NATURAL GAS UTILITY FLOW-THROUGH AND NORMALIZATION TAX TREATMENT POLICY

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I. INTRODUCTION

In November 1975 a major alteration in the Canadian natural gas pricing scheme was implemented as a result of major world-price increases and changing energy-policy goals. Prior to that date, any increase in pipeline tolls was passed on to the gas consumer. Following the change, such increases resulted in a reduced price to producers for their gas.

As a result of the changes in the natural-gas-pricing scheme, the producers recognized that whereas before they had been free to establish their price by contract, it was now to be established by a process over which they had no direct control. They recognized that their only substantial point of influence would be at the various regulatory hearings. Since the size of the "natural-gas-price pie" was now fixed, the size of the producers' share would depend on their success in reducing the portion available for Alberta Gas Trunk Line Co. Ltd. (A.G.T.L.) and the extraprovincial shippers. Thus, a major problem foreseen by the producers was the "necessity to 'police' all future rate hearings", and that meant large expenditures of time and money.[1]

The new statutory requirements and the new participation by the producers brought to life an issue that had previously been dormant in Canadian regulatory hearings. The issue raised was what tax expense figure should be recognized by the regulatory authority for inclusion in a pipeline's cost of service or revenue requirement. Regulatory authorities endeavoured to establish policies with which to deal with this tax treatment issue by addressing appropriate general regulatory questions and issues specific to tax.

This paper identifies those questions and issues, discusses how they have been handled by various regulatory authorities, and describes the tax treatment policies that have evolved. In conclusion, the paper analyzes the grounds upon which each regulatory authority has based its tax treatment policy, and suggests strategic alternatives for dealing with the policy in future hearings. The purpose is to establish a foundation

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* Of the Bar of Alberta.

[1] Edie, *Natural Gas Pricing in Alberta*, 14 ALTA. L. REV. 455, at 471 (1976).

upon which the participant to future regulatory hearings can deal more effectively with the tax treatment issue.

II. Natural Gas Pricing Scheme

A. *Statutory Framework*

Prior to November 1975 the natural gas pricing scheme was similar to that of most products in a free-enterprise market. Although regulatory authorities supervised and approved some of the costs of delivering the gas, the end price to the consumer was composed of the aggregate of the prices charged from producer to local public utility. The wellhead price was established by contract between the producer and the extraprovincial purchasing shipper. A.G.T.L. charged a price for carrying the gas from the wellhead to an Alberta utility or to shipper-delivery points at the Alberta border. The shipper charged a rate for carrying the gas to the particular gas utility outside Alberta and the local utility charged for delivering the gas to the consumer.

As of November 1975 a new natural-gas-pricing scheme was established in Canada. Section 4(1) of The Natural Gas Pricing Agreement Act (N.G.P.A.A.)[2] and section 50 of the Petroleum Administration Act (P.A.A.)[3] authorize the Alberta and Federal Governments respectively to enter into an agreement relating to natural gas pricing. Until 1 November 1980 such an agreement was in existence. The agreement[4] prescribed in section 3 that the "Alberta border price" was to be established by subtracting, from the Toronto reference price, "the cost of transmission and metering and all other costs associated with the movement of gas from the Alberta-Saskatchewan border to Toronto for C.D. service at 100 percent load factor, as determined by the National Energy Board". This amount, called the "Canadian Cost of Service", was to be determined in accordance with Part IV of the National Energy Board Act which requires that such amounts be "just and reasonable".[5]

Section 51(1) of the P.A.A. allows the Governor-in-Council to prescribe prices for Alberta natural gas that enters interprovincial and international trade. These prices were set out in the Natural Gas Prices Regulations.[6] Section 10(1) of the N.G.P.A.A. deals with gas intended for consumption outside Alberta, but within Canada.[7] The regulated field price (received by the producers) is calculated by taking the Alberta border price together with two components. First, the price adjustment is

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[2] S.A. 1975, c. 38, *as amended by* S.A. 1977, c. 84.

[3] S.C. 1974-75-76, c. 47, s. 50.

[4] Alta. Reg. 305/78, s. 1, *as amended by* Alta. Reg. 30/80.

[5] R.S.C. 1970, c. N-6, s. 52.

[6] C.R.C., c. 1259, s. 3.

[7] The cost of service concept relating to the export pricing system is the same.

added. This adjustment is the difference between the price received by the Alberta Petroleum Marketing Commission (A.P.M.C.) pursuant to section 14(5) of the N.G.P.A.A. from the sale of international export gas, and the price paid out to producers for such gas pursuant to section 14(3). This differential is distributed pursuant to section 16 of the N.G.P.A.A. as a price adjustment to producers and other eligible parties on a monthly basis as established by section 5 of the Act. Secondly, from this figure is subtracted the Alberta cost of service (A.C.O.S.), defined in section 1.1(1) of the N.G.P.A.A. as

> determined by the [A.P.M.C.] and may include costs and changes wherever incurred that
> (a) are attributable to the acquisition of the gas by the original buyer, except the contract field price or regulated field price, whichever applies,
> (b) are associated with the movement and metering of the gas in Alberta,
> (c) are related to any processing required to cause the gas to become marketable gas or that are otherwise related to the supply of the gas,
> (d) consist of interest or other costs or charges that, under a contract entered into prior to November 1, 1975, were recoverable by the original buyer from the price at which he sold the gas, or any portion of those costs or charges, or
> (e) as prescribed by regulation.

The A.P.M.C. establishes the rates as a mere administrative process without hearings[8] and as a matter of practice accepts the A.G.T.L. charges without review.[9] Section 7 of the N.G.P.A.A. provides for an appeal to the Public Utilities Board (P.U.B.) in accordance with the Alberta Regulation.[10] The rates set by A.G.T.L. and accepted by A.P.M.C. are also subject to a complaint procedure. Under section 30(2) of The Alberta Gas Trunk Line Act (A.G.T.L.A.) the P.U.B. may "determine the justness and reasonableness of the rates...."[11]

In the case of gas consumed within Alberta, section 10(2) of the N.G.P.A.A. provides for a regulated field price plus the lesser of an A.C.O.S. determination and a contract field price plus price adjustment. Notwithstanding that determination, the cost of service of a consumer gas utility is established by adding the following two factors. First, under The Natural Gas Rebates Act,[12] the Alberta Government subsidizes the cost of natural gas to Alberta gas utilities. For the period 1 December 1980 to 30 June 1981 the provincial support price is 79 cents per gigajoule.[13] Secondly, the P.U.B., pursuant to Part III of The Gas Utilities Act,[14] determines the other utility expenses and an appropriate

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[8] ALBERTA PUB. UTILS. BD., PROCEDURE TO BE FOLLOWED BY THE PUBLIC UTILITIES BOARD IN HEARING IMPERIAL OIL LTD. APPEAL OF THE ALBERTA PETROLEUM MARKETING COMMISSION DETERMINATION 77-15, at 9 (17 Mar. 1978) (Order No. E78034).

[9] Interview with E. McCoy, Alberta Pub. Utils. Bd. (29 Feb. 1980).

[10] Alta. Reg. 127/77, *as amended by* 194/79.

[11] S.A. 1954, c. 37, *as amended*.

[12] S.A. 1974, c. 44.

[13] Alta. Reg. 355/80.

[14] R.S.A. 1970, c. 158.

rate of return on its rate base. Utility rates are then established by allocating the determined cost of service according to a rate design.[15] Section 27 of The Gas Utilities Act requires that such rates be "just and reasonable".

Since 1 November 1980 there has been no agreement between Alberta and the Federal Government. Until such an agreement is concluded the natural gas pricing structure is established by The Natural Gas Price Administration Act[16] in Alberta, and section 52 of the P.A.A. together with The Natural Gas Prices Regulations, 1980.[17]

The major change has been that both Alberta and the Federal Government have provided, in their respective legislation, the authority for each of them to set unilaterally the "Alberta border price" which had previously been established by agreement. For purposes of this paper there are no other substantial changes of note. For example, section 1.1(1) of the N.G.P.A.A. defining A.C.O.S. has been brought forward without change as section 1.1(1) of The Natural Gas Price Administration Act. Further, at such time as an agreement is reached between the two governments the pre-November 1980 pricing mechanism will presumably be reinstated.

The following are requirements of regulatory authorities as provided by law: the Canadian cost of service figure arrived at by the N.E.B. must be in accordance with the federal-provincial agreement, or "just and reasonable"; the Alberta cost of service figure determined by the A.P.M.C. or the P.U.B. must be in accordance with the definition in the N.G.P.A.A., or "just and reasonable" pursuant to the A.G.T.L.A.; and the gas utility consumer rates must be "just and reasonable". The methods, factors, precepts and principles established and utilized by the regulatory authority to meet those legal requirements are, however, totally within its discretion. It has been recently held that as long as the N.E.B. and the P.U.B. address their minds to the right questions, consider the relevant factors, and do not base their decisions on clearly irrelevant considerations, they have complete discretion in carrying out their statutory mandate.[18]

In discussing the income tax component of the Canadian and Alberta costs of service, with passing reference to their place in consumer gas rates, it is important therefore to determine the right questions and the relevant factors.

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[15] ALBERTA PUB. UTILS. BD., PUBLIC UTILITIES BOARD ANNUAL REPORT 7 (1978).

[16] S.A. 1975 (2d Sess.), c. 70, *as amended*.

[17] S.O.R./80-823, *as amended*.

[18] *See* Trans Mountain Pipe Line Co. v. National Energy Bd., [1979] 2 F.C. 118, at 121, 29 N.R. 44, at 47 (C.A.); Alberta Gas Trunk Line Co. v. Amoco Canada Petroleum Co., [1980] 3 W.W.R. 48, at 60, 20 A.R. 384, at 396 (C.A.).

A number of issues are dealt with in the pleadings of current N.E.B. and P.U.B. tax treatment decision appeals which, given the present law, must be considered as going to the question of regulatory jurisdiction and not to the merits of tax treatment policy. As a result, they are not addressed in this paper.

B. *Policy Framework*

A utility's cost of service (or revenue requirement) is the aggregate of operating costs (including income tax) and a return on the rate base.[19] For income tax to become part of the cost of service, it must fall therefore within the "cost" category. Three questions are relevant.

Is the particular tax item a cost? A "cost" is defined as an outlay of assets consumed in the production of revenue, and is synonymous with "expense and expenditure".[20] It may either denote an actual outlay of cash or a liability defined as "moneys owed; debts or pecuniary obligations".[21] In the standard case, evidence led from the accounting profession (*e.g.*, the Canadian Institute of Chartered Accountants) or as set out by the regulatory authority's Uniform System of Accounts raises a presumption that this item will be recognized as a cost by the authority.[22] A.J. Priest points out that the inclusion of an income tax item has been accepted for so long that no doubt remains as to its appropriate inclusion today.[23]

Is the particular tax item incurred according to statutory requirements such as section 1.1(1) of The Natural Gas Price Administration Act?

If these two questions are answered in the affirmative, is it a cost that should be recognized? According to public utility regulatory principles a balance should be struck between the utility and those paying the rates[24] such that the authority is satisfied that the "proposed expenditures will be necessary in order to maintain an adequate level of service to its customers".[25] Examples of disallowed expenses are those resulting from inefficiency, arbitrary action, waste, and so on.[26] Evidence of the quantum of costs provided by company records will establish, in most cases, a *prima facie* case.[27]

As indicated above, the quantum of taxes actually paid to Revenue Canada will be recognized as a component of utility cost of service. This paper is concerned with that portion of the income tax item which, although not actually paid in the current period, the utility wants to be recognized as a cost to be paid in the future. It is, however, uncertain as to when or if it will be paid out. In order to decide whether to accept or

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[19] ALBERTA PUB. UTILS. BD., ALBERTA COST OF SERVICE INQUIRY 75 (30 Jun. 1978) (Report No. E78100).

[20] M. GORDON & G. SHILLINGLAW, ACCOUNTING: A MANAGEMENT APPROACH 30 (4th ed. 1969); A. PRIEST, PRINCIPLES OF PUBLIC UTILITY REGULATION 45 (1969).

[21] THE RANDOM HOUSE DICTIONARY OF THE ENGLISH LANGUAGE 825 (1969).

[22] F. WELSH, PREPARING FOR THE UTILITY RATE CASE 208 (1954).

[23] A. PRIEST, *supra* note 20, at 51.

[24] Alberta Gas Trunk Line Co. v. Amoco Canada Petroleum Co., *supra* note 18, at 61, 20 A.R. at 397.

[25] ALBERTA PUB. UTILS. BD., THE ALBERTA PUBLIC UTILITIES BOARD, A BRIEF OVERVIEW 43 (30 May 1977).

[26] A. PRIEST, *supra* note 20, at 51.

[27] F. WELSH, *supra* note 22, at 210.

reject this item by answering the three questions above, the regulatory authority must address a whole new body of issues and wrestle with a variety of factors.

III. TAX TREATMENT POLICY ISSUES

A. *Background*

The issue as to which basis is more appropriate for the calculation of the tax component of a utility's cost of service or revenue requirement "has raised and sustained such a controversial debate for many years in North America and more recently, in Alberta".[28] The source of that debate is attributable to the interplay of generally accepted accounting principles and the Income Tax Act.[29]

Under generally accepted accounting practices the income tax calculation is based on "accounting income", while taxes to be paid pursuant to the Income Tax Act are to be calculated on "taxable income". While in the long run the taxes payable will be the same under either process, the actual tax liability in a particular accounting period will differ. Thus, the difference between the tax figure recognized in either case is attributable to "timing differences".

Timing differences result from a disagreement between the Income Tax Act and the accounting profession as to the appropriate accounting period in which revenues and expenses should be recognized. The largest timing difference is that between depreciation claimed in accordance with accounting principles and capital cost allowance (C.C.A.) deducted pursuant to the Income Tax Act. In the case of non-regulated companies, actual taxes paid to Revenue Canada are recognized as a "tax expense" while the difference between that figure and taxes recognized based on accounting income is accommodated in a "deferred taxes" account. As the difference increases or decreases over the periods, the account is augmented or drawn down respectively.

Flow-through tax treatment permits only those taxes actually paid to Revenue Canada to be added to the utility's cost of service. Normalization treatment on a deferred tax basis recognizes not only the actual taxes paid, but also a "deferred taxes" component that arises from calculating taxes on accounting income rather than taxable income. Normalization treatment on an all-taxes-paid basis provides for taxes to be calculated on accounting income, but only takes that amount of capital cost allowance required to equate taxable income and accounting income. This method therefore results in no deferred taxes.

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[28] ALBERTA PUB. UTILS. BD., INCOME TAX INQUIRY REPORT 11 (1 Aug. 1979) (Report No. E79079).

[29] S.C. 1970-71-72, c. 63, *as amended*.

To illustrate the different methods of tax treatment, take the following circumstances in which a natural gas utility might find itself.

Assets	$1000
Net income before depreciation	$800
C.C.A.	50%
Depreciation	Straight line method over 20 years (no residual salvage)
Income tax rate	50%

Flow-Through and Normalization-Deferred Taxes Treatments	Normalization-Deferred Taxes Treatment	Normalization-All Taxes Paid Treatment
Income ....$800 C.C.A. .... 500 Taxable income .....$300 Actual taxes payable $150	Income ....$800 Depreciation .... 50 Accounting income ....$750 Taxes recognized ....$375 Actual taxes Payable ....$150 Deferred taxes $225	Income ....$800 C.C.A. claimed = depreciation .... 50 accounting income ....$750 Actual taxes payable $375

Depending upon the tax treatment policy adopted, the regulatory authority would recognize the following tax amounts as a cost of service component:

1. flow-through: $150;
2. normalization-deferred taxes: $375, shown in the utility's accounts as $150 tax expense and $225 deferred taxes;
3. normalization-all taxes paid: $375 as actual taxes payable.

As seen in the illustration above, the normalization-all taxes paid treatment would result in a higher income tax payment than would the other two methods. Under growth conditions this situation would be expected to continue.[30] Not surprisingly, therefore, this option has not been supported by either applicants or intervenors in most rate hearings. Due to certain provincial and federal legislation, however, this method is attractive to electric utilities.

While the tax treatment issue is only between flow-through and normalization-deferred taxes, it is worthwhile to discuss briefly the application of normalization-all taxes paid.

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[30] INCOME TAX INQUIRY REPORT, *supra* note 28, at 19.

B. *Normalization — All Taxes Paid*

Historically, Alberta Power Ltd. (A.P.L.) has used the flow-through method, while the other major electric utility, Calgary Power Ltd. (C.P.L.), has used normalization-deferred taxes, as required by regulation[31] under The Water Resources Act.[32] In 1972 this requirement was deleted from the legislation[33] and C.P.L. subsequently changed over to the normalization-all taxes paid method.

In May 1977 A.P.L. applied to the P.U.B. to change over to the all taxes paid method. The P.U.B., however, in August of that year formally initiated an inquiry into the whole issue of the appropriate tax method to be adopted. The matter with respect to A.P.L. was therefore deferred until August 1979 when the P.U.B. published its findings following the inquiry.[34] A.P.L. renewed its request shortly thereafter.[35]

The tenor of A.P.L.'s argument was that such a change in method would yield significant financing advantages to the utility and leave no significant increase in the cost to consumers. No intervenors appeared at the hearing. The Board approved A.P.L.'s request on the following grounds. First, a greater cash flow before taxes would be generated which would improve interest coverage ratios and perhaps lower A.P.L.'s cost of capital. Secondly, by claiming less C.C.A. by this method than was available, such an unused accumulation would be available to offset future tax liability. Thirdly, the Federal Government, pursuant to the Public Utilities Income Tax Transfer Act,[36] rebates 95% of taxes paid by A.P.L. to the Alberta Government. The Utility Companies Income Tax Rebates Act, 1977[37] requires the province to rebate to customers the federal rebate and 100% of the taxes paid by the utility to the province. The aggregate effective rebate to customers is 96.2% of income taxes paid by A.P.L., thus resulting in a negligible cost increase to customers. Fourthly, such a change would yield a consistency of treatment as between C.P.L. and A.P.L.[38]

Support for the use of this method has recently been confirmed by the P.U.B. in its report on C.P.L.'s latest rate application.[39]

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[31] Alta. Reg. 284/57.

[32] R.S.A. 1970, c. 388.

[33] Alta. Reg. 306/72, s. 1(*d*).

[34] INCOME TAX INQUIRY REPORT, *supra* note 28.

[35] *See* note 38 *infra*.

[36] R.S.C. 1970, c. P-37.

[37] S.A. 1977, c. 99.

[38] Alberta Pub. Utils. Bd., Alberta Power Ltd. Rate Application (31 Dec. 1979) (Decision No. E79170).

[39] Alberta Pub. Utils. Bd., Calgary Power Ltd. Rate Application 41 (28 Jan. 1980) (Decision No. E80009). There are, however, indications that the Federal Government is planning to cut its rebate from 95% to 50%. *See* The Advocate (Red Deer), 3 Apr. 1980 where R. McKinnon of Calgary Power Ltd. reaffirms this. In the INCOME TAX INQUIRY REPORT, *supra* note 28, at 154, the P.U.B. indicated that such a cut might very well require the Board to reconsider its approval of normalization — all taxes paid for the electric utilities.

C. *Flow-Through versus Normalization — Deferred Taxes*

The debates as to the appropriate tax treatment policy to be adopted by regulatory authorities involves a number of issues that fall within four categories: accounting, cross-over, financing, and public policy.[40]

1. *Accounting Issue*

The Canadian Institute of Chartered Accountants (C.I.C.A.) Handbook recommends that normalization be used since it achieves the fundamental accounting principle of proper matching of costs and revenues. It goes on to suggest, however, that in the case of regulated utilities, flow-through would be acceptable provided there is a "reasonable expectation" that future taxes payable be approved for inclusion in future rates and that they be recoverable from the customer at that time. The question is whether this position supports any of the tax treatment policies.

2. *Cross-Over Issue*

This issue is central to the debate. In the early years, the capital cost allowance (C.C.A.) on a utility company asset will be greater than depreciation. Taxable income will be therefore less than accounting income, and actual taxes paid will be less than those recognized on the accounting income basis. The question here is whether the actual taxes to be paid, based on taxable income, will ever equal and then cross-over and exceed taxes recognized on accounting income? The question can also be asked in terms of revenue requirement cross-over and utility rate cross-over. If cross-over occurs, the deferred tax fund merely represents a deferred liability. If it does not occur, the fund is a permanent tax saving amounting to a pool of cost-free capital contributed by the consumer.

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[40] Two subsidiary issues may have to be dealt with by the regulatory authority following the adoption of normalization.

First, should the utility be entitled to a return on the accumulated deferred tax refund due to the inherent risk of investing in the plant, or is it paid out in taxes? Both the National Energy Board (N.E.B.) (*see* note 68 *infra*) and the P.U.B. (*see* note 19 *supra*) are of the view that the fund should not be entitled to yield a return and thus the accumulated deferred tax fund should be deducted from the rate base for purposes of calculating the utility's return on the base figure.

Secondly, where a change-over from flow-through to normalization is implemented, should the utility collect deferred taxes that were not collected in the past? Both the N.E.B. (*see* note 68 *infra*) and the P.U.B. (*see* note 19 *supra*) have decided that the collection of past deferred taxes, or "catch-up", is not desirable.

(a) *Tax Cross-Over*

Those who support normalization cite the "single unit of property" model.[41] To illustrate this model, assume the following figures.

Assets $1000
Net income before depreciation $500/year
C.C.A. 50%
Straight line depreciation over 20 years.
Tax rate 50%

	Flow-Through			Normalized		
Year	C.C.A.	Taxable Income	Taxes Paid	Depreciation	Accounting Income	Taxes Paid or Deferred
1	500	0	0	50	450	225
2	250	250	125	50	450	225
3	125	375	188	50	450	225
4	63	437	219	50	450	225
5	32	468	234	50	450	225
6	15	485	243	50	450	225
7	8	492	246	50	450	225
8	4	496	248	50	450	225
9	2	498	249	50	450	225
10	1	499	250	50	450	225

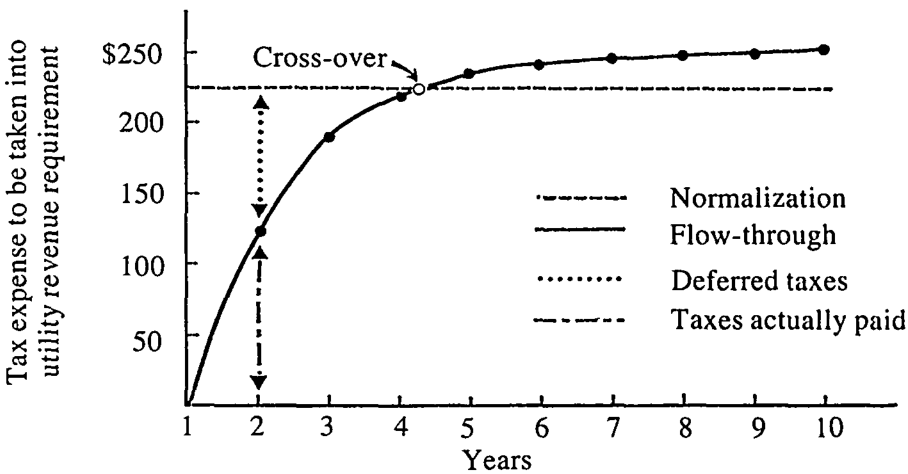

Figure 1. Single Unit of Property Model

[41] P. Garfield & W. Lovejoy, Public Utility Economics 111 (1964).

In this example it is clear that cross-over will occur and that the deferred tax fund will begin at that time to be drawn down.

Those who support flow-through describe the above example as unrealistic and suggest a model where assets are augmented by $1000/year; net income before depreciation increases by $500/year; and there is replacement of ten-year-old assets.

Flow-Through				Normalized		
Year	C.C.A.	Taxable Income	Taxes Paid	Depreciation	Accounting Income	Taxes Paid or Deferred
1	500	0	0	50	450	225
2	750	250	125	100	900	450
3	875	625	313	150	1350	675
4	938	1062	531	200	1800	900
5	970	1530	765	250	2250	1125
6	985	2015	1008	300	2700	1350
7	993	2507	1254	350	3150	1575
8	997	3003	1502	400	3600	1800
9	999	3501	1751	450	4050	2025
10	1000	4000	2000	500	4500	2250
11	1000	4000	2000	500	4500	2250

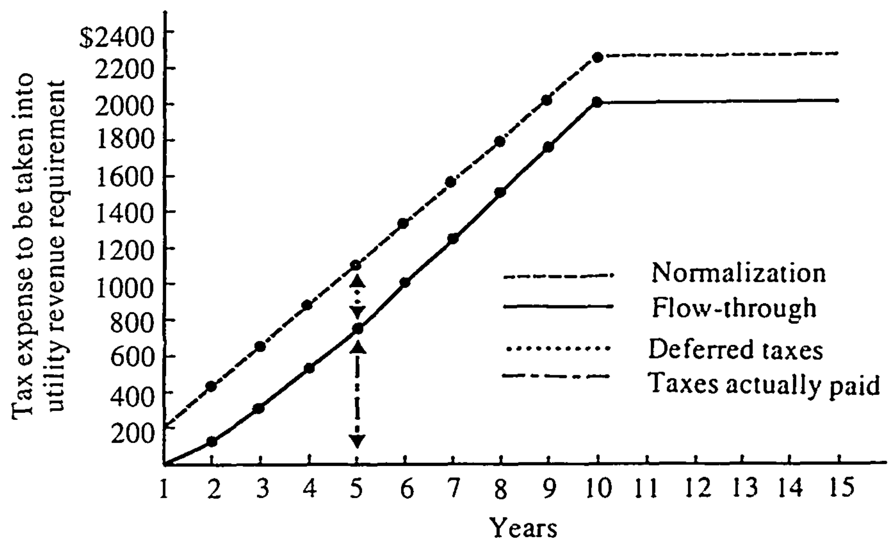

Figure 2. Aggregate Property Model

In such a case, it is suggested that under conditions of expanding or static plant (plant additions equal to annual depreciation) cross-over will never be reached.[42]

(b) *Revenue Requirement Cross-Over*

The issue is the same here, but the point at which a cross-over of the revenue requirement takes place is different under the competing tax treatments. Additional factors such as an expected declining rate base reducing the return component and the existence of "no-cost capital" provided by the deferred tax fund[43] result in a different cross-over point. Declining plant may not be necessary for cross-over to take place.

(c) *Utility Rate Cross-Over*

To determine the conditions under which rate cross-over will take place requires the consideration of a number of additional variables.[44] The rate of growth or decline at which cross-over will occur varies accordingly.

Returning to the direct question of cross-over, there are a number of implications which flow from determining whether cross-over will occur at all. While these implications have been dealt with as somewhat independent issues in regulatory hearings, they cannot in fact stand on their own. They are, however, important additional considerations to be recognized when determining the cross-over issue.

First, is a cost being incurred? C.C.A. is something having value, and it can be argued that when C.C.A. is claimed in an amount greater than what the depreciation would be, a cost is thereby incurred (a loss of value). It is argued that depreciation is recognized as a cost even though it involves no cash outlay, and to adopt flow-through would ignore the cost of using up C.C.A. This argument is countered by the view that depreciation cost is recognized as attributable to the diminution of asset value and is required to offset the decrease in order to preserve in the aggregate the value of shareholders' capital. While C.C.A. may be something of value in the abstract, no cost is incurred by its use where the gap between C.C.A. and depreciation never closes to a cross-over point.

Secondly, is there a tax liability? A liability is a debt, certain to be paid at some future time. As the certainty of the debt decreases, so its character as a liability becomes increasingly less distinct, finally to be relegated to a financial note as a contingent liability.

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[42] INCOME TAX INQUIRY REPORT, *supra* note 28, at 79; Alabama-Tennessee Natural Gas Co. v. Federal Power Comm'n, 359 F. 2d 318, at 336 (5th Cir. 1966).

[43] INCOME TAX INQUIRY REPORT, *supra* note 28, at 76.

[44] Brigham, *The Effects of Alternative Tax Depreciation Policies on Public Utility Rate Structures*, 20 NAT'L TAX J. 204, at 214 (1967).

Thirdly, is there inter-generational or inter-class equity? Under normalization, payments are made by present customers to fund future tax liabilities. Flow-through leaves any future tax liabilities to be paid for by future customers. It is argued that the result under flow-through is that the customers now are paying less than their fair share of taxes, leaving a greater share to be borne by future customers. Flow-through supporters argue that if the "deferred tax liability" is never paid, present customers are contributing capital by overpaying taxes.

3. *Financing Issue*

A number of financial implications potentially arise from the adoption of normalization through the existence of a fund of deferred taxes: greater cash flow; reduction in the need to depend on "external" sources of capital; greater flexibility in determining the best times to sell securities issues; better debt interest coverage; and reduced cost of capital. It is apparent that these suggested results overlap and are interrelated to a great degree. For example, it can be argued that the flexibility and reduced cost of capital stems from the reduction in the need to depend on external capital and better debt interest coverage, which in turn result from the greater cash flow.

The question in this case is whether flow-through utilities can compete financially with these normalization benefits; or indeed whether this issue is at all relevant in the debate as to the appropriate tax treatment.

4. *Public Policy Issue*

The regulation of utilities is undertaken in response to a recognition that the particular service or product has a central characteristic of public necessity and purpose, and that such purpose cannot be achieved by leaving it to the forces of the free market due to the lack of intra-modal competition.[45] The question here is which of the competing parties, given the present reality of the industry and the country generally, as seen by the regulatory authority, can best use the tax deferral dollars in order to most effectively reach the public policy goals that have been set.

It is thus incumbent on a regulatory authority to identify its view of the industry and the general social, political, and economic milieu in which it makes its determinations; to set out, as specifically as possible, what it sees as the policy goals for which the authority was given responsibility; and to establish what it anticipates or intends will be the result of its action on the parties. Although some discussion is centred on this issue, the accounting, cross-over, and financial issues remain at the centre of the argument.

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[45] J. BONBRIGHT, PRINCIPLES OF PUBLIC UTILITY RATES 8 (1961).

IV. Regulatory Authorities' Handling of the Issues

"The relative merits of flow-through and normalization tax treatment have been mightily belaboured by regulatory bodies, academics and business practitioners throughout North America for a considerable period."[46] This is no doubt due to the large sum of money involved[47] and the nature of the issue which precludes a definitive answer. In addition, after twenty-five years spent by the United States regulatory authorities wrestling with the issue, the United States position is as uncertain as ever. In Canada debate has been active for merely the last three or four years.

A. *United States Federal Energy Regulatory Commission (F.E.R.C.)*

The tax treatment policy of the F.E.R.C. (prior to August 1977, the Federal Power Commission (F.P.C.))[48] has indeed had a "change and change again history".[49]

1. *1956-1964*

In 1956 the F.P.C. ruled in favour of tax normalization where a utility was using "liberalized tax accounting".[50] This referred to the use of diminishing-charge procedures for calculating depreciation pursuant to section 167 of the United States Internal Revenue Code, 1954, and is comparable to the use of C.C.A. in Canada. Although entertaining doubts about the merits of approving normalization, F.P.C. apparently felt that a ruling in favour of flow-through would frustrate the intent of Congress in providing for liberalized tax accounting. The intent was to stimulate investment expansion and to reflect the actual lifetime of an asset better than is done through straight-line depreciation.[51]

2. *1964-1969*

In 1964, following a hearing of a rate application by the Alabama-Tennessee Natural Gas Co. the F.P.C. held, *inter alia*, that

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[46] Alberta Petroleum Marketing Comm'n, Determination 78-9 Alberta Cost of Service, Application by Pan-Alberta Gas Ltd. 4 (21 Jun. 1978).

[47] Converting to flow-through would reportedly require A.G.T.L. to refund $16 million collected in 1979: Campbell, *A.G.T.L. loses appeal against P.U.B. rulings*, The Edmonton Journal, 25 Jan. 1980, C-1, at col. 4.

[48] Department of Energy Organization Act, Pub. L. No. 95-91, s. 402, 91 Stat. 565 (1977).

[49] Income Tax Inquiry Report, *supra* note 28, at 141.

[50] Amere Gas Util. Co., 15 F.P.C. 760, at 781-82 (1956).

[51] J. Bonbright, *supra* note 45, at 218.

normalization, rather than merely deferring taxes, actually produced a permanent tax savings under a stable or a growing plant; that Congress did not intend to dictate how tax affairs should be reflected in rates fixed by regulatory authorities, and flow-through met the fundamental objectives of the Internal Revenue Code; that Alabama-Tennessee's rates should reflect only actual taxes payable (adoption of flow-through treatment).[52] In 1966 the Fifth Circuit Court of Appeals dismissed a petition for review under section 19(*b*) of the Natural Gas Act[53] brought by Alabama-Tennessee to quash the F.P.C.'s decision and, in so doing, confirmed the Commission's reasons.[54]

3. *1969-1976*

The United States Congress passed the Tax Reform Act of 1969[55] in response to its view that the F.P.C. did indeed thwart the intent of the liberalized depreciation provisions, and thereby supposedly caused a large loss of taxes by requiring flow-through. The Act prohibited normalization utilities from switching to flow-through and gave flow-through utilities the option for post-1969 "expansion plant"[56] to normalize or, upon approval by the regulatory authority, to switch to straight line depreciation.

The F.P.C. agreed in 1970 to normalization for post-1969 expansion property. It also reverted to complete normalization for utilities using liberalized depreciation. The reason given was that with normalization being mandatory for post-1969 expansion plant, the concerns expressed in the *Alabama-Tennessee* case were not being met by preventing normalization of the rest of the plant.[57]

In June 1975 the F.P.C. issued a general policy Order No. 530 allowing normalization following "appropriate factual showings"[58] in individual rate proceedings. This change was said to be the result of a change from a period of encouraging gas consumption to a period of conservation, and from a period of utilities' ease in raising capital to a period of difficulty. Increased use of normalization, it was felt, would improve cash flows and reduce the need for external financing.

A rehearing resulted in Order No. 530-A in January 1976 which defined "appropriate factual showings" as a demonstration that normalization would only result in tax deferrals — not permanent tax savings. The F.P.C. said that this was to be a prerequisite for normalization, although the need for cash flow would continue to be relevant.

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[52] A. PRIEST, *supra* note 20, at 126.

[53] 15 U.S.C.A. s. 717r(*b*) (West 1976).

[54] *Alabama-Tennessee*, *supra* note 42.

[55] Pub. L. No. 91-172, 83 Stat. 487 (1969).

[56] Additions to capital that resulted in an expansion of the plant.

[57] Bruder, *Development and Present Status of Tax Normalization and C.W.I.P Treatment at the F.P.C.*, in FEDERAL POWER COMMISSION 1975: GAS AND ELECTRIC RATE DESIGN POLICIES AND PRACTICES 133, at 137 (1975) (Practising Law Institute).

[58] 53 F.P.C. 2123, at 2127 (1975).

4. *1976-Present*

Order No. 530-B, issued in July 1976, followed a further rehearing and although it confirmed earlier F.P.C. decisions in favour of normalization, its reasoning appeared to radically depart from prior orders. The F.P.C. rejected the tax-saving/tax-deferral distinction and adopted a general policy permitting normalization. It stated that normalization was acceptable so long as it involved only "timing differences" rather than "permanent differences" between book and tax treatment.[59] It concluded that there was no basis for predicting that tax savings would result from normalization.

Finally, an Order Denying Rehearing of Order No. 530-B, issued in September 1976, made the naked claim that normalization is "the proper and preferable method for ratemaking and accounting purposes".[60] It added that the F.P.C. felt that its prior insistence that normalization was needed to protect the industry's financial health would now be abandoned. Financial issues were to go to rate-of-return questions — not tax treatment questions.

A petition was subsequently brought challenging the F.P.C. (now the F.E.R.C.) orders and the decision was recently handed down.[61] The United States Court of Appeals, District of Columbia Circuit, proceeded on the basis that "[section] 19(*b*) of the Natural Gas Act . . . prescribes a 'substantial-evidence' standard for findings of fact in orders".[62] The opinion struck down the F.E.R.C. orders since they "failed to assess the consequences of its action for the industry and indicate fully and carefully the purposes behind orders".[63]

The court therefore took the last two orders as accurately stating F.E.R.C.'s opinion regarding the tax treatment issue. In striking down the orders, it has placed the United States situation in some uncertainty. While the F.E.R.C. will probably continue to hold a presumption in favour of normalization, it will have to provide adequate reasons. F.E.R.C. did state that such a policy would reduce uncertainties for utilities, thus aiding in capital attraction and financial planning, and would result in shorter rate cases. However, as pointed out by the court, such a result would also accrue from adopting a flow-through presumption. The financial issues appear to have been discounted. Finally, the F.E.R.C. feels the accounting profession favours normalization but, as pointed out in the *Alabama-Tennessee* case, "accounting for tax purposes and even the Commission's present Uniform System of Accounts may be valuable tools, but they cannot dictate ratemaking policies".[64]

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[59] F.P.C. Order 530-B, at 8.

[60] F.P.C. Order Denying Rehearing of Order No. 530-B, at 3.

[61] Public Systems v. Federal Energy Regulatory Comm'n, 196 U.S. App. D.C. 66, 606 F. 2d 973 (D.C. Cir. 1979).

[62] *Id.* at 72, 606 F. 2d at 979.

[63] *Id.* at 66, 606 F. 2d at 973.

[64] *Supra* note 42, at 336.

B. *National Energy Board (N.E.B.)*

1. *History of the Issue*

In early 1975, prior to the net-back pricing scheme established later that year, TransCanada Pipelines Ltd. (T.C.P.L.) made a rate application containing a request to change over from flow-through to normalization. The request was based upon, first, the accounting issue, and secondly, the cost incurred and inter-class equity questions.[65] T.C.P.L. denied that the financing issue was a consideration in the basis for the request.

In June of that year the N.E.B. decided not to accede to the request on several grounds. First, the C.I.C.A. recommendation was neutral, for it recognized that either method would accomplish matching costs with revenues in the case of regulated utilities. Secondly, while theoretically the flow-through method may understate the true cost of service in the early years, thus making normalized income taxes an expense, there was no evidence that this would result in practice. Thirdly, the equity argument was theoretical, without evidence of what practical effect, if any, it might have. With a fixed Canadian price at the international border and a domestic commodity value pricing policy (not yet implemented at that time), the type of tax treatment would have no effect on customers.[66]

The Board summed up its position: "In the circumstances of this case, and considering the situation at this particular juncture in the evolution of TransCanada, the Board is of the view that the Applicant has not presented a case sufficient to warrant a change of such significance at this time."[67] In the July 1978 report of the hearing the Board explained that the circumstance referred to was the "time of great uncertainty for the gas industry when a shortage appeared to be developing and a new pricing scheme under the Petroleum Administration Act had not yet been finalized".[68]

It was not until three years later that the tax issue was dealt with in great detail. In a landmark decision in May 1978[69] the Board ruled *inter alia* that Westcoast Transmission Co. was allowed to change over to normalization from flow-through, which it had been using since 1957. In the same month the N.E.B. heard a T.C.P.L. rates application, including

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[65] Nat'l Energy Bd., Reasons for Decision, Application under Part IV of the National Energy Board Act (Rates Application — Phase II, Part I) of TransCanada Pipelines Ltd. 3:2-3 (Jun. 1975).

[66] *Id.* at 4:5-8.

[67] *Id.* at 4:8.

[68] Nat'l Energy Bd., Reasons for Decision, Application under Part IV of the National Energy Board Act (Rates Application) of TransCanada Pipelines Ltd. 2:3 (Jul. 1978).

[69] Nat'l Energy Bd., Reasons for Decision, Application under Part IV of the National Energy Board Act (Rates Application — Phase I) of Westcoast Transmission Co. (May 1978).

a renewed request for approval of normalization. As a preliminary matter the Industrial Gas Users Association (I.G.U.A.) maintained that the June 1975 N.E.B. order denying normalization to T.C.P.L. was *res judicata*. This contention was rejected by the Board. In July 1978 the Board, hard on the heels of its *Westcoast* decision, ordered approval of normalization.[70]

Meanwhile in June applications had been filed, and in July a hearing was held into whether a review should be made of the *Westcoast* decision pursuant to section 17(1) of the National Energy Board Act.[71] The Board granted the applications and after a review issued a report in November confirming its decision in favour of normalization in the May order.[72] As a result the Westcoast and T.C.P.L. tax treatments were brought into conformity. Normalization for T.C.P.L. was reaffirmed by an N.E.B. decision in July 1979,[73] and in September 1979 the N.E.B. reaffirmed its *Westcoast* decision.[74]

British Columbia Hydro appealed to the Federal Court of Appeal the November 1978 N.E.B. decision, *inter alia*, permitting Westcoast to adopt normalization. The case was decided against British Columbia Hydro,[75] and leave to appeal to the Supreme Court of Canada was denied.[76]

2. *Normalization Policy*

(a) *Accounting Issue*

Both *Westcoast* and *T.C.P.L.* decisions confirmed the view expressed in the 1975 *T.C.P.L.* decision that this was considered a non-issue since the C.I.C.A. recommendation was seen to be neutral.

(b) *Cross-Over Issue*

The *Westcoast* decision concluded that tax cross-over was "not sufficiently uncertain to warrant the continued use of the flow-through

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[70] *Supra* note 68.

[71] R.S.C. 1970, c. N-6.

[72] Nat'l Energy Bd., Reasons for Decision, Review of Decision on Phase I of the Application under Part IV of the National Energy Board Act of Westcoast Transmission Co. (Nov. 1978).

[73] Nat'l Energy Bd., Reasons for Decision, Review of the July 1978 Application by TransCanada Pipelines Ltd. 4:15 (Jul. 1979).

[74] Nat'l Energy Bd., Reasons for Decision, Review of the November 1978 Application by Westcoast Transmission Co. 8:1 (Sep. 1979).

[75] Westcoast Transmission Co. v. B.C. Hydro & Power Author. (not yet reported, F.C. App. D., 19 Jan. 1981).

[76] E.S. Binavince of Gowling & Henderson. Leave to appeal was denied 27 May 1981.

method''[77] since, according to the figures in evidence, cross-over was predicted as early as 1982.[78] Although not specifically addressed in the *T.C.P.L.* decision, the expectation of cross-over was evident.[79] Revenue requirement cross-over was also discussed in the *Westcoast* decision, with the conclusion that although the cross-over may not occur, as maintained by the intervenors, "in fact, the reverse situation could occur''.[80] The inter-generational equity question was also dealt with. In the *T.C.P.L.* decision, although not specifically addressing itself to the question of cross-over, the Board suggested that normalization produces a more equitable allocation of costs between customers and that such a principle applies also in the case of taxes.[81] In suggesting that flow-through places a greater burden upon future users of the pipeline while normalization spreads the taxes more evenly over its life, the Board was assuming implicitly that tax cross-over would occur.

The Board concluded, on balance, that normalization provides a greater cost-of-service stability over time, and yields the greatest intergenerational equity.

(c) *Financing Issue*

In both decisions the Board recognized the extent to which normalization constituted an additional source of funds, therefore reducing the need for external financing and enhancing its ability to compete in capital markets.

(d) *Public Policy Issue*

The federal policy goals as enunciated in the Petroleum Administration Act provide the basis upon which the N.E.B. discussed the public policy matters involved. The Act states:

> The purpose of this Part is to provide legislative authority for measures that will, so far as may be practicable, enable the Government of Canada
> (a) to achieve a uniform price, exclusive of transportation and service costs, for gas used in Canada outside its province of production;
> (b) to achieve a balance in Canada between the interests of consumers and producers in Canada;
> (c) to protect consumers in Canada from instability of prices for gas and to preserve a reasonable balance between the prices of alternative fuels in Canada; and
> (d) to encourage the discovery, development and production of a supply of gas adequate to the self-sufficiency of Canada.[82]

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[77] *Supra* note 72, at 2:16.
[78] *Id.* at 2:14.
[79] *See* note 81 and accompanying text *infra*.
[80] *Supra* note 72, at 2:22.
[81] *Supra* note 65, at 4:6.
[82] S.C. 1974-75-76, c. 47, s. 49.

The N.E.B. spent much time, particularly in the *Westcoast* decision, canvassing the impact on other groups of a change to normalization.

First, the Board found that the proposed increased rates would have no significant impact on the competitive position of natural gas relative to other forms of energy.

Secondly, with the present advantageous position held by gas, the Board concluded that it was better to levy deferred tax costs against customers who would presently not be put in a disadvantageous position rather than leave the collection to a future date when customers may be unable to pay the extra taxes due to a diminution in the competitive position of gas.

Thirdly, with reference to a reduction in net-backs to producers, the N.E.B. concluded that since the *Westcoast* decision affects export gas from Alberta, it would result in an insignificant drop in the monthly price adjustment paid by the Alberta Petroleum Marketing Commission. In the case of T.C.P.L. it was decided that the effect on producers would be of no consequence since 30 to 45% of producers' revenue is paid in royalties; all net revenue is not necessarily reinvested in Canada; the producers have been the beneficiaries of vast increases in revenue since 1975; and no significant disincentive to continued exploration and development would result. Overall, it was felt that the extra revenue provided to T.C.P.L. by normalization would best contribute to Canada's goal of energy self-sufficiency.

3. *Non-Gas Utilities*

To complete the review of the N.E.B.'s position on normalization it is worthwhile to note the situation of two non-gas pipelines.

(a) *Interprovincial Pipe Line Ltd. (I.P.L.)*

This company has used normalization since 1954. The issue is whether it should be permitted to continue on a normalized basis — a very different issue than that faced in the *Westcoast* or *T.C.P.L.* decisions. In its decision of December 1977 in response to an I.P.L. application, the N.E.B. took four factors into consideration: cross-over was expected well before 1988 with the result that the uncertainty of cross-over would not exist; a present change to flow-through would prejudice inter-generational equity; if flow-through were ordered now, I.P.L.'s ability to borrow at competitive rates might be impaired; and accounting principles should be consistently applied over time. The first two factors were said to be more persuasive.[83]

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[83] Nat'l Energy Bd., Reasons for Decision, Part II of a Public Hearing Respecting Tariffs and Tolls Charged by Interprovincial Pipe Line Ltd. 4:36-39 (Dec. 1977).

(b) *Trans Mountain Pipeline Co. Ltd. (T.M.P.L.)*

Not only has this company used normalization since its inception, but it has also been drawing down on its deferred tax account since 1967, with the exception of 1974. We, therefore, see a company that has already experienced cross-over.

C. *Public Utilities Board*

1. *History of Issue*

In response to A.G.T.L. raising its rates and creating an increase in its rate of return from 8% to 8.75% in June 1970, complaints were filed by four shippers. The report issued by the Board in May 1971 fixed the rate of return at 8.25%.[84] In doing so the Board expressed the opinion that A.G.T.L.'s difficulties in meeting its interest coverage requirements were not due to an inadequate rate of return; instead they were due to the use of flow-through rather than normalization.[85] During the 1970s A.G.T.L., in accordance with that view, worked to change over. In 1973 its agreements with Alberta and Southern Gas Co. Ltd., Westcoast Transmission Ltd., and Westcoast (Alberta) provided for A.G.T.L. to collect normalized taxes as part of its rates. In 1976 and 1977 the same change over was agreed to by T.C.P.L. and Pan-Alberta Gas Ltd., respectively.

Following the establishment of net-back pricing, the Lieutenant-Governor-in-Council directed the P.U.B. to "conduct an inquiry into the principles and methods which would apply to the determination of the Alberta cost of service pursuant to the The Natural Gas Petroleum Administration Act with respect to any gas or the movement of any gas within Alberta".[86] This would provide the A.P.M.C. with the means of carrying out its new responsibilities. In July 1977 complaints were filed with the P.U.B. pursuant to section 30(2) of the Alberta Gas Trunk Line Act[87] respecting, *inter alia*, A.G.T.L.'s use of normalization rather than flow-through in its cost of service. This time the complainants were the producers, not the shippers. This was followed a month later by a P.U.B. report indicating the intention of the Board to initiate an inquiry into the methods of computing the income tax component of the utility revenue requirement for Alberta utilities.[88]

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[84] Alberta Pub. Utils. Bd., In the Matter of Alberta Gas Trunk Line Company Act (25 May 1971) (Decision No. 30228).

[85] *Id.* at 95.

[86] P.C. 1976-1016.

[87] S.A. 1954, c. 37, *as amended*.

[88] Alberta Pub. Utils. Bd., Calgary Power Ltd. Rate Application — Phase I (11 Aug. 1977) (Decision No. E77121).

By 1978 the stage was set for Alberta to take its place in the flow-through/normalization debate. Marvin McDill expressed the prevailing view at that time:

> At the moment, therefore, there are three panels of the P.U.B. dealing with the question of whether the normalized or flow-through method of income tax treatment should be adopted for regulatory purposes. The decisions of the Board in these matters will have considerable impact on all producers in the oil and gas industry.[89]

The decision of the Alberta Cost of Service Inquiry was forthcoming in June 1978. With reference to the tax component, it recommended that the flow-through basis be adopted.[90] In November the decision of the A.G.T.L. rate complaint was brought down.[91] It concluded *inter alia* that in line with the consistent position of the Board with respect to all utilities within its jurisdiction, flow-through should be used. The third of the P.U.B. panels reported in August of 1979. The Income Tax Inquiry report constituted the widest canvassing of the issues. The conclusion was that flow-through should be applied to all utilities except where "special circumstances" existed such as a dire need for an "internal" source of capital, the imminence of cross-over, or income tax rebate to customers.[92]

In the meantime A.G.T.L. had appealed the P.U.B. rate complaint decision to the Alberta Court of Appeal, which dismissed it on a variety of grounds.[93] Until December 1979 A.G.T.L. had refused to implement flow-through[94] and each year the producers had obtained interim orders from the P.U.B. confirming its earlier decision ordering flow-through. The latest such order was issued in February 1980.[95] A.G.T.L. has recently obtained leave to appeal to the Supreme Court of Canada.[96]

2. *Flow-Through Policy*

(a) *Accounting Issue*

It is felt that the C.I.C.A. recognizes that flow-through is just as viable in matching costs and revenues as is normalization, since such

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[89] McDill, *Natural Gas Pricing in Canada*, 17 ALTA. L. REV. 120, at 132 (1979).

[90] *Supra* note 19, at 31-32.

[91] Alberta Pub. Utils. Bd., Alberta Gas Trunk Line Co. (8 Nov. 1978) (Decision No. C78147).

[92] INCOME TAX INQUIRY REPORT, *supra* note 28, at 22-24.

[93] Alberta Gas Trunk Line Co. v. Amoco Canada Petroleum Co., *supra* note 18.

[94] G. Kaita of Pan-Alberta Gas Ltd.

[95] Alberta Pub. Utils. Bd., In the Matter of the Alberta Gas Trunk Line Company Act (6 Feb. 1980) (Order No. E80020).

[96] A.S. Hollingworth of McLaws & Co. A.G.T.L. has also amended its application for leave to appeal, reflecting its new corporate name: Nova, An Alberta Corporation.

matching is done by the regulatory authority without need to rely on accounting techniques.

(b) *Cross-Over Issue*

The Board rejects the "single unit" model of Figure 1[97] as too superficial since it does not reflect aggregate costs on an on-going basis. More relevant is the aggregate tax model of Figure 2[98] which indicates a lesser likelihood of cross-over, particularly in a growth situation. Even if cross-over does occur in the future, the changing value of the dollar and other changes would likely make the deferred tax fund inadequate. The Board concludes that where "there is little probability of an aggregate cross-over . . . in the foreseeable future . . . deferred taxes . . . should not be included in the utility revenue requirement".[99]

With reference to the tax liability question, the Board considers deferred taxes merely as a potential liability, with great uncertainty as to whether in fact they will ever have to be paid. Should cross-over occur the tax is levied against those future customers.

On the inter-generational and inter-class equity matter the Board feels that the issue is how taxes can be allocated most equitably. In the Board's view this is accomplished by flow-through since normalization does not reflect the "real tax burden". The A.C.O.S. report points out that inter-generational cross-subsidization is an existing regulatory philosophy as, for instance, between old and new residential subdivision utility costs.

As to whether a cost is incurred in a growing market situation, the Board considers differences between accounting and taxable income as permanent and not timing differences, since any cash outlay attributable to such differences occurs at a very indeterminate time. Even though a value or benefit (C.C.A.) is being used up, a cost is not necessarily being incurred if the savings will not need to be paid out in the future.[100] Such an amount has no place in a utility's revenue requirements.

(c) *Financing Issue*

First, the Board concedes that normalization produces significant financial benefits such as reducing external fund requirements, greater timing flexibility in the sale of securities issues, and so on. Secondly, it also concludes that flow-through will not prevent a utility from obtaining the capital it requires. Tax methods is only one factor considered by investors and Alberta has a favourable investment climate. Should

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97 *See* p. 32 *supra*.

98 *See* p. 33 *supra*.

99 INCOME TAX INQUIRY REPORT, *supra* note 28, at 84.

100 Implicitly, discounts cross-over in the near future.

existing circumstances change so as to make financing more difficult or costly, the P.U.B. would be prepared to step in and provide the appropriate remedies. Thirdly, where the deferred taxes are never paid, the accumulated fund becomes a capital contribution from customers or producers, who have no securities to show for it. The Board concludes that the financing issue deals with alternative sources of capital, and should be kept quite distinct from the tax methodology issue.

(d) *Public Policy Issue*

It has been suggested[101] that the Alberta government had similar purposes in mind, as expressed in section 49 of P.A.A., for passing the N.G.P.A.A., although qualified by a different constitutional viewpoint. They were not, however, directly reflected in the Board's reports. The Board merely reflects upon the tax treatment decisions of other regulatory authorities. It discounts suggestions that there is any particular trend in Canada or the United States and the Board concludes that even if there were such a trend in favour of one method or the other, such an argument *per se* would not be considered persuasive.

D. *Alberta Petroleum Marketing Commission*

The Commission's position reflects the historically prevailing practice in Canada for transmission and distribution companies to use flow-through. Although net-back pricing appears to have been the moving force for the N.E.B. approval of normalization, the A.P.M.C. feels it is restricted by section 1.1(1)(*d*) of The Natural Gas Price Administration Act. That provision requires that costs to be included in the A.C.O.S. are, at least *prima facie*, those recoverable by the original buyer prior to net-back pricing. This is reflected in the A.P.M.C. *Alberta Cost of Service, Responsibilities and Procedures Manual*: "Income taxes, calculated on the basis used by the original buyer prior to November 1, 1975, unless otherwise determined by the Commission".[102] All such buyers except one are using flow-through.[103]

In *Determination 78-9*[104] the A.P.M.C. rejected Pan-Alberta's request to change over to normalization. This was the first such request. The A.P.M.C. pointed out that normalization "would result in a significant transfer of funds from gas producers to transmission companies"[105] — a result which was not considered desirable. It compared the high-risk return of the unregulated producer with the

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[101] Edie, *supra* note 1, at 456.

[102] ALBERTA PETROLEUM MARKETING COMM'N, ALBERTA COST OF SERVICE PURSUANT TO THE NATURAL GAS PRICING ACT, RESPONSIBILITIES AND PROCEDURES 18 (1979).

[103] The one company not using flow-through is Consolidated Natural Gas Ltd.

[104] *Supra* note 46, at 2.

[105] *Id*. at 4.

"guaranteed" return of the regulated transmission company and concluded that the former must have a higher priority when it comes to allocating the availability of deferred tax funds.

V. ANALYSIS

A. *General*

This paper has endeavoured to lay a foundation consisting of the following assertions: a statutory framework empowers regulatory authorities to make rate and cost of service determinations; to make such determinations, a regulatory authority adopts policies based on relevant issues and factors; in adopting tax treatment policies, the authorities considered accounting, cross-over, financing, and public policy issues and the relevant factors pertaining to each.

Based upon the foregoing, the first step is to inquire to what extent did each of those issues constitute the grounds upon which the tax treatment decision was based. It is submitted that the tax treatment policy is in fact grounded on the public policy issue. That is, in formulating its policy, each regulatory authority asked itself implicitly or explicitly the following question: Assuming the present reality as we see it, which of the competing parties can best use the tax deferral dollars in order to most efficiently reach the public policy goals that have been set? The N.E.B. concluded in favour of the shippers, thus adopting normalization; the P.U.B. and A.P.M.C. were in favour of the producers, thus adopting flow-through; the F.E.R.C. found in favour of utilities and it adopted normalization.

The second question is as follows: To what extent is each of those issues relevant in support of, or in attacking, the tax treatment policy of the particular regulatory authority in future rate and cost of service hearings? While the overall burden of proof in a regulatory hearing is upon the applicant,[106] the "evidential burden" shifts between the parties. Where the applicant's position is in accordance with the policy, the applicant need only present *prima facie* evidence in order to discharge the onus. Such would be the situation regarding a T.C.P.L. cost-of-service determination by the N.E.B. regarding the tax treatment issue. On the other hand, where the position of an applicant or intervenor is contrary to the policy of the regulatory authority, the party pressing that position must lead evidence to prove one of two positions based on alternative strategies. First, the party may assert that the policy grounds are no longer valid or no longer exist. In the case of the tax treatment policy, it must be shown that the perceived reality or circumstances surrounding the adoption of the policy have changed, or that the prior

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[106] *A.G.T.L.*, *supra* note 91, at 9.

public policy goals have been altered. Secondly, the party may assert that the policy is correct, but that the particular application is a special case which ought to be considered as an exception to the general policy. It is submitted that this second strategy is properly supported by argument based upon the accounting, cross-over, and financing issues. In support of these conclusions, the position of each of the regulatory authorities previously discussed will be analyzed.

B. *Regulatory Authorities*

1. *National Energy Board*

Prior to the establishment of net-back pricing, the N.E.B. supported a flow-through policy. As grounds for its position it cited a situation where a gas shortage appeared to be developing and where uncertainty characterized both the future gas pricing system and the industry generally.[107] With uncertain energy goals and uncertainty as to who might have a greater need for the tax deferral funds, the N.E.B. understandably chose to maintain its flow-through policy. It is submitted that the evidence led in the June 1975 *T.C.P.L.* hearing[108] relating to the accounting and expense issues could not have been effective in altering the policy and was far too weak to support an exception. The N.E.B. characterized the evidence as theoretically plausible, but felt that no hard evidence had been provided as to how such issues would be resolved so as to support an exception in the case of T.C.P.L.

In 1978 the N.E.B. changed its policy due to a change in the circumstances. It perceived that the producers had been receiving large price increases since 1975, and that gas was a very competitive energy source. Thus an increase in rates would not affect its competitive edge, and producers would not feel any effect. It was anticipated that exploration and development would proceed unhindered. Another reason for the change was the establishment of policy goals as set out in section 49 of the P.A.A.[109] In opting for a change in policy, the N.E.B. answered the central public policy issue question by finding that the public policy goals would be attained most effectively by giving the tax deferral dollars to the shippers rather than to the producers.

Again, it is submitted that the voluminous evidence relating to the accounting, expense, and financial issues was not and would not be instrumental in establishing the new policy or maintaining the old. The accounting issue was held to be neutral — it could support either position.[110] As the *Alabama-Tennessee* decision pointed out, accounting

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[107] *T.C.P.L.* (Jul. 1978), *supra* note 68.

[108] *T.C.P.L.* (Jun. 1975), *supra* note 65.

[109] As discussed at pp. 43-46 *supra*.

[110] As illustrated in *T.C.P.L.* (Jun. 1975), *supra* note 65, at 4:5; *T.C.P.L.* (Jul. 1978), *supra* note 68, at 2:7; *Westcoast*, *supra* note 72, at 2:11.

practices cannot provide an independent basis for adopting a particular regulatory policy, but merely an adjunct to other issues such as the cross-over issue.[111] The cross-over issue was dealt with by simply stating that cross-over was "not sufficiently uncertain" to warrant flow-through.[112] In addition, in response to the claim that revenue requirement cross-over may never occur, the N.E.B. replied that "in fact, the reverse situation could occur".[113] The N.E.B. dealt with the financing issue by merely noting it in passing.[114]

Such handling of these issues and the phrasing used is indicative of the existence of a policy or presumption based upon issues other than these, with the "evidential burden" upon the party disagreeing with the policy. It appears that where the evidence was evenly balanced the decision went in favour of the party espousing the policy position.

Examples of situations in which exceptions to the general policy were established include the *I.P.L.* case, where normalization was approved, in spite of the N.E.B.'s old flow-through policy, on the grounds that there was specific evidence of imminent cross-over and that a change to flow-through would prejudice inter-generational equities.[115] Another example is the T.M.P.L. situation in which cross-over had actually been reached.[116] In these cases specific exceptions to the policy were established upon evidence relating to the cross-over issues.

2. *Public Utilities Board and the Alberta Petroleum Marketing Commission*

Prior to net-back pricing, little consideration was given to the issue of tax treatment. The historical practice was the use of flow-through by gas transmission and distribution companies. The issue was not raised by consumers, who paid the deferred tax portion before 1975, and the producers at that time felt no effect from the use of normalization. The tax treatment was merely subject to a freely contracted arrangement between A.G.T.L. and the extraprovincial shippers. Given such circumstances, it is perhaps possible to characterize the P.U.B. policy in this regard as indifferent. In response to shipper complaints in 1970 relating to A.G.T.L.'s rate of return, the P.U.B. mentioned that it felt that perhaps A.G.T.L.'s financial difficulties were due to the use of flow-through instead of normalization.[117] In so doing it appears that the P.U.B. was not setting policy, but rather giving gratuitous advice or making an exception to its general policy.[118]

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[111] *Supra* note 42.

[112] *Westcoast*, *supra* note 72.

[113] *Id.* at 2:22.

[114] *Id.* at 2:17; *T.C.P.L.* (Jul. 1978), *supra* note 68, at 2:11.

[115] *Supra* note 83.

[116] *See* p. 43 *supra*.

[117] *A.G.T.L.A.*, *supra* note 84.

[118] Alberta Pub. Utils. Bd., Response to the Alberta Gas Trunk Line Co. Grounds for Appeal from Decision No. C78147 (Appeal Book).

After 1975, however, the P.U.B. undertook to establish affirmatively a policy relating to tax treatment.[119] Oddly, the central public policy questions were not addressed. Instead the accounting, cross-over, and financing issues were reviewed. It is submitted that these were inappropriate issues on which to focus since they could only be the basis for a policy exception in a specific case.

Just as the N.E.B. had done, the P.U.B. considered the accounting issue as neutral between the two positions. Further, all discussion relating to the cross-over issue follows from accepting the aggregate tax model as a realistic representation of what generally occurs. In view of the extreme difficulty in developing accurate models in this area due to the large number of variables and unknowns, it would appear to be an extremely weak basis upon which to formulate a policy. The conclusion in support of flow-through was that "[w]hile the customers presented evidence to suggest that aggregate cross-over of capital cost allowance and depreciation would not occur, the Utilities did not present evidence to suggest that it would certainly occur. . . ."[120] It is submitted that this puts the "evidential burden" clearly on the normalization proponents, indicating the existence of a flow-through policy existing on other grounds.

On the financial issue the P.U.B. conceded the financing advantage afforded by normalization, but decided that flow-through utilities would not suffer from this difference. Again, the onus was apparently on the proponents of normalization to positively rebut the presumption as represented by the policy.

It is submitted that the true basis of the P.U.B.'s support for the flow-through policy is as expressed by the A.P.M.C. in its review of the subject.[121] In support of its flow-through policy it pointed to what it feels is a requirement in the N.G.P.A.A. (and The Natural Gas Price Administration Act) for retention of pre-1975 tax treatment policy: the undesirability of allocating the deferred tax dollars away from the high risk producers in favour of the common carrier and shipper whose income is "guaranteed". In this way, the policy reflected, once again, an opinion as to which party could best use the tax deferral funds in order to most effectively reach the public policy goals that have been set, assuming a certain reality of surrounding circumstances.

The P.U.B. confirmed that the imminent cross-over[122] and the financial issue[123] were grounds for exceptions to the policy. There is no indication that these issues would be the basis of the policy itself. A further exception to the policy of flow-through is supportable in the case of the electric utilities which are permitted to use the normalization-all

[119] The development of this policy is outlined earlier at pp. 43-46 *supra*.
[120] INCOME TAX INQUIRY REPORT, *supra* note 28, at 84.
[121] *Determination 78-9*, *supra* note 46.
[122] INCOME TAX INQUIRY REPORT, *supra* note 28, at 23.
[123] *A.G.T.L.*, *supra* note 91, at 32.

taxes paid method as long as the tax rebate legislation remains in place.[124]

3. *Federal Energy Regulatory Commission*

The conclusions reached above are also confirmed by United States experience. The policy of flow-through was based upon circumstances characterized as buoyant: plenty of gas and a financially healthy utility industry. The public policy goals encouraged consumption. Today, normalization is the F.E.R.C.'s policy, grounded in a less healthy utility industry and a change in public policy towards conservation. The F.E.R.C.'s mention of the need for greater regulatory certainty and shorter rate cases reflect these views.[125] Again, in addressing the fundamental question in settling the public policy issue, the F.E.R.C. has said that, assuming the present reality as it sees it, utilities can best use the tax deferral dollars in order to most effectively reach the public policy goals that have been set.[126] The paucity of reasons provided by the F.E.R.C. in its latest Orders makes it difficult to even guess what factors would yield an exception to the policy being made.

Since an applicant can overcome a policy only, as discussed above, by showing that the policy grounds are no longer valid or that the particular application is a special case, it is of fundamental importance that the hearing participants are fully conversant will all of the reasons the authority had for setting the policy. Without those reasons, participants are impotent. It is for this reason that United States applicants and intervenors are anxiously awaiting the F.E.R.C.'s response to the Court of Appeals' decision.

VI. Conclusion

There is evidence of a feeling of uncertainty among those familiar with this issue as to the true grounds upon which the N.E.B. and P.U.B. decisions have been based. Reasons given range from an Eastern "conspiracy" propagated by a Federal Cabinet-dominated N.E.B., to the decisions simply being "results-oriented", to a P.U.B. that simply "seems to have something against A.G.T.L.". These comments are symptomatic of the incomplete reasons given for regulatory authority decisions which seem to avoid the true grounds upon which the authority bases its tax treatment policy. Resulting from this failure, much time will be wasted presenting argument on issues that have no efficacy in altering policy or are not situation-specific enough to prove an exceptional case.

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[124] *Alberta Power*, *supra* note 38.
[125] *See* earlier discussion at p. 38 *supra*.
[126] *See* pp. 36-38 *supra*.

In the near future the Supreme Court of Canada will hear an appeal from the tax treatment decision of the P.U.B.[127] While resolving a jurisdictional question, this case will in no way diminish the importance of this issue. The United States has been grappling with it for twenty-five years, and remains a considerable distance from a definitive position. In light of our meagre five-year experience, it is realistic to forecast a continuing lively debate of the issue in Canada for many years into the future.

[127] *See* p. 44 *supra*.