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ONTARIO COURT OF APPEAL: REGULATED UTILITIES MUST BALANCE RIGHTS OF SHAREHOLDERS AND RATEPAYERS

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As Bastarache J. explained in ATCO . . . “utility regulations exist to protect the public from monopolistic behaviour and the consequent inelasticity of demand while ensuring the continued quality of an essential service”. In other words, the OEB’s regulatory power is designed to act as a proxy in the public interest for competition . . .”

Toronto Hydro-Electric System Limited v. Ontario Energy Board 2010 ONCA 284, at para. 48

Introduction

The Ontario Energy Board (the “OEB”) is of the view that it is entitled to intervene in corporate decision-making to ensure that a regulated utility operates in a manner that balances the interests of its shareholders against the interests of its ratepayers. The Ontario Court of Appeal recently endorsed this view.

At first blush, the decision of the Ontario Court of Appeal in *Toronto Hydro-Electric System Limited v. Ontario Energy Board*, 2010 ONCA 284 (“*THESL v. OEB*”), is contrary to the Supreme Court of Canada’s decision in *ATCO Gas and Pipelines Ltd. v. Alberta Energy & Utilities Board* (2006 SCC 4) (“*ATCO*”). In *ATCO*, the SCC considered the power of the Alberta Energy & Utility Board (the “AEUB”) to allocate the proceeds from the sale of non-utility assets to the utility’s rate-paying customers, instead of leaving the gain for the utility’s shareholders. The SCC held that the AEUB did not have such jurisdiction and that its decisions made in the public interest must be balanced against the corporate utility’s property rights. *THESL v. OEB* similarly involved a consideration of the OEB’s jurisdiction to intervene in matters pertaining to the regulated utility’s usual corporate right to declare dividends to its shareholders.

As will be discussed further below, the Ontario Court of Appeal held that the OEB had such jurisdiction.

Facts

The OEB regulates Ontario’s electricity markets and is mandated by the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15 (the “*OEBA*”) to “protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service” (section 1(1)). One of the OEB’s principal functions is to set “just and reasonable rates” that utilities may collect from ratepayers in respect of utility services. THESL is a wholly-owned subsidiary of Toronto Hydro Corporation (“THC”). All shares of THC are owned by the City of Toronto. The OEB licenses and regulates THESL as an electricity distributor.

From 2004-2005, THC had paid in excess of \$116 million to the City of Toronto in dividends and interest payments, largely through significant annual increases in dividends from THESL and by charging THESL interest charges, above market rates, on an inter-company loan. The OEB noted that THESL paid such dividends and interest charges with no capital plan in place for reinvestment in its own aging infrastructure.

When THESL applied to the OEB to approve distribution rates for 2006, the OEB refused to allow interest charges above market rates as a regulatory expense. Further, the OEB required a majority of THESL’s independent directors to approve any future dividend payments. The OEB held that if THESL paid its entire retained earnings to its shareholders, its credit rating would be impaired, which could result in harm to ratepayers – through increased costs and diminished services. THESL appealed this decision to Ontario’s Divisional Court.

Before the Divisional Court, THESL argued that the OEB had no jurisdiction to impose the requirement that a majority of THESL’s independent directors approve any future dividend payments, either by statute or at common law. THESL further argued that the OEB’s requirement represented an unwarranted and unlawful restriction on the authority of THESL’s board of directors to declare a dividend. A majority of the Divisional Court

panel agreed with THESL. The Honourable Mr. Justice Lederman dissented. The OEB appealed.

Decision

The issue before the Court of Appeal was stated as “whether the OEB had the ability, as part of its 2006 rate decision, to require THESL to obtain the approval of a majority of its independent directors before declaring any dividends.”

The Court first considered whether the OEB had exceeded its statutory grant of power, acknowledging at the outset that the OEB must balance the interests of ratepayers against ensuring a financially viable electricity industry that is both economically efficient and cost effective. The Court further determined, through its review of applicable case law, including *Toronto Hydro-Electric System Ltd. v. Ontario Energy Board et al.* (2009), 252 O.A.C. 188 (Div. Ct.), (leave to appeal to Ont. C.A. refused) that the OEB’s power in respect of setting rates is to be interpreted broadly and extends well beyond a strict construction of the task:

Unlike the cases relied upon, this issue directly relates to the OEB’s determination of rates and goes to the heart of its regulatory authority and expertise. There is no dispute that the OEB has rate-setting powers under the *OEBA* which are broad enough to encompass the power to determine reduced revenue requirements as a result of the sale of non-surplus assets. [*Toronto Hydro-Electric System Ltd. v. Ontario Energy Board et al.* (2009), 252 O.A.C. 188 at para.17.]

The Court found that the *OEBA* reflected a clear legislative intent to confer a subjective and open-ended grant of power to enable the OEB to engage in the necessary inquiry to achieve its rate-setting function. The Court went on to find that the OEB was entitled, as part of its rate-setting function, to take into account the history of THESL’s dividend payments.

The Court distinguished *ATCO*, holding that it was not a “rate-setting case”:

This case is distinguishable from *ATCO*. The statutory grant of power in *ATCO* to “impose any additional conditions that the Board considers necessary in the public interest” is different than the statutory grant of power in this case. Bastarache J. referred to this provision as vague, elastic, and open-ended. In the present case, the OEB’s

imposition of a condition it considers proper (s. 23(1)) has to be guided by the legislated objectives set out in s. 1(1). These objectives are not vague, elastic, and open-ended. To the extent that there is uncertainty with respect to the achievement of the s. 1(1) objectives, that is a matter undeniably within the expertise of the OEB. Further, unlike the *ATCO* provision, the objectives in the Act require that the OEB protect the interests of *both* the customer and the utility. [para. 33]

The Court determined that the OEB did not exceed its statutory grant of power. Its further inquiry concerned whether the OEB could order that the declaration of a dividend requires the approval of a majority of THESL’s independent directors. Unlike the majority in the Divisional Court which applied a “correctness” standard of review, the Court of Appeal instead applied a “reasonableness” standard. The Court noted that having corporate law principles at play did not alone suggest a correctness standard of review, and that corporate law principles will often be engaged when making decisions regarding regulated corporations. However, it is the OEB’s duty to apply corporate law principles *within the context of its objectives*.

THESL is described as a regulated monopoly. As a result, the Court found that it could convey the cost of any business decisions to customers – either in increased prices or in diminished services. As Justice Lederman stated in his dissent (which the Court of Appeal quoted with approval), “. . . it is not unusual to have constraints imposed on utilities that may place some restrictions on the board of directors. That is so because the directors of utility companies have an obligation not only to the company, *but to the public at large*” [at para. 49] [emphasis added].

Different principles govern regulated utilities which operate as monopolies than those that govern private companies. In private, unregulated companies, directors and officers must act in the best interests of the company or of its shareholders. Conversely, a regulated utility must strike a fine balance: it must accommodate the interests of shareholders and those of ratepayers. In this case, the OEB had serious concerns about the THESL’s aging plant and lack of capital in the context of increased dividend payments in 2004 and 2005. Whether THESL continued to overlook its aging infrastructure or took on loans to manage it, ultimately, its customers would pay.

The OEB had concerns that dividends not be paid out when there was insufficient capital for plant

maintenance. The OEB had concluded, and the Court agreed, that the best compromise given its concerns was to require approval by a majority of independent directors before dividends were paid. The remedy proposed by the OEB reposed a discretion with THESL's directors to declare a dividend, with an additional safeguard built in by THESL's independent directors, thus balancing the interests of shareholders and customers alike. The Court of Appeal agreed.

Comment

The Ontario Court of Appeal restored the OEB's decision, requiring THESL to obtain the approval of a majority of its independent directors before declaring any dividends. In doing so, the Court took a precautionary, and broad, approach to the OEB's power to regulate. One of the OEB's objectives, as set out in the *OBEA*, is to protect the interests of consumers with respect to prices and the adequacy, reliability and quality of electricity service. The Court did not necessarily find that there had been any failure to protect the interests of consumers; however, the Court did find that there might, in the future, be such a failure, and rendered its decision accordingly. In effect, the Court permitted the OEB to intervene to prevent a possible future harm to ratepayers: that they might endure increased costs and diminished services if THESL continued to make high payouts of dividends.

The applicable legislation in *ATCO* had included a provision that allowed the AEUB to, "impose any additional conditions that the Board considers necessary in the public interest." The SCC took the position that this language did not allow the AEUB to exercise a precautionary or broad power. Instead, the SCC found it to be, "vague, elastic, and open-ended." The Court of Appeal distinguished *ATCO*. Questions, however, remain. Principally, perhaps, is the legislative regime in Alberta so different than in Ontario to warrant such a different result? Some would argue it is not. Assuming there is not such a marked difference, does Ontario's approach simply reflect a judicial preference for stronger regulation of monopolies? Where there is a balance to strike, will the courts tip that balance toward ratepayers over shareholders? Are the courts, as well as the public, seeking greater oversight for all institutions, including utilities? Perhaps only time will tell. In the meantime, to the ratepayer, apparently, go the spoils.

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