



## *Canada-U.S. Energy Issues: Electricity and Regulatory Sovereignty*

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### **Introduction and Background**

One of the key goals of the free trade negotiations for both Canada and the United States was securing a continental energy market. For Canada this meant stabilizing Canadian access to U.S. markets in the face of potential protectionist forces, while for the United States the goal was clearly to provide a greater measure of security of supply, especially with respect to petroleum and natural gas. Less remarked on in the energy provisions of the Canada-U.S. Free Trade Agreement (FTA) were the provisions relating to electricity trade. The FTA provided for free trade in electricity as for other energy goods.<sup>2</sup> However, the particular characteristics of electricity trade are not fully reflected in the FTA (or subsequently in the NAFTA), and those provisions that do relate specifically to Canadian-U.S. electricity markets are largely *ad hoc* and designed to address then-current transborder irritants. In particular, neither the FTA nor the NAFTA addresses in any depth the role of domestic regulatory bodies in the conduct of energy trade. This relative silence comes in spite of the significant role these bodies have played in the governance of North American energy markets, especially in natural gas and electricity.

The historical significance of regulatory tribunals in the natural gas and electricity sectors in both Canada and the United States is largely accounted for by the industry structure that, at least until recently, has characterised those two industries. In both cases, the typical industry structure was one of large, vertically-integrated monopolies, regulated under traditional principles of utility regulation. This structure began to give way in the 1980s with the regulatory re-structuring of the natural gas industry in both countries, followed in the 1990s with a similar re-structuring of the electricity industry, a process that is still underway. In both cases, the thrust of the re-structuring involved the “unbundling” (whether through divestiture of assets, or, as was more typical in the electricity re-structuring, the functional unbundling of assets<sup>3</sup>), so that those parts of the industry that were not natural monopolies were opened up to market forces, while those parts that could not be opened up continued to be governed by utility regulators (essentially, pipelines in the natural gas industry and the “wires” industry – transmission

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and distribution activities – in the case of electricity). Effectively, then, energy regulatory bodies became the instrument through which natural gas and electricity markets were opened up to competition – *including international competition*. By spelling out the rules under which new competitive markets would operate, including the rules that would apply with respect to foreign competition, these tribunals effectively acted as the gatekeepers to their respective markets. The most important gatekeeper in this respect for Canada is the U.S. Federal Energy Regulatory Commission (FERC). It is really FERC initiatives, much more than the FTA or NAFTA provisions, that have exercised the dominant policy influence on the U.S. importation of natural gas and electricity from Canada.

Although the FERC has insisted that it does not extend its regulatory mandate beyond the United States, in practice it has at a minimum taken actions that have had significant impacts in Canada – and might even be construed as infringements of Canada’s own regulatory sovereignty. With specific respect to the electricity sector, the most obvious examples of FERC extending its regulatory arms into Canada relate to a number of actions flowing from its landmark Order No. 888, which represented a major initiative in the opening up of U.S. wholesale electricity markets to competition. In applying the principles in this Order to imports of electricity from Canada, the FERC insisted, among other things, that as a condition for the right to sell electricity at free market rates in the United States, Canadian exporters would be expected to provide reciprocity of treatment (in the form of access to transmission) in Canada. This FERC demand almost certainly was influential in accelerating the pace of electricity sector re-structuring in Canada. Whether or not one regards this movement toward greater competition in the electricity industry as good thing, it is at least worth reflecting upon the possible dangers inherent in having Canadian public policy being driven by U.S. regulatory decisions. Moreover, it is debateable whether the FERC’s insistence on reciprocity of treatment is even consistent with U.S. trade obligations under NAFTA. The NAFTA provides for a standard of national treatment, not one based on reciprocity of treatment. In other words, Canada is expected to afford U.S. exporters treatment as good or better as that extended to nationals – not treatment that is equivalent to that received by Canadian (or other) entities in the United States.

This is not the only instance where U.S. energy regulators have taken initiatives that have had direct impacts in Canada. Similar intrusions on Canada’s regulatory sovereignty can be found in the course of the deregulation of U.S. natural gas markets. Nor is this likely to be the last time that the FERC acts contrary to Canadian regulatory interests. Potential problems in the electricity sector are discussed further on in this note.

### **Key Issues**

The key issue addressed in this briefing note is the extent to which Canada will be able to exercise regulatory sovereignty in the electricity sector in light of the increasing movement towards re-structuring of the North American electricity industry in the direction of a greater role for market forces in generation and ancillary services. An important determinant in this respect is Canada’s success in developing and articulating

an effective national position in response to U.S. initiatives – particularly in light of the asymmetrical jurisdictional approaches that have been taken towards electricity sector regulation in Canada as compared to the United States.

Quite apart from the leverage available to the FERC as the gatekeeper to the U.S. market, the United States arguably enjoys a significant regulatory advantage compared to Canada because of the differences between the two countries in the distribution of regulatory authority. In general, the FERC regulates virtually all aspects of the U.S. wholesale market in electricity, while state authorities regulate the retail markets. As a result, the FERC has been able to move forward with a unified approach to re-structuring the U.S. wholesale market in electricity in the direction of greater competition, although the nature and pace of retail market re-structuring in the individual states has varied dramatically. By contrast, the regulatory authority with respect to the electricity industry in Canada is much more diffuse. For historical reasons – partly relating to the originally local nature of electricity generation facilities and partly because of the emergence of provincial Crown monopolies – the federal regulatory role in managing Canadian electricity markets has been restrained compared to its role in the regulation of interjurisdictional natural gas flows.<sup>4</sup> In practice this has meant that much of the technical capacity for regulating electricity markets has developed in the provinces. As a result, in contrast to the situation in the United States, provinces exercise the dominant role in regulating both wholesale and retail electricity markets in Canada. While this presents certain advantages in terms of having one level of government with most of the authority for re-structuring both types of market, it also presents certain disadvantages insofar as one thinks there is value in having a unified “national” approach to the re-structuring of wholesale electricity markets (which increasingly are interjurisdictional in their scope).

There is at least some evidence that the asymmetrical distribution of regulatory authority as between Canada and the United States in the electricity sector does indeed place Canada at a disadvantage when binational disputes do arise. For example, Canada and the United States have had cross-border conflicts in both the natural gas and electricity sectors as the result of initiatives by the FERC and state regulatory authorities to open up energy markets to competition. In the case of the natural gas sector, where Canada’s National Energy Board (NEB) is given significantly greater regulatory authority than it is in the electricity sector, the ability of the Board to act as the single national regulator in interjurisdictional natural gas trade seems to have resulted in a more effective assertion of

## **Choices for Canadians**

The choices for Canadians in approaching the issue of regulatory sovereignty arise in two distinct (albeit related) respects: in our bilateral relations with the United States and in our domestic interjurisdictional regulatory arrangements.

Tying first to the bilateral relationship, the FTA and NAFTA provided a strong impetus for the continental energy market that had already begun to emerge by the mid-1980s.<sup>5</sup> In effect, the trade agreements were largely a confirmation of a convergence of Canadian and U.S. energy policy that was already well under way. The bargain that was struck in these agreements was in essence one of guaranteed access to U.S. markets for Canadian producers in return for guaranteed access to energy resources for U.S. consumers. However one views that bargain (and it certainly was not without controversy in Canada when it was concluded), Canadians must now ask themselves whether they are increasingly facing a different bargain in practice – one in which access to the U.S. market is conditioned not only on meeting the undertakings with respect to access in the NAFTA, but also on structuring our regulator

## Potential Flash-Points

There are at least three emerging issues that are likely to raise the question of Canada's ability to respond effectively to U.S. initiatives in the electricity sector. One issue that will likely arise in the short term, given the expectation that comprehensive energy legislation will be introduced in the new Congress,<sup>6</sup> is how to institute a new electricity reliability management system that will be effective across international borders. Briefly put, the move to a less regulated electricity sector has imposed pressures on the existing system of reliability management, which has been built on the premise of self-regulation through an industry-run organization (the North American Electric Reliability Council – NERC) that develops voluntary standards for its members. This system worked well in an industry environment characterised by large, regionally-based, vertically-integrated monopolies, which could pass on the costs of such a system through its regulated rates. In a much more fragmented market, however, where there are many more actors, with different interests, an approach based on an “old boys club” is simply not tenable. As a result, there is clearly a need – which is being addressed in the U.S. legislation – to move towards an organization that is not stakeholder dependent, and which will develop and enforce mandatory reliability standards. For these standards to be mandatory, there is a practical need that they be “backstopped” by a regulatory authority with the appropriate statutory mandate. Because – given the integrated nature of the Canada-U.S. grid – there is a need for essentially the same reliability standards on both sides of the border, this means that there is at least a possibility of regulatory conflict in the development and enforcement of standards. As yet, however, no binational mechanism has been developed to resolve such possible conflicts – and no clear process has been developed within Canada for arriving at a “Canadian” position in a timely and effective way if such a conflict arises.

A second potential issue relates to the increasing recognition on both sides of the border that there is a need for substantial investment in the North American transmission grid. There have been strong suggestions from the FERC that there may be a need for regional transmission planning if that is to take place – particularly given the often long delays in gaining approvals for such facilities, and also given the reluctance many jurisdictions exhibit towards locating such facilities in their own back yard. Again, given the increasingly integrated nature of the North American grid, what is the likelihood that the FERC will insist on some measure of cooperation in such planning processes as the price of admission to the U.S. marketplace and how would Canada respond effectively if that were the case?

Finally, although the issue is less likely to be dealt with directly by the FERC, what are the implications of the current emphasis on homeland security as an increasing hallmark of U.S. public policy? This was certainly an important aspect of the recent U.S. National Energy Policy (the so-called “Cheney Report), and, if anything, is a concern that has only grown since its issuance. Again, to what extent would Canadian electricity marketers be asked to comply with U.S. security standards *in Canada*, and to provide assurances that their supply of energy is “secure”, and how should Canada arrange its domestic

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<sup>6</sup> Such legislation was introduced in the current Congress, but will almost certainly not be passed.

