2, Tab 1, Schedule 1, and are similar to the modifications applied in Hydro One's Cost Allocation Information Filing of January 15, 2007 as part of Proceeding RP-2007-0001.

2.0 APPORTIONMENT OF REVENUE REQUIREMENT

Hydro One used the OEB Cost Allocation Methodology to allocate the proposed $1,067 million revenue requirement to customer classes. The allocated revenue requirement was compared to the revenues that would be collected from customers at adjusted 2007 Distribution rates. The adjustment consisted of increasing the 2007 approved rates proportionally to recover the 2008 Revenue Requirement of $1,067 million. Revenue to cost ratios were then calculated. Revenue to cost ratios above 1 mean that the customer class is over-contributing and revenue to cost ratios below 1 mean that the customer class

is under-contributing. The results of the cost allocation study are summarized in the Table below.

Table 1
Hydro One Cost Allocation Study Results

	UR	R1	R2	Seasonal	UGSe	UGSd	GS e	GS d	ST	DG	Street Light	Sent. Light	Tota
Rev Req $M	66.0	240.2	390.3	83.6	9.3	16.8	111.1	105.4	27.4	0.4	8.1	8.0	1,066
Revenue at current rates $M	57.7	197.1	404.6	77.0	12.1	16.0	119.6	107.9	64.2	0.6	4.9	4.9	1,066
Rev/cost ratio	**0.87**	**0.82**	**1.04**	**0.92**	**1.29**	**0.95**	**1.08**	**1.02**	**2.35**	**1.63**	**0.60**	**0.62**	**1.00**

More details on the results of the cost allocation study can be found in Exhibit G2, Tab 1, Schedule 1.

3.0 TARGET REVENUE TO COST RATIO

Hydro One is proposing to use the revenue to cost ratio ranges recommended in the Board's report issued November 28, 2007 under proceeding EB-2007-0667, "Application of Cost Allocation for Electricity Distributors". The Board recommended revenue to cost ratios range from 0.7 for street lights to 1.8 for large commercial customers. Given that this is the first time that the OEB's cost allocation methodology is being used as a basis for determining distribution rates, the wider range of revenue to cost ratios proposed by the Board will reduce the potential bill impacts on customers whose distribution rates have to increase to closer reflect cost causality. The proposed range of revenue to cost ratios will result in those customer classes with a revenue to cost ratio above 1 continuing to cross-subsidize those customer classes with a revenue to cost ratio below 1.

Hydro One is proposing the following revenue to cost ratios for the various new proposed customer classes.

For the R2 Residential, General Service energy billed, and General Service demand billed customer classes, the current revenue to cost ratio is proposed to be maintained:

For the Distributed Generation customer class, the revenue to cost ratio is proposed to be set at 1.0 rather than the current 1.63 in support of Government policy to promote Distributed Generation in Ontario.

For Street Light and Sentinel Light classes it is proposed to increase the revenue to cost ratio from about 0.6 to 0.7. This is the lower end of the revenue to cost ratio proposed by the Board for this class of customers.

For the Urban General Service energy billed class it is proposed to reduce the revenue to cost ratio from 1.29 to 1.2. This is the higher end of the revenue to cost ratio proposed by the Board for small commercial customers.

For the Sub-Transmission class it is proposed to reduce the revenue to cost ratio from 2.35 to 1.15. This is the higher end of the revenue to cost ratio proposed by the Board for large users.

In order to recover almost all of the 2008 Revenue Requirement based on the revenue to cost ratios described above, the revenue to cost ratio for Urban Residential, R1 Residential, Seasonal Residential and Urban General Service demand billed customer classes will have to increase. The revenue to cost ratios for the Urban Residential, Seasonal Residential, and Urban General Service demand billed customer classes are proposed to be set to 1.0. For the R1 Residential customer class, the proposed revenue to

cost ratio is 0.88, which results in bill impacts that are considered to be the maximum that Acquired residential customers being harmonized to this customer class can sustain.

The proposed revenue to cost ratios result in Hydro One not being able to fully recover its 2008 proposed Revenue Requirement. The shortfall is estimated to be $2.5 million per year, which is the difference in the total proposed revenue requirement shown in Table 2 as compared to Table 1. Hydro One proposes to establish a variance account, as described in Exhibit F1, Tab 3, Schedule 1 to record this revenue shortfall for recovery at a future date from all customers.

Table 2
Proposed Revenue/Cost Ratio by Customer Class

	UR	R1	R2	Seasonal	UGSe	UGSd	GS e	GS d	ST	DG	Street Light	Sent. Light	Tota'
Proposed Revenue Requirement $M	66.0	211.4	404.6	83.6	11.2	16.8	119.6	107.9	31.5	0.4	5.7	5.6	1,064.
Proposed revenue to cost ratio	**1.0**	**0.88**	1.04	**1.0**	**1.2**	**1.0**	1.08	1.02	**1.15**	**1.00**	**0.7**	**0.7**	1.0

*Revenue to cost ratios in bold show the proposed change

4.0 REVENUE TO COST RATIO EQUAL TO ONE

In response to feedback received during the stakeholdering process, Hydro One explored the impact of moving all customer classes to a revenue to cost ratio of 1. Table 3 shows the average impacts that would result from making this change. As shown in Table 3, the resulting average total bill impacts under a revenue to cost ratio of 1 is generally greater and could be as much as three times the impact under the proposed revenue to cost ratios. As a result, using a revenue to cost ratio of 1 for all customer classes would result in either unacceptable bill impacts or the need for an excessively long impact mitigation period.

Table 3
Impact to Customer Classes of Revenue/Cost Ratios

	Proposed R/C	Average impact %	R/C = 1	Average impact %
UR	1.0	3.4	1	3.4
R1	0.88	3.0	1	8.3
R2	1.04	1.0	1	(0.8)
Seasonal	1.0	9.7	1	9.7
UGe	1..2	(2.3)	1	(6.3)
UGd	1.0	0.3	1	0.3
GSe	1.08	0.5	1	(2.2)
GSd	1.02	(2.1)	1	(2.7)
DG	1	(29.0)	1	(29.0)
Street Light	0.7	5.0	1	21.7
Sentinel Light	0.7	25.0	1	118.1
ST	1.15	(4.7)	1	(5.0)

Statutory Powers Procedure Act, s. 9.1

R.S.O. 1990, CHAPTER S.22

Proceedings involving similar questions

9.1(1)If two or more proceedings before a tribunal involve the same or similar questions of fact, law or policy, the tribunal may,

(a) combine the proceedings or any part of them, with the consent of the parties;

(b) hear the proceedings at the same time, with the consent of the parties;

(c) hear the proceedings one immediately after the other; or

(d) stay one or more of the proceedings until after the determination of another one of them.

Exception

(2)Subsection (1) does not apply to proceedings to which the *Consolidated Hearings Act* applies. 1994, c. 27, s. 56 (19).

Same

(3)Clauses (1) (a) and (b) do not apply to a proceeding if,

(a) any other Act or regulation that applies to the proceeding requires that it be heard in private;

(b) the tribunal is of the opinion that clause 9 (1) (a) or (b) applies to the proceeding. 1994, c. 27, s. 56 (19); 1997, c. 23, s. 13 (15).

Conflict, consent requirements

(4)The consent requirements of clauses (1) (a) and (b) do not apply if another Act or a regulation that applies to the proceedings allows the tribunal to combine them or hear them at the same time without the consent of the parties. 1997, c. 23, s. 13 (16).

Use of same evidence

(5)If the parties to the second-named proceeding consent, the tribunal may treat evidence that is admitted in a proceeding as if it were also admitted in another proceeding that is heard at the same time under clause (1) (b). 1994, c. 27, s. 56 (19).

Ontario Energy Board Act, 1998

S.O. 1998, CHAPTER 15
SCHEDULE B

Consolidation Period: From August 20, 2007 to the e-Laws currency date.

Last amendment: 2007, c. 8, s. 222.

Board's powers, miscellaneous

Consolidation of proceedings

21. (5) Despite subsection 9.1 (1) of the *Statutory Powers Procedure Act*, the Board may combine two or more proceedings or any part of them, or hear two or more proceedings at the same time, without the consent of the parties. 2003, c. 3, s. 20 (2).