TELEPHONE RATE REGULATION IN NEW BRUNSWICK AND THE RATE REGULATION PROCESS

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In an article in last year's issue of this Journal,[1] the author raised the question of whether the New Brunswick Board of Commissioners of Public Utilities understood normal rate regulation procedure. At that time the decision of the Board in the 1976 rate application of the New Brunswick Telephone Company[2] raised some doubt on this matter.

Since then the Board has considered and decided another rate application by the New Brunswick Telephone Company.[3] As a result of the 1977 decision, the doubt raised by the 1976 decision has been removed. It is now clear that the Board does not understand normal rate regulation procedure.

The clarity of the 1977 decision relates primarily to the same question that was discussed a year ago, the Board's treatment of the test year concept. That concept was fully explained in the previous article and that discussion will not be repeated here. In its 1977 decision the Board has made clear what was doubtful a year ago by explicitly authorizing the Telephone Company to collect over a period of 9½ months the amount of additional revenue which under the test year concept ought to be collected only over a period of 12 months.

The extent of the Board's failure to understand the rate regulation process is indicated by another aspect of the 1977 decision — the calculation of the rate base. In the 1976 decision the Board adopted a future test year. It adopted the Company's projected average rate base for that year for the purpose of caluclating the Company's allowable additional revenue requirement. As it turned out, the Company cut back its projected construction programme during the year. As a result, its average rate base during 1976 was

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1 R.W. Kerr, Telephone Rate Regulation in New Brunswick and the Test Year Concept (1976), 25 U.N.B.L.J. 115.

2 *In the Matter of the Application of the New Brunswick Telephone Company,* Decision dated February 18, 1976, and Order dated February 26, 1976, not reported (New Brunswick Board of Commissioners of Public Utilities).

3 *In the Matter of the Application of the New Brunswick Telephone Company,* Decision dated March 7, 1977, not reported (New Brunswick Board of Commissioners of Public Utilities).

approximately $5 million less than what was projected when the 1976 rate decision was made.

While the Board neither approved or disapproved of this action which it viewed as a decision left to management under the regulatory system, the Board apparently concluded that the effect was to render excessive the rates allowed in 1976. To compensate, the Board reduced the average rate base for 1977 as otherwise calculated by an amount equivalent to the $5 million excess of the 1976 projected average rate base over the 1976 actual average rate base.

Two factors relating to this rate base adjustment by the Board tend to further confirm that the Board does not understand the rate regulation process. First, there is no evidence that the Board made the sort of analysis which would be necessary to establish whether the 1976 rates were actually rendered excessive by the reduction in construction. Secondly, by the type of adjustment made to compensate for the supposedly excessive 1976 rates, the Board introduced an element into the newly approved rate structure which tends to render the new rate structure inadequate.

Whether the 1976 rates were actually excessive requires a review, not merely of the 1976 rate base, but of the 1976 rate of return. The Board makes no reference to this in adopting the rate base adjustment. Unless this question is considered, it is just as possible that the Company's cutback in construction was fully consistent with, and arguably compelled by, the Board's 1976 decision as it is that the cutback was inconsistent with the 1976 decision. If the former is the case, any downward adjustment in the new rate structure on this basis seems unjustified and punitive.

The objective of the Company in cutting back construction was undoubtedly to decrease what it calls the cost of capital. Since new construction is, for the most part, financed by new capital, any decrease in construction reduces the amount the company has to pay, by way of interest or dividends, for such new capital.

Since the Company normally has a fair amount of unused capacity in its system, such cutbacks can, moreover, be accomplished without significant effect on revenue in the short run. Indeed, since the actual cutbacks in this case involved rural improvements which appear not to be a profitable investment anyway, even in the long run the effect of reducing such construction tends to reduce expenditures more than it reduces revenues.

In its 1976 decision the Board authorized the Company to increase rates so as to realize a rate of return of 13% on common equity. It also approved a rate of return on common equity fluctuating to as high as 15% "if the Company can achieve a return higher than 13% because of favourable cost developments".

Taking all factors into account, there are two likely possibilities as to what the Company was attempting to achieve by the constuction cutback and reduction in capital costs. It may be that developments, whether in terms of income or cost, were less favourable than the Company's 1976 projections and that the Company was not even achieving the minimum 13% return on common equity. Alternatively, it may be that the Company was achieving this 13% rate of return, but was seeking to increase the rate of return on common equity to 15%.

If the Company was achieving a rate of return on common equity of at least 13%, it may have thought it was entitled to seek an increase to 15% by cutting capital costs on the basis that these were favourable cost developments within the 1976 decision of the Board. If this was the Company's objective, however, it is submitted that it was inconsistent with the Board's 1976 decision as properly interpreted and the Board had cause to regard the 1976 rates as excessive. Capital costs, including interest on borrowed capital, are treated as part of the rate of return in rate regulation, and the Board's decisions to this extent have followed normal rate regulation practice. The Board's reference to favourable cost developments in its 1976 decision seems clearly to involve something outside of and in contrast to the rate of return which is separately referred to in the same sentence. It seems obvious that the Board was referring to costs reflected in the Company's income statement, and not to the cost of capital. Therefore, by cutting construction and capital costs to achieve a 15% return on common equity, the Company would not be acting as contemplated by the 1976 decision. The Board allowed for a 15% return on common equity, but by reducing current costs, not capital costs.

On the other hand, if the Company was not achieving the minimum 13% return on equity, it was faced with an entirely different situation. No provision for such a situation was made by the Board. In such circumstances, the Company would surely be entitled to use its best judgment in undertaking whatever measures were necessary to restore its financial position to that level which the Board approved as a minimum. Indeed, since in these circumstances the rates approved by the Board would be clearly inadequate, as seen with the benefit of aftersight, one could even say that the Company was compelled by the Board decision to achieve economies wherever possible.

At the very least, a reduction in unprofitable capital expenditures would be reasonable measure in these circumstances, and it would take clear language to say that such action was contrary to the Board's intendment. In any event, as long as the rate of return on common equity following such measures remained at or below 13%,

there could be no basis for the Board to say that the rates were excessive. Unless the rates in 1976 were excessive, there is no justification for any consequential adjustment in the 1977 rates, but such an adjustment is precisely the effect of the rate base adjustment made by the Board.

If it is assumed that the rates for 1976 were excessive as a result of the Company's construction cutback, the question arises as to what was an appropriate compensatory adjustment. Doubts may also be raised as to whether the Board has power to make such an adjustment, but, since that is a question of the jurisdiction of the Board which does not affect the question of its appreciation of the rate regulation process, it is not proposed to consider that question here.

The theory of rate regulation is that a set of rates are approved for the indefinite future as being reasonable on the basis that they yield a reasonable rate of return during a sample year of the Company's operation. That is the test year concept. If the rates are set below the level which is indicated by the figures of the sample year, which is the effect of the rate base adjustment made by the Board, then the rates are purely and simply inadequate.

While such rates may be justified for a short term in compensation for excessive rates in a prior period, this overlooks the fact that the rates are fixed for the indefinite future. If rates are fixed at a level which is inadequate on the basis of present circumstances, the effect is to accelerate the date on which a new rate application will be necessary. While annual rate applications appear to be the current practice in New Brunswick anyway so that no real effect on the frequency of such application may result, the failure of the Board to even consider this question again suggests that they do not understand the process of rate regulation.

Where a need for a rate increase is indicated, it would seem better to adjust for the prior excessive rates by postponing implementation of that increase entirely for whatever period is appropriate to offset the previous excess. In that way the new rates, when they do come into force, will be adequate rates and will stand a better chance of remaining so for some reasonable period of time.

Rough calculations indicate that the tendency to inadequacy of the approved rates resulting from the rate base adjustment was approximately balanced by the tendency to excessiveness of those same rates resulting from the Board's lack of understanding of the test year concept. If the resulting rates are reasonable, however, it is a matter of coincidence, not of sound rate regulation. It seems appropriate to recall the old adage that two wrongs do not make a right.

If the Board does not understand what it is doing, the question arises whether there is some process, other than the process of rate regulation, that the Board is following. The answer seems clear. The Board is acting as if it were assessing compensation or damages.

In its peculiar application of the test year concept, the Board determined that in the coming year the Company was entitled to a certain additional profit. It then awarded that profit to the Company by allowing it to set whatever rates are necessary to realize that profit, without regard to the rate of return that the Company actually earns while those rates are in force.

In its adjustment of the rate base, the Board determined that the award it had made the previous year was excessive in view of what actually occurred, and it reduced its award for the coming year by the same amount as a set-off. Again, the Board gave no consideration to the actual rate of return that the rates produced, either with respect to the previous year for which it determined there to be an excess or with respect to the current year in which it imposed the set-off.

The effect of this approach by the Board is that it has adopted, perhaps without realizing it, a philosophy of rate regulation that is quite controversial. This is the philosophy that the role of regulation is to fix profits, rather than rates. This philosophy is controversial, not because it involves an upper limit on profits which is the object of rate regulation, but because it leads rather easily to the attitude by the regualtor that part of its role is also to guarantee a certain profit to the regulated industry. This attitude can lead to overly ready acceptance of accounting figures submitted by the regulated industry and an automatic passing on of increased costs into the form of increased rates. This attitude tends to reduce the need for the regulated industry to exercise sound entrepreneurial judgment and seek internal efficiencies. Yet it is presumably the desire for the exercise of such judgment which is a major contributing factor to the decision that a public utility should be left in private hands under regulation, rather than taken over by public ownership.