TELEPHONE RATE REGULATION IN NEW BRUNSWICK AND THE TEST YEAR CONCEPT

Robert W. Kerr*

In February of 1976 the Board of Commissioners of Public Utilities of New Brunswick granted the New Brunswick Telephone Company Ltd. its second rate increase in seven months. While the increases allowed by the Board were substantially less than the Company had asked for, a good case can be made that the increases granted were substantially more than the Board by its decision indicated the Company was entitled to.

In its decision the Board approved rate increases which would earn the Company a return of 13% on the common equity capital of the Company. On this basis the Board approved rate increases that would allow an overall rate of return on its investment of 10.4%. As a result the Board indicated approval of rate increases which would earn the Company an additional $2.8 million in the 1976 test year adopted by the Board.

The Company in turn submitted rate increases that would earn it an additional $2.8 million during its 1976 fiscal year. The Board approved the rates submitted.

While the events as set out above may appear to the average person as quite in order, there is an additional factor, the test year concept, which upsets this appearance of order. With a proper understanding of the test year concept, one is led to the conclusion that the legality of the rates approved by the Board is doubtful. If these doubts are justified, the New Brunswick Telephone Company Ltd. will during 1976 collect from its subscribers in New Brunswick approximately half a million dollars more than it is entitled to.

The test year concept is well-known in rate regulation circles. It involves using an income and expense statement of the company being regulated for a one year period as a basis for determining what is the company's present rate of return on investment and how much additional revenue the company would need to achieve the rate of return which the regulating agency finds proper.

---

* Associate Professor of Law, Faculty of Law, University of New Brunswick. Professor Kerr was Public Intervener at the latest New Brunswick Telephone Company Limited rate increase application.

Two types of test year are recognized. The use of one type or the other varies from regulatory board to regulatory board and from time to time.

One type is the historic test year. This means that the revenue and expense statement is based on the experience of the company during some actual twelve month period in the past. Various adjustments may be made, but basically the historic test year means using actual figures.

The other type of test year is the projected test year. This involves using the company's projections for a twelve month period which is either partly or entirely in the future. If the period is already in progress, part of these figures may be based on actual experience, but a significant part of the figures depends on projections.

Generally the period of the test year corresponds to a fiscal year for the company being regulated. Since the company's own financial records are related to its fiscal years, this simplifies the preparation of the necessary income and expense statements.

At the same time, it must be emphasized that the test year is something distinct from any fiscal year of the company. It is a hypothetical year which is used to calculate the revenue that the company would need in order to earn an approved rate of return if approved rates were in effect throughout the year. If the historic test year is used, the test year differs from the actual year in that the rates in question were never in effect during that year since regulatory boards are not authorized to grant retroactive increases. If a projected test year is used, the actual year may differ in many respects from the figures used for the test year since no one has yet developed a foolproof method of predicting the future. Also, if the projected test year is partly over, the approved rates cannot be in effect throughout the test year because of the lack of authority to grant a retroactive increase.

In its February decision the New Brunswick Board approved rate increases that would produce a return on common equity of 13%, a return on total investment of 10.4%, and additional revenue of $2.8 million in the projected test year of 1976. The company then submitted rate increases to become effective on or after March 15 which would realize additional revenue of $2.8 million between then and the end of the 1976 fiscal year. The company's fiscal year is the calendar year.

By March 15 the company was already two and one-half months into its 1976 fiscal year. This means that, if these same rates had been in effect throughout the test year of 1976, they would have earned the company approximately $3.5 million in additional revenue. This would yield an overall rate of return of about 10.6%, and a return on common equity of about 13.4%. All of these figures exceed what the Board's decision allowed.

Looked at in another way, if the company had applied for rates within the $2.8 million limit in the test year, these would have yielded additional revenue of only about $2.3 million from March 15 to the end of the year. The rates approved, therefore, will exceed what was authorized by the Board's decision by approximately half a million dollars in 1976.

Two possibilities occur as to what really transpired in the Board's mind between its decision and its subsequent approval of the Company's revised rate application. First, the Board may have changed its mind and decided that the $2.8 million allowed over the test year was not enough.

Alternatively, the Board may not have fully appreciated what it was saying in its original decision. The federal anti-inflation guidelines were a major factor in the Board's decision since the Board indicated that, but for the guidelines, it might have approved rates producing a return on common equity as high as 15%. As it was, the Board indicated the company might achieve such a return by cutting costs, but not by raising prices. (Needless to say, the Board will have to be cautious in the future that the company does not artifically increase costs in order to obtain further rate increases preliminary to achieving the authorized higher rate of return by cutting those same costs.)

Under the guideleines, the company could earn an additional $2.8 million anytime during 1976 since the guidelines apply to actual fiscal periods, and do not incorporate the test year concept. Thus, if an increase up to the maximum allowed by the guidelines was intended, the rates approved satisfied the Board's intentions.

However, the Board's decision was not framed in these terms. The controlling language was the approval of the 13% and 10.4% rates of return and $2.8 million additional revenue over the test year. The recognition that this would comply with the guidelines appears to be secondary.

Moreover, one could read the decision as indicating the 13% rate of return was adopted in compliance with the spirit of the guidelines, as distinct from the letter of the guidelines, since this was the rate of return approved on the last application before the guidelines came into being. This would reinforce the view that the 13% rate of return was intended to be controling in so far as rate increases were concerned.

Whether the Board changed its mind or incorrectly expressed its mind in the first place, the effect was to grant increases in excess of those allowed by the decision. It is doubtful whether the Board had any jurisdiction to do this since in either case the decision was effectively altered. The Board's decision as to rate of return and the additional revenue allowed over the test year was final in form.

Once the decision was rendered on these points, the Board may have exhausted its jurisdiction with respect to these matters. The only question on which jurisdiction was reserved was the approval of rates consistent with the decision. The rates approved were not consistent with the decision and therefore are arguably unlawful.

The course of events in this proceeding raises a serious doubt as to whether the New Brunswick Board understands the test year concept and how that concept is used in rate setting. This doubt is compounded by a similar, although much less substantial, discrepancy between the decision and the order of the same Board on the previous application of the same company in 1975.

At that time the Board approved a rate of return on overall investment between 9.5% and 10%, and on that basis allowed additional revenue of $5.1 million in the 1974 (historic) test year. It then proceeded to approve rates which would in the test year have produced additional revenue of over $6 million. The discrepancy is explained by the fact that the $5.1 million figure was based on a return of 9.7%, that is, in the middle of the allowable range, while the rates approved would have produced a rate of return at 10%, that is, the top of the range. Whether the Board committed an error depends on whether the $5.1 million figure or the maximum 10% rate of return was intended to be controlling. The decision was ambiguous in this regard, so that actual error would be difficult to establish.

However, the common practice in rate regulation is that the additional revenue figure is the key figure. This dollar figure is a necessary bridge between the rate of return allowed and the actual telephone rates that the company is authorized to charge.

Moreover, it is also common for the additional revenue figure to be calculated on the basis of a rate of return which lies in the middle of an allowable range of rates of return. This is because it is recognized that the income and expense statement for the test year which is based on the new rates is a hypothetical one. Actual experience under the new rates in the test year might produce either more or less than the calculations indicate.

This is true even in the case of the historic test year since some reduction in the demand for service may result from higher rates. An adjustment is made for this in calculating the additional revenue that increased rates would produce. If the decrease in demand is underestimated, the new rates would have produced less revenue in the test year than is caluculated. But, if the decrease in demand is overestimated, the new rates would have produced more additional revenue in the test year than is calculated.

If the additional revenue figure is calculated on the basis of the maximum allowable rate of return, there is a possibility that actual experience would produce a rate of return in excess of that allowed. An additional revenue calculation using a rate of return in the middle of an allowable range makes allowance for the fact that actual experience may be either more or less than the hypothetical test year calculation. The approval of rates in excess of the additional revenue figure so calculated on the previous application again creates doubts about the New Brunswick Board's appreciation of normal rate setting procedure and the test year concept on which that procedure heavily depends.

If the Board does not fully appreciate such basic concepts, then their ability to effectively fulfil their responsibility to regulate in the public interest is undermined. The public would rest easier if the decisions of the Board demonstrated such an appreciation, rather than raised doubts about it.