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A Legal Opinion Concerning  
the Impact of International Trade Disciplines  
on the Privatization and Restructuring of  
Ontario's Electricity Sector

Prepared for the Ontario New Democratic Party

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December, 2001

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**TABLE OF CONTENTS**

Executive Summary .....	3
<b>PART I: INTRODUCTION</b> .....	10
The Application of International Trade Disciplines to Ontario's Electricity Sector . . . .	10
Privatization vs. De-regulation .....	11
The Exclusive Rights of Foreign Investors and Service Providers .....	12
Qualifications .....	13
<b>PART II: THE FACTS</b> .....	15
The Plan to Restructure Ontario's Electricity System .....	15
<u>The MacDonald Commission</u> .....	15
<u>The White Paper</u> .....	16
The Break-Up of Ontario Hydro .....	18
Expanding the Role of the Ontario Energy Board .....	23
<u>Transforming the Electricity Distribution System</u> .....	24
A System in Transition .....	25
<b>PART III: THE FRAMEWORK OF INTERNATIONAL TRADE DISCIPLINES</b> .....	27
Electricity and International Trade Rules .....	27
Application .....	27
<u>Provincial and Local Governments</u> .....	27
<u>Regulatory Institutions, Monopolies and Crown Corporations</u> .....	28

NAFTA Energy Rules .....	29
NAFTA Investment Rules .....	30
<u>Dispute Settlement</u> .....	30
International Investor Rights and Energy Corporations .....	31
Electricity Related Services .....	32
<u>Canada's Services Commitments</u> .....	34
Canada's GATS Obligations .....	34
<u>The Current Round of GATS Negotiations</u> .....	36
<b>PART IV: SECURITY OF SUPPLY .....</b>	<b>37</b>
Import and Export Controls .....	37
Export Taxes .....	39
National Treatment of Foreign Energy Goods .....	40
National Treatment for Investors and Service Providers .....	41
In Sum .....	41
<b>PART V: CONSUMER PROTECTION AND PRICE REGULATION .....</b>	<b>43</b>
Price Controls as Maximum Import Price Requirements .....	44
Price Controls and Investor-Rights .....	44
<u>Article 1110</u> .....	45
<u>Pope and Talbot</u> .....	46
<u>Performance Requirements</u> .....	47
In Sum .....	48
<b>PART VI: THE IMPACT OF TRADE DISCIPLINES ON POLICY AND LAW REFORM .....</b>	<b>50</b>
Tools for De-regulation .....	51
Challenging Environmental Regulation .....	51
<u>Metalclad vs. Mexico</u> .....	52
<u>Environmental Protection and Conservation are No Excuse</u> .....	53
Is the Electricity Competition Act Trade Compliant? .....	54
Undermining Safeguards and Exceptions .....	57
<u>Existing non-conforming measures</u> .....	58
<u>Public Services: From Exempt to Included Status</u> .....	59
<u>Contracting In</u> .....	59
<b>CONCLUSION .....</b>	<b>60</b>

## **EXECUTIVE SUMMARY**

### **Unforeseen Consequences**

Trade liberalization objectives with respect to energy goods, services and investment were largely realized in the North American context with the establishment of NAFTA in 1994. However, the actual implementation of these policies in the domestic context was effectively constrained with respect to the electricity sector by three factors:

- i) the continued existence of vertically integrated public sector monopolies for electric power generation, transmission and distribution;
- ii) impediments to supply liquidity caused by limited interconnections facilities between Canada and the US and among Canadian provinces; and
- iii) exceptions and reservations that exempted non-conforming measures of provincial and municipal governments from certain NAFTA and WTO requirements.

Present privatization and de-regulation initiatives, coupled with commitments to increase interconnection with other jurisdictions, would remove the impediments which have allowed Ontario to maintain public control of its electricity system in the face of free trade disciplines designed to serve an agenda for de-regulation and privatization. It is also important in this regard to appreciate that once current safeguards are abandoned, and public ownership and control relinquished, they cannot under the rules of trade liberalization, be revived.

In simple terms, the disciplines of both North American Free Trade Agreement (NAFTA) and the World Trade Organization (WTO), related to the trade in goods and services and investment, contain an extensive catalogue of regulatory measures that may not either be established or maintained by federal, provincial or municipal governments. Yet, many of these government actions may be necessary to ensure that the implementation of a market competition model not become, as it has in California and Alberta, an uncontrolled experiment in which supply reliability and affordable service become the first casualties.

However, notwithstanding the seriousness of these potential consequences, there appears to have been little analysis, public discussion or debate about the impact of international trade and investment rules on Ontario's plans to establish a market competition model for the electricity sector. It would be prudent in our view to correct these deficiencies before further and irreversible steps are taken to implement an agenda that is likely to have adverse and unforeseen consequences.

### **The Exclusive Rights of Foreign Investors and Service Providers**

Another factor that is likely to exert a significant influence on the character of the market model now planned for Ontario's electricity sector, arises from the interests of foreign investors and service providers who are now poised to gain a substantial stake in Ontario's electric power system. Allowing US energy corporations to participate in Ontario's electricity market is an explicit objective of Ontario's pro-competitive plan for this sector.

However, under NAFTA and the WTO, these corporations have rights and remedies that are simply unavailable to Canadian companies competing in the domestic electricity market. Moreover, under NAFTA investment rules this includes the unilateral right to invoke binding international arbitration to claim damages where it is alleged that any Canadian government or regulatory institution has acted in a manner that infringes the broad rights accorded foreign investors under this treaty.

Thus the participation of foreign investors and service providers in Ontario's electricity market transforms what would otherwise be matters of domestic regulation and contract law, into relationships governed by international rules concerning services and investment. This is true even where energy transactions - generation, transmission, distribution and consumption - occur entirely within the province.

While diplomatic and strategic considerations may obviate the possibility of state initiated trade challenges to Ontario energy policy and regulation, these factors have little relevance to the parochial concerns of foreign investors. While Canadian electricity systems remains largely impervious to foreign investment interests, the risks posed by NAFTA investment procedures are relatively modest. However if the Province proceeds to open Ontario's electricity market as now planned for the spring of 2002, the special rights and privileges of foreign investors will come into play.

### **The Expanding Reach of International Trade Disciplines**

Over the past decade the scope of international trade and investment agreements has been substantially expanded to encompass broad areas of policy, programs and law which had previously been entirely matters of domestic concern and beyond the reach of international trade disciplines and sanctions. The importance of these developments are further underscored by the fact that, unlike the treaties they supercede, the new generation of international trade agreements are binding and enforceable.

Because of the expansive way in which the rights of foreign investors and service providers have been defined under these regimes, trade rules now apply to policy and regulatory measures that may have little, if anything, to do with international trade as conventionally understood. Another common

misconception about these regimes is the notion that trade rules simply preclude governments from discriminating against foreign goods, investors and services. In fact, several NAFTA and WTO disciplines prohibit broad categories of policy and regulatory initiatives even where these are designed and applied in precisely the same manner to both domestic and foreign companies.

While of critical importance to government policy and law, Canada's international trade obligations remain obscure and poorly understood by policy makers, regulatory officials, politicians and even by many in the business community. In fact, the reach of international trade agreements has expanded so rapidly that according to Renato Ruggiero, the first Director General of the World Trade Organization (WTO), neither governments nor industries yet appreciate the full scope or value of the new guarantees provided to foreign investors and services providers. Nevertheless, these regimes are certain to exert a broad and constraining impact on Ontario's options concerning the electricity sector.

### **Security of Supply**

NAFTA sets out a comprehensive regime for de-regulation of international energy trade which prohibits import and export controls, export taxes and other forms of border price regulation. These rules also give foreign consumers a proportionate share of Ontario energy resources even if supply shortages arise. These constraints are further reinforced by investment and services disciplines which assure foreign corporations the right to access Ontario markets on the most favourable terms allowed to any domestic competitor. Moreover, the rights of foreign investors in Canada have now been interpreted to include access to US markets.

It is clear, in our view, that the effect of these constraints undermines the entire premise upon which the day to day reliability of Ontario's electricity system must depend - effective regulation of supply and demand. Moreover, the inherent lack of predictability associated with open borders undermines the capacity to make reliable predictions of future system needs, or for anyone to plan for them. This, in turn, is likely to compromise the reliability of the system over the longer term as well.

One of the fundamental problems presented by the free trade model when coupled with the de-monopolization of the electric power system is that it fails to provide rules or institutions capable of managing systems across international boundaries. In other words, there is an asymmetry between the authority of regulators such as the Ontario Energy Board, which is limited to Ontario, and the geographic area within which economic activity can take place, which is interprovincial and international.

Yet another way to understand this problem is to appreciate that, while system reliability depends upon sophisticated regulatory controls that carefully balance supply and demand, trade disciplines superimpose a regime of de-regulation whenever those transactions cross international boundaries.

## **Consumer Protection and Price Regulation**

The concept of price regulation is fundamentally incompatible with the objective of establishing an unregulated free market for electricity. However, as we have seen in both California and Alberta, the failure to establish effective price regulation can result in unstable prices and sharp increases in the cost of electricity. Moreover, market manipulation and other strategies can reap enormous wind-fall profits for power generators who are willing to exploit the opportunity that imperfectly regulated markets present. Therefore, to prevent electricity costs from rising out of reach for many Ontario residents and businesses, electricity prices will need, as they have in the past and elsewhere, to be regulated.

While the imposition of price controls may make sense from a public policy point of view, price regulation is difficult and probably impossible to reconcile with NAFTA disciplines that prohibit export taxes, maximum import price requirements, or government measures which directly or indirectly expropriate investments. For price controls to be effective, they must also be coupled with restrictions on exports to prevent generators from simply redirecting output to export markets where higher prices may prevail. However, NAFTA rules prohibit all forms of export controls, whether imposed through quotas, taxes or tariffs. The effect of these constraints is to:

- preclude the establishment of two price energy policy that would assure Ontario consumers access to electricity at prices below those that may from time to time be paid in neighbouring US markets;
- render price controls, particularly when coupled with mandatory service obligations, vulnerable to challenge either on the grounds that they effectively limit exports, or alternatively, impose a maximum import price on electricity generated outside the province for end-users in Ontario; or
- invite foreign investor claims on the grounds that such controls represent expropriation of foreign investments where damages equal the difference between the regulated and market price.

Yet other provisions of NAFTA and the GATS might be invoked to discourage or challenge price controls including rules proscribing the imposition of performance requirements, or quantitative restrictions on service providers.

In our view, the imposition of price controls either to shield Ontario consumers from escalating international prices; address short term price instability; or prevent consumers from being gouged by corporations who find ways to manipulate the market - are all likely to be regarded as offending both the spirit and the letter of free trade disciplines.

## **Environmental Protection and Resource Conservation**

Environmental regulation has now become a common target of trade challenges and foreign investor damage claims, and the list of environmental and conservation measures that have been the casualties of such disputes continues to grow. As we know, environmental requirements concerning: siting transmission lines; carrying out environmental assessments for new generation facilities; controlling emissions from power stations; or managing radioactive wastes - all entail significant costs. They are never popular with the corporations that must bear them. NAFTA and the WTO provide powerful new tools which may be enlisted to discourage or challenge unwanted policy and regulatory measures.

There is also mounting evidence that simply the apprehension or threat of trade challenges or investor claims is sufficient to sideline environmental reforms. Moreover, under the GATS, and NAFTA investment and services regimes, governments are substantially denied recourse to the modest exceptions trade rules have traditionally allowed for measures considered necessary for environmental or conservation purposes.

## **The Need for Flexible and Adaptive Regulation**

The regulatory regime required to control Ontario's privatized electric power system will be distinguished by its sophistication and complexity. Experience in other jurisdictions indicates that the regulatory framework will need to be modified to address emerging problems associated with a competitive electricity market. In addition to dealing with the problems of market manipulation and predatory pricing which bedeviled California's system, changes to the regulatory framework will be needed simply to address technical problems related to the operation of the system itself.

But trade liberalization has imposed substantial constraints on government policy, programmatic and regulatory options. Often these limitations are broadly worded, ill-defined and untested. As noted, in addition to requiring non-discriminatory treatment to the goods, investments and services of foreign corporations, both NAFTA and WTO rules impose significant limits on the capacity of government to adopt or maintain non-discriminatory measures as well.

We also know that the configuration of the regulatory framework, and of changes that may be needed to it, can have significant impacts on the profits of companies that establish investments in the electricity sector. Given the latitude that international tribunals have been given to define the scope of NAFTA investment disciplines, any regulatory measure that adversely affects the interests of foreign investors may found a claim under this regime.

### **Undermining or Negating Current Safeguards and Exceptions**

Many aspects of current Ontario policy, law and programs concerning the electricity sector, including the activities of Ontario Hydro's successor companies, offend free trade principles and disciplines. But these measures were grand-fathered as non-conforming measures when NAFTA was established. But to be sustained, such measures must remain in place. While changes to law and policy are permitted under NAFTA, this is only true where reforms are liberalizing. This means that once markets are opened, the safeguards now in place to preserve public policy options for this sector will be lost and may not be recovered.

A similar concern exists with respect to the status of measures concerning the electricity sector under the GATS because of the exclusion for services delivered "in the exercise of government authority," or where these are classed as procurement. But the unbundling and privatization of the services once offered by Ontario Hydro, would defeat any claim to exempt status that might have been asserted under GATS rules.

### **The Trade Consistency of the Electricity Competition Act**

As noted, the current legal framework for Ontario's electricity sector appears to have been crafted with little regard to the considerable constraints established by NAFTA and WTO disciplines on the policy and regulatory options available to government. This explains why several elements of the current regulatory framework appear to conflict with the requirements of NAFTA and WTO disciplines - these include measures that permit:

- taking into account, in granting licenses relating to electricity generated from facilities located in a jurisdiction outside of Ontario, whether that jurisdiction allows for equivalent access to its markets [s. 66 of the OEB Act];
- restrictions on the business activities that certain transmitters and distributors may engage in [s. 71 of the OEB Act];
- the authority of the OEB to review acquisitions, transfers and sales of or relating to generation, transmission and distribution systems, unless this review falls within very limited exceptions allowed under NAFTA rules [ss. 82 and 86 of the OEB Act]; and
- certain mandatory obligations to provide certain customers with service [s.29 of The Electricity Act].

It was beyond the scope of this opinion to review the specific provisions of Ontario's new regulatory and framework to determine their consistency with Canada's international trade and investment

obligations. We point out these apparent conflicts then, simply to illustrate a problem that we suspect is endemic to the new legal framework for the Province's electricity sector.

**In sum**

Canada's international trade obligations impose significant constraints on public policy and law concerning Ontario's electricity sector. These undermine the capacity of Ontario governments to achieve broader societal objectives such as environmental protection, or community economic development, and may also frustrate the efforts of provincial regulators to ensure system reliability and stable affordable energy prices.

Given the experience other jurisdictions, most notably California and Alberta, it is now generally acknowledged that adopting a market competition model for the electricity sector can be a risky undertaking that jeopardizes supply reliability and the interests of both retail and business consumers. In our view, the constraints imposed by Canada's obligations under NAFTA and WTO will significantly exacerbate these risks if Ontario proceeds further with its program to privatize and de-regulate its electricity sector.

## **PART I: INTRODUCTION**

This opinion describes the general framework of international trade law as it applies to public policy and law concerning the electricity sector in Ontario. It also assesses the likely impact of Canada's international trade obligations on the regulatory, price and other controls that may be needed to ensure the reliable supply of electricity to Ontario businesses, and consumers at stable and affordable prices.

Before considering any of the details of how international trade law is likely to come into play in this context, we need to make a few general observations about the unprecedented developments that have been taking place in international trade law.

### **The Application of International Trade Disciplines to Ontario's Electricity Sector**

Trade liberalization objectives with respect to energy goods, services and investment were largely realized in the North American context and with the establishment of North American Free Trade Agreement (NAFTA) in 1994.<sup>1</sup> However, the actual implementation of these policies in the domestic context was effectively constrained with respect to the electricity sector by three factors: 1) the continued existence of vertically integrated public sector monopolies for electric power generation, transmission and distribution; 2) the application of certain reservations that protected non-conforming measures at the provincial and local government levels; and 3) impediments to supply liquidity caused by limited interconnections facilities between Canada and the US and among Canadian provinces.<sup>2</sup>

Present privatization initiatives, coupled with commitments to increase interconnection with other jurisdictions, would remove the impediments that have allowed Ontario to maintain public control of its electricity system in the face of free trade disciplines designed to serve an agenda for de-regulation and privatization.

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<sup>1</sup> NAFTA added Mexico as a party and provisions related to services and enforcement of investment disciplines, to the basic framework established by the Canada-US Free Trade Agreement of 1988.

<sup>2</sup> A further impediment to full realization of trade liberalization policies as these apply to electricity sector arose from the general perception that governments could rely upon the general exception relating to the conservation of exhaustible natural resources (Article XX:(g)) to preserve export controls that would otherwise prohibit the use of quantitative export controls. But the exceedingly narrow interpretation that this safeguard has been accorded by the trade dispute panels that have considered it, make this provision an unreliable basis upon which to defend measures that would otherwise offend GATT and NAFTA strictures.

### **Privatization vs. De-regulation**

The complexity of the privatization enterprise for the electricity sector, together with the considerable social and economic consequences that result from supply disruptions and escalating energy costs, underscore the importance of establishing effective and adaptive regulatory and price controls to avert such outcomes. However, the underlying premise of trade liberalization policy is that privatization and de-regulation objectives are mutually supportive and should proceed in tandem. The notion that privatization measures might necessitate the need for enhanced regulatory control is alien to this trade agenda.

Yet as acknowledged by the WTO Services Secretariat:

Those countries who have ended the monopoly of vertically integrated public utilities, have had to introduce new complex regulation in order to ensure the creation of a competitive market. **In this respect competition has required re-regulation rather than deregulation.**<sup>3</sup>

In simple terms, the disciplines of both NAFTA and the World Trade Organization (WTO), related to the trade in goods and services, as well as investment, contain an extensive catalogue of regulatory measures that may not either be established or maintained by federal, provincial or municipal governments. Yet, many of these government actions and regulatory responses may be needed to ensure that the implementation of a market competition model not become, as it has in California and Alberta, an uncontrolled experiment in which supply reliability and affordable service become the first casualties.

In addition, the self-described ratchetting effect<sup>4</sup> of these international regimes makes retreat from unsuccessful privatization initiatives difficult, expensive and uncertain. The combined effect of these dynamics is to constrain the implementation of appropriate safeguards to manage the risks associated with privatization, while at the same time reducing the capacity of governments to correct errors or address unwanted outcomes.

Moreover, many of the trade disciplines that are likely to come into play in this context, are ill-

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<sup>3</sup> Council for Trade in Services, *Energy Services, Background Note by the Secretariat*, 9 September, 1998. S/C/W/52, para. 64.

<sup>4</sup> See discussion *infra* in Part VI. The immutability of liberalizing reforms under NAFTA and WTO disciplines arises from the effect of several trade disciplines including those concerning expropriation, existing non-conforming measures, proportional sharing of energy resources, commitments to progressive liberalization, and the need to pay compensation under GATS market access disciplines.

defined, unprecedented and the subject of little if any judicial interpretation. Furthermore, when applied by international trade panels or investment tribunals, these disciplines have consistently been given more expansive application than the federal government apparently anticipated.<sup>5</sup> Crafting policy and regulatory measures to comply with the broadly worded constraints of these trade regimes is a daunting challenge. Moreover, further liberalization of energy trade and services continues to be vigorously promoted by the United States.

If the process of privatizing the electricity sector is complex, unpredictable and fraught with unanticipated consequences, the same has been true for the application of international trade disciplines to Canadian policy and law. Recent experience in California and Alberta reveals that unleashing market competition in the electricity sector can be a risky endeavour. As the following assessment documents, the superimposition of binding international trade disciplines in this sphere will substantially exacerbate those risks.

### **The Exclusive Rights of Foreign Investors and Service Providers**

Another observation that we should make concerns the interests of foreign investors and service providers that are poised to gain a substantial stake in Ontario's electric power system. As we know, the energy industry is dominated by an increasingly small number of transnational corporations. Allowing these corporations to participate in Ontario's electricity market is an explicit objective of Ontario's pro-competitive plan for this sector.

However, under NAFTA and the WTO, foreign investors and service providers have rights and remedies that are simply unavailable to Canadian companies competing in the domestic electricity market. The notion that international trade rules simply preclude governments from discriminating against foreign goods, investors and services is one of the common misconceptions about these regimes. In fact, several NAFTA and WTO disciplines apply to non-discriminatory domestic measures of general application.

Another misconception about international trade rules, is that they are limited in application to international transactions. With the addition of investment and services disciplines, these regimes now apply to broad areas of domestic policy and law that have never traditionally been understood as trade related.

Thus the participation of foreign investors and services provides in Ontario's electricity market

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<sup>5</sup> This in part explains Canada's dismal record in defending Canadian policies and programs, from drug patent laws, cultural programs and environmental regulation, to the Autopact - when these have been challenged under NAFTA and WTO rules. Yet health care, culture, the environment, and the Autopact were supposed to have been beyond the reach of international trade, investment and services disciplines.

transforms what would otherwise only be matters of domestic regulation and contract law, into relationships also governed by international rules concerning services and investment. For example, if a local distribution company enters into a contract with a US based energy corporation<sup>6</sup> to purchase electricity, it will also be entering into a foreign investment relationship governed by NAFTA investment rules even where the power is generated in Ontario. Similarly, the same scenario would be defined as international trade in services under the General Agreement on Trade in Services (GATS).

While of critical importance to the viability of government policy, programmatic and regulatory initiatives, Canada's international trade obligations remain obscure and poorly understood by policy makers, regulatory officials, politicians and even by many in the business community.

Renato Ruggiero, who as first Director General of the WTO must be taken as an authority on the subject, described the GATS this way:

*the GATS provides guarantees over a much wider field of regulations and law than the GATT; the right of establishment and the obligation to treat foreign service suppliers fairly and objectively in all relevant areas of domestic regulation extend the reach of the Agreement into areas never before recognized as trade policy. I suspect that neither governments nor industries have yet appreciated the full scope of these guarantees or the full value of existing commitments.<sup>7</sup>*

This candid assessment not only confirms the unprecedented reach of the GATS, but also that many in government and the private sector have yet to appreciate the full implications of such binding international rules. Moreover, while the GATS represents an ambitious expansion of the domain of international trade law, it doesn't yet go as far as the investment and services disciplines of NAFTA.

### **Qualifications**

Finally, by way of introduction, we must qualify our opinion by identifying the issues which we have not attempted to canvass. These include the constitutionality of the trade rules we survey, the role of US federal regulatory institutions, the impact of the federal-provincial Agreement on Internal Trade, or the provisions of the legislative framework established under *The Electricity Act* or the *Ontario Energy Board Act*.

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<sup>6</sup> For the default Standard Supply Service.

<sup>7</sup> Ruggiero 1998 - *Towards GATS 2000, A European Strategy* - Address to the Conference on Trade in Services. Brussels, June 2.

However even a perfunctory review of this Ontario legislation, reveals several potential conflicts with NAFTA and WTO disciplines. An assessment of how extensive these conflicts may be, would require a thorough review of this new policy and regulatory framework, and is beyond the ambit of this opinion. Rather, our intention here, is simply to illustrate the nature of the difficulties that are likely to arise if the requirements of international trade law are ignored in the present context.

We have also narrowed the scope of our assessment to three areas of trade liberalization that are particularly relevant to the privatization and deregulation initiatives that are now underway for Ontario's electricity sector. These are:

- i) NAFTA investment and services disciplines;
- ii) the General Agreement on Trade in Services (GATS) of the World Trade Organization (WTO); and
- iii) NAFTA rules specific to energy trade.

However, even with our focus thus narrowed, the following review is far from complete, and in many ways only samples the complexity of issues that arise when Ontario's agenda for the electricity sector is considered in light of the Canada's international trade obligations.

There are also several areas of international trade regulation which we will not consider at all. These include the topics of procurement, national security, technical regulation, countervailing duty and antidumping disciplines, subsidies, state enterprises and intellectual property. The impact of these rules are also of concern in our view, but a comprehensive assessment of the current framework of international trade law is simply beyond the scope of this opinion.

Finally, in this regard we have not examined the critical issue of financial services as these are defined under NAFTA and WTO services regimes, and relate in particular to the activities of the Independent Market Operator. While we would regard the application of these disciplines to the IMO as a critical subject, the complexity of these issues warrants its own and thorough treatment.

## **PART II: THE FACTS**

### **The Plan to Restructure Ontario's Electricity System**

#### The MacDonald Commission

Since the mid-1990s, the Ontario Provincial Government has taken a number of significant public policy, legislative and regulatory steps designed to transform Ontario's electricity system from a publicly-owned, single supplier model to a predominantly privately-owned, deregulated, competitive market model in which foreign, as well as domestic firms will play a major role.

In late 1995, the Government appointed an Advisory Committee, chaired by former Federal Finance Minister Donald S. MacDonald, to examine options for the future of electricity services in Ontario. In May 1996 its report, *A Framework for Competition*, was submitted to the Government.

The Advisory Committee made a number of far-reaching recommendations, including:

- the establishment of wholesale competition for the sector to be followed by the phased introduction of full retail competition;
- the creation of an independent System Operator to manage the dispatch of electricity and the operation of the transmission grid;
- setting up an Electricity Exchange to deal with the financial transactions involved in a competitive electricity market; and
- the elimination of Ontario Hydro's monopoly on the generation of electricity.

It also recommended breaking up Ontario Hydro into six separate companies and allowing the "...introduction of private equity into the ownership of Ontario Hydro's generation assets...to enhance the introduction of competitive forces in Ontario's electricity system."<sup>8</sup>

The Advisory Committee concluded that a competitive, deregulated system would result in significant price advantages for Ontario customers. In its words:

*Under conservative assumptions, the Advisory Committee's analysis shows that its recommendations for a competitive generation market are likely to result in future wholesale electricity rates that are lower than those which can be expected by maintaining the current system. Moreover, these electricity price benefits can be achieved without imposing a burden*

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<sup>8</sup> The Advisory Committee on Competition in Ontario's Electricity System, Honourable Donald S. MacDonald, Chair, *A Framework for Competition*, Toronto: Queen's Printer, May, 1996 pp. III, V.

*on Ontario's taxpayers.*<sup>9</sup>

### The White Paper

In November 1997, the Government released a White Paper, entitled *Direction For Change: Charting a Course for Competitive Electricity and Jobs in Ontario* that incorporated many, although not all, of the recommendations of the Advisory Committee. The White Paper outlined the Government's policy rationale for the restructuring of Ontario's electricity system, arguing that competition, deregulation and opening the system to private investment were now needed for a number of reasons.<sup>10</sup>

First, other jurisdictions were restructuring their electricity systems and Ontario "...risks falling behind."<sup>11</sup> The White Paper listed a number of jurisdictions that had enacted legislation to introduce competition into their electricity sectors, including Alberta, California and several adjacent US states. It argued that some of these jurisdictions were already seeing the benefits of this new competitive approach.

Second, competition would lower prices. Citing a study of the US Energy Information Administration, the White Paper asserted that "...for the US as a whole, the introduction of

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<sup>9</sup> Ibid. p. 110. Many of the Committee's recommendations paralleled the deregulation initiatives occurring in the US at both federal and state levels. In 1992, the US Federal Government passed the Energy Policy Act which mandated wholesale competition in the generation of electricity. In the following years, the Federal Energy Regulatory Commission (FERC) developed a comprehensive blueprint for competition at the wholesale level – a blueprint that was eventually reflected in orders 888, 888A and FERC 2000, as well as numerous decisions dealing with specific regulatory applications made by individual utilities. At the state level, jurisdictions like California were also putting in place an entirely new regulatory framework for electricity. California eliminated the legally mandated monopolies of the major private utilities in favour of a competitive market, in which other generators would have access to their formerly captive customers. It also compensated them generously for the resulting 'stranded assets', that is investments made under the assumption that they would continue to have a regulated, captive market. The MacDonald Commission was aware of these developments as well as deregulation initiatives in a number of other countries, such as Great Britain. It is also worth noting that some of the economic assumptions made by the Committee in projecting the benefits for Ontario from competition now look somewhat questionable. For example, the Committee's estimates of the likely increases in natural gas prices were very low in hindsight.

<sup>10</sup> "Direction for Change: Charting a Course for Competitive Electricity and Jobs in Ontario" Ministry of Energy, Science and Technology, November, 1997.

<sup>11</sup> Ibid. pp 1-4. The paper lists the various states that have passed legislation or are in the process of passing legislation to deregulate their systems.

competition could result in electricity price reductions of 8 to 15 percent.”<sup>12</sup> A competitive system would bring comparable benefits to Ontario consumers, while ensuring that Ontario businesses would be able to purchase electricity at competitive rates and thus would not lose their price advantage compared with businesses in neighbouring US states.

Third, the performance of publicly owned Ontario Hydro was “unsatisfactory”. Prices, according to the White Paper, rose by over 30 percent during the 1990s, while taxpayer-supported Ontario Hydro debt increased to \$30 billion. It pointed to the poor track record of Hydro’s nuclear generating stations in recent years, and declining public confidence in the safety of its plants.

Fourth, it argued that competition would benefit Ontario by stimulating investment and job creation. It would do so not only by lowering prices but also by providing a range of new business opportunities for Ontario firms, both within the Province and internationally. In sum, the White Paper concluded that the traditional model of a publicly owned, single supplier (monopoly) could no longer be sustained.

Based on its analysis of the need for change, the White Paper set out an agenda for restructuring Ontario’s electricity industry. It advocated breaking up Ontario Hydro, separating the monopoly from competitive elements of the system, introducing wholesale and retail competition, establishing an independent market operator to manage the physical and financial markets, and giving the Ontario Energy Board greater regulatory powers in the electricity sector.

Shortly after the release of the White Paper, the Government introduced legislation to implement the Paper’s key recommendations. Two key Acts, passed in 1998, provide the legal framework for these changes: *Bill 35: The Electricity Act (TEA)* and the *Ontario Energy Board Act (OEB Act)*. (These were both included as part of the overall *Energy Competition Act, 1998*.)<sup>13</sup>

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<sup>12</sup> Ibid. p.4.

<sup>13</sup> The purposes of the *Electricity Act* are set out as follows:

- to facilitate competition in the generation and sale of electricity and to facilitate a smooth transition to competition;
- to provide generators, retailers and consumers with non-discriminatory access to transmission and distribution systems in Ontario;
- to protect the interests of consumers with respect to prices and the reliability and quality of electricity service;
- to promote economic efficiency in the generation, transmission and distribution of electricity;
- to ensure that Ontario Hydro’s debt is repaid in a prudent manner and that the burden of debt repayment is fairly distributed;
- to facilitate the maintenance of a financially viable electricity industry; and
- to facilitate energy efficiency and the use of cleaner, more environmentally benign energy sources

While some provisions of the legislation have not yet been proclaimed (including, most notably section 26(1) that would open the market to full competition), the main features of the Government's restructuring plan are already being implemented.<sup>14</sup> The Government has ended Ontario Hydro's electricity monopoly, broken up the corporation and created the institutional framework for a competitive market. It is moving, step-by-step, towards its objective of giving private electricity generators, marketers and service suppliers the ability to sell electricity and related energy services directly to all Ontario customers on a competitive basis.

To end the dominant role of Ontario Hydro's successor company, Ontario Power Generation Inc. (OPGI), in the production of electricity, the Province has made a commitment to transfer two thirds of Ontario's public electricity generating capacity to private investors over the next decade. This will be done through a variety of mechanisms including outright sale, contract or lease.

### **The Break-Up of Ontario Hydro**

Since the creation of Ontario Hydro by Sir Adam Beck a century ago, Ontario has provided its citizens with electricity through an integrated, publicly owned utility. Ontario Hydro was responsible for electricity generation and transmission through high voltage lines. It also regulated distribution to the customers of municipal electric utilities (MEUs), or in some cases provided distribution directly to certain large users and to customers of all load sizes in parts of Ontario not served by MEUs (largely in rural and northern Ontario). It was effectively a single supplier of electricity for the Province, responsible for all aspects of the system, including planning, capital investments and system maintenance. The 1998 legislation has changed all this.

The new system adopts many of the standard elements of the deregulation model advocated by the US Federal Energy Regulatory Commission (FERC). Under this approach, ownership of generation must be separated from transmission to allow competition among electricity suppliers. The transmission system (which remains a monopoly) must give non-discriminatory access to all suppliers, allowing them full and unencumbered access to potential customers. The market, not government regulators, will determine the price of electricity. Private firms, not the Government, will be responsible for making future investments according to their projections of provincial energy needs. Long term planning will be left to the market.

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in a manner consistent with the policies of the Government of Ontario. (1998, c. 15, Sched. A, s. 1.)

<sup>14</sup> The market opening has already been postponed several times. The Government has indicated it intends to proclaim s. 26 (1) in May 2002.

Under this model, competition has normally been introduced on a step-by-step basis, initially starting with wholesale competition (i.e. sales to recognized utilities) and then moving to full retail competition in which all industrial, commercial and residential customers are allowed to purchase their electricity directly from the supplier of their choice. (However, Ontario's current approach differs somewhat in that the Government has indicated that it will introduce wholesale and retail competition simultaneously. It also differs from the prevailing US model in that it involves the break up of an integrated public utility and taking major steps towards privatization of its key components, rather than the restructuring of privately owned utilities.<sup>15</sup>)

While it is not the intention of this opinion to focus on the many details of Ontario's new arrangements, a brief overview of the transformed landscape is warranted, both to highlight its complexity and to identify some of the critical areas where international trade agreements may impact on the system's proposed operations.

The Government has split Ontario Hydro into five separate companies: Ontario Power Generation (OPGI), Hydro One, Ontario Electricity Financial Corporation, the Electrical Safety Authority and the Independent Market Operator.

*Ontario Power Generation Inc. (OPGI).* This new provincially-owned company is responsible for managing approximately 85% of the generation assets of the former Ontario Hydro, including its major hydroelectric facilities, thermal power plants and nuclear generating stations (with the exception of the Bruce Nuclear Station which has now been contracted to Bruce Power, a subsidiary of British Energy).<sup>16</sup> However, as noted above, the Government has made a commitment that within 10 years of the opening of the market, it will require OPGI to sell, lease or transfer at least 65% of its generation assets to private investors. The Government's rationale is to reduce the overall market power of OPGI to facilitate a more competitive market in the supply of electricity.

*Hydro One* (formerly the Ontario Hydro Services Company). This entity is responsible for the operation and maintenance of the transmission grid. It delivers electricity from generating stations to local electricity distribution companies, directly connected industrial customers and remote or rural customers. It is also responsible for the construction of new transmission capacity, including new interconnections with other jurisdictions. Hydro One is also a holding company; responsible

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<sup>15</sup> This is not to suggest that FERC's new rules do not affect the significant number of publicly owned electrical utilities in the US. However, the overwhelming impact has been on private, investor owned utilities.

<sup>16</sup> The full terms of this contract have not been made public. However, a recent newspaper article has raised questions about certain financial aspects of the deal, including the provision that enables the company to terminate the contract after 2006 and the size of the company's anticipated profit from the deal. See Martin Mittelstaedt, "Bruce Deal is Sweet, Toronto Globe and Mail, Oct. 29, 2001.

for overseeing a variety of other subsidiaries involved with distribution, retailing, and fibre optics, engineering and construction services. The Government has directed Hydro One to upgrade key interconnections with Quebec and neighbouring US states to open Ontario to additional electricity trade. This, in turn, will further integrate Ontario's electricity system with other jurisdictions in the region, giving out-of-province suppliers greater ability to sell into the Ontario market, while also enabling Ontario based generation facilities to export more power, particularly to US markets.<sup>17</sup>

*Ontario Electricity Financial Corporation (OEFEC)*. This company is the legal successor to Ontario Hydro. It holds the bonds and other debt that was issued in the name of Ontario Hydro. It is charged with the reduction of Ontario Hydro's \$30 billion debt. The OEFEC manages the finances of the NUG Power Purchase Agreements and the nuclear decommissioning fund. The Ministry of Finance closely oversees its operations.

*Ontario Electrical Safety Agency (OESA)*. This entity is responsible for the maintenance of safety standards and safety practices in the system.

Although the Government has established these companies as public entities, they have been structured to facilitate the transition to a competitive model in which private generators, marketers, wholesalers, service providers and investors will eventually predominate. While the Government has not explicitly indicated it will privatize these entities, we understand that there have been signals from Queen's Park that it is considering this option.

*Independent Market Operator (IMO)*. By eliminating Ontario Hydro's status as an integrated, single supplier and breaking up the company, the Government has abandoned its traditional tools for managing Ontario's electricity system. Under the old regime, Ontario Hydro was accountable to the Government for policy direction. This guiding hand is now to be replaced by the market. However, the creation of a competitive electricity market requires a new – and extensive – regulatory framework to oversee the operation of the emerging privatized system.

The Independent Market Operator (IMO), along with the Ontario Energy Board, have been given responsibility for regulating key aspects of the new system. *The Electricity Act (TEA)* created the IMO to carry out the market component of these functions. The 1998 *Ontario Energy Board Act* substantially expanded the OEB's regulatory powers over the electricity sector.

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<sup>17</sup> It is worth noting that, as Federal Energy Regulatory Commission (FERC) mandated deregulation across the US, it also began to pressure Canadian provinces to do likewise as a condition of continued access to US electricity markets. This attempt to apply US law in Canada was arguably a violation of the National Treatment and Performance Requirements obligations of NAFTA. However, dependence on US markets has frequently been an effective tool to force domestic change in Canada and in this regard the electricity sector is no different than a number of other sectors that have faced this type of pressure.

The IMO's mandate is set out by The *Electricity Act*. It includes:

- establishing market rules, ensuring regulatory compliance and maintaining system security;<sup>18</sup>

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<sup>18</sup> The *Electricity Act* outlines these rule making powers as follows:

**Market rules**

32. (1) The IMO may make rules,

- (a) governing the IMO-controlled grid;
- (b) establishing and governing markets related to electricity and ancillary services. 1998, c. 15, Sched. A, s. 32 (1).

**Examples:**

(2) Without limiting the generality of subsection (1), the market rules may include provisions,

- (a) governing the making and publication of market rules;
- (b) governing the conveying of electricity into, through or out of the IMO-controlled grid and the provision of ancillary services;
- (c) governing standards and procedures to be observed in system emergencies;
- (d) authorizing and governing the giving of directions by the IMO, including,
- (e) for the purpose of maintaining the reliability of electricity service or the IMO-controlled grid, directions requiring persons, within such time as may be specified in the direction, to synchronize, desynchronize, increase, decrease or maintain electrical output, to take such other action as may be specified in the direction or to refrain from such action as may be specified in the direction, and
- (f) other directions requiring market participants, within such time as may be specified in the direction, to take such action or refrain from such action as may be specified in the direction, including action related to a system emergency; and
- (g) authorizing and governing the making of orders by the IMO, including orders,
- (h) imposing financial penalties on market participants, (ii) authorizing a person to participate in the IMO-administered markets or to cause or permit electricity to be conveyed into, through or out of the IMO-controlled grid, or
- (i) terminating, suspending or restricting a person's rights to participate in the IMO-administered markets or to cause or permit electricity to be conveyed into, through or out of the IMO-controlled grid. 1998, c. 15, Sched. A, s. 32

**General or particular**

(3) A market rule may be general or particular in its application. 1998, c. 15, Sched. A, s. 32 (3).

**Regulations Act**

(4) The Regulations Act does not apply to the market rules or to any directions or orders made under the market rules. 1998, c. 15, Sched. A, s. 32 (4).

**Publication and inspection of market rules**

(5) The IMO shall publish the market rules in accordance with the market rules and shall make the market rules available for public inspection during normal business hours at the offices of the IMO. 1998, c. 15, Sched. A, s. 32

**Transition**

(6) Despite subsections (1) and (5), until a date prescribed by the regulations,

- (a) the Minister, instead of the IMO, may make the rules referred to in subsection (1);
  - (b) the Minister, instead of the IMO, shall publish the market rules; and
- sections 33, 34 and 35 do not apply to the market rules. (1998, c. 15, Sched. A, s. 32 (6))

- managing the day-to-day operations of the system, including the function of the daily dispatch of electricity from power generators;
- responsibility for overseeing – and settling - the financial side of wholesale market transactions;
- allocating financial transmission rights that determine how transmission congestion issues are to be resolved;
- acting as a financial clearinghouse, issuing settlement statements to the market participants, documenting what they owe, or are owed;
- ensuring that there are sufficient operating reserves, both physical and financial in the system;
- overseeing the procurement market for ancillary electricity services. (e.g. black start to be able to re-start the system if it were to go down, reactive power support and frequency control);
- negotiating ‘reliability must-run’ contracts designed to ensure the availability of power in certain local situations where shortages could be a serious issue;
- establishing a futures market for electricity and electricity services, and a financial capacity reserve market when the Government feels it is timely to set these up; and
- adjudicating disputes among market participants. (However, its jurisdiction in this area will not necessarily be absolute because market participants also have rights to appeal to the OEB, the courts and, as we discuss more extensively later in this opinion, international trade tribunals.)

Thus the basic functions of the IMO are to establish market rules and oversee their application. This is a significant challenge.

To begin with, it is difficult to store electricity. Therefore the physical supply (generation) and demand (consumption) of electricity must be perfectly matched to avoid brownouts and blackouts. Demand for electricity fluctuates on a seasonal, monthly, daily and hourly basis, and is affected by factors such as the level of economic activity and weather conditions. Electricity must also be moved over high voltage transmission systems that have a fixed capacity and which may, for this reason, impose supply constraints particularly during peak demand periods. In addition, non-hydro electrical generation facilities normally have a narrow optimum efficient operating range and cannot readily be shut down and started up again at short notice. Coordinating these various elements of the system was always a challenge, even with a single entity in charge of generation and transmission. However, this challenge is greatly increased in the context of having to co-ordinate the actions of numerous suppliers and literally millions of customers through a market mechanism.

In addition to contending with the physical characteristics of electricity systems, regulators must also oversee the financial relationships in this market that exist among generators, marketers, brokers, financial institutions, service suppliers, wholesale and retail customers and other players. Rules are

needed to ensure that financial transactions among market participants are handled effectively and prudently, while ensuring that financial difficulties, or disputes, do not affect the reliability and security of the electricity system. Back-up arrangements must be made to ensure that the failure of a supplier to deliver electricity does not result in outages in the system.

Regulatory decisions must also be made concerning the types of financial transactions that will be allowed and those that are to be discouraged or forbidden. Potential abuses of market power must be identified, analysed and suitable remedies enforced. In short, the financial market must be managed in a manner that ensures that electricity services will be delivered reliably and in a manner that ensures that customers, as well as investors get a fair deal.

Although it has expended considerable resources in addressing these complex issues, the IMO is still very much a 'work in progress.' It has yet to finalize the complex rules needed to regulate the new system when (and if) the Government opens the market to full competition. In wrestling with the difficult and complex tasks before it, the IMO is encountering many of the same problems experienced in several other jurisdictions.<sup>19</sup>

### **Expanding the Role of the Ontario Energy Board**

The 1998 *Ontario Energy Board Act* gives the Ontario Energy Board (OEB) broad powers to oversee and regulate the Province's electricity system (as opposed to managing the day-to-day operations of the market, which is the role of the IMO). These powers include:

- Promoting competition in generation and sale of electricity, including the transition to a competitive market;
- Providing market participants and consumers with non-discriminatory access to electricity transmission and distribution;
- Consumer protection;
- Maintaining system reliability and service quality;
- Encouraging economic efficiency in all areas of the electricity industry; and
- Promoting energy efficiency and environmental conservation

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<sup>19</sup> The most obvious example of this is the challenge facing regulators in California, where price spikes dramatically increased power costs in 2000 and earlier this year, and gave rise to enormous public pressure to impose price caps and other measures to address alleged market manipulation. This experience underlined the inadequacy of the rules that had taken years to develop, resulted in numerous lawsuits and led to significant conflicts between the state government and FERC – conflicts that have still not been fully resolved. The lesson from this experience is that operating an electricity market is enormously complex, posing challenges that even the most well resourced and sophisticated systems have yet to resolve satisfactorily.

Under section 57, the OEB is given authority for licensing market participants. This includes generators, transmitters, distributors, local distributors, wholesalers, retailers and the IMO. However, significant components of s. 57 have not been proclaimed. While a number of temporary licenses have been granted, the full extent of the licensing regime will not be clear until the remaining sections of s. 57 are implemented.

License holders are (or will be) required to conform to certain codes of conduct, such as the Affiliate Relationships Code for Electricity Distributors and Transmitters that establishes the standards of conduct between regulated companies and their unregulated affiliates. Retail license holders must also meet the provisions of the Electricity Retailer Code of Conduct.

The OEB is responsible for licensing transmission and distribution operators and for approving electricity rates associated with the distribution and transmission of electricity. It also has responsibility for approving: business restructuring in the industry, including mergers and amalgamations among electricity distributors, share acquisitions involving distribution and transmission utilities, disposal of electricity distribution and transmission assets and the acquisition of generating facilities by distributors or transmitters and distribution/transmission facilities by generators. It has established a set of guidelines for regulating Mergers, Acquisitions, Amalgamations and Divestitures (MAADs).

The OEB has jurisdiction over the IMO and approves both its operating budget and the fees it charges market participants for various services. It is responsible, in a general way, for monitoring the operation of the electricity market and reporting to the Minister of Energy, Science and Technology on the fairness, efficiency, transparency and competitiveness of the market. It is also responsible for regulating the monopoly elements of the system, including Ontario Power Generation Inc.'s progress towards meeting the objectives of the Market Power Mitigation Agreement. Its approach to rate regulation and distribution is based on the concept of Performance Based Regulation (PBR). Finally, the *Act* gives the OEB responsibility for approving the construction, or renovation, of generation and other facilities.

### Transforming the Electricity Distribution System

The Government's agenda for restructuring Ontario's electricity sector also extends to the municipal level. Historically, electricity has been distributed to most consumers through approximately 300 municipally owned distribution utilities (MEUs). However, the MacDonald Commission and, subsequently, the authors of the White Paper took the view that this distribution system should be rationalized. Small MEUs should be encouraged to merge to eliminate administrative duplication and achieve economies of scale.

The introduction of competition requires separating the monopoly functions of the MEUs (principally

the operation of the “wires” delivering electricity to customers in their geographic area) from their other energy services. Once implemented, competition will also eliminate the MEU’s captive customer base because it will permit customers to purchase their electricity from suppliers other than their local MEU.

In addition to promoting rationalization and consolidation of local power distribution, the Government has required municipalities to convert their MEUs into Local Distribution Companies (LDC’s). These are to become profit-making corporations operating under the same legal framework as other businesses, and must pay quasi-income taxes and capital gains taxes. The intent is to create a level playing field for private investors in the local distribution market.

While municipalities have thus far shown little enthusiasm for selling their LDCs to private investors, a number of amalgamations have taken place. Other municipalities have sold their LDCs to Hydro One, which is still a major distributor of electricity to over 1 million customers, primarily in rural and northern communities.

The Government has not required municipalities to sell their LDCs to private investors. To the extent that municipalities do sell out in the future, this will constitute another major step in the elimination of public sector involvement in Ontario’s electricity system.<sup>20</sup>

### **A System in Transition**

The preceding description of the emerging electricity system in Ontario underlines the enormity of the changes that the Government has introduced. The integrated, public utility model formerly embodied in Ontario Hydro has been dismantled. It is being replaced by a competitive, private sector model, in which foreign investors will play a growing role in shaping Ontario’s energy future. Even at the municipal level the system is being transformed to facilitate competition and open the door to the future privatisation of public assets.

As noted, Ontario’s agenda for transforming the province’s electricity system is still a ‘work in progress’. There may be significant change to this framework in the coming years, based on the experience of other jurisdictions. Moreover, as delays in opening the market indicate, the Government is still grappling with implementation and transition issues. If not handled properly, these could negatively affect the reliability, security and stability of the electric power system.

To date consumers continue to benefit from a system that is still very much the product of public

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<sup>20</sup> Historically, there have also been a handful of privately-owned LDCs whose existence pre-dated the current restructuring initiatives of the Government. These include Great Lakes Power, Canadian Niagara Power and Cornwall Electric. It is not clear at this stage how the Government intends to integrate them into the new market.

rather than market control. There are a number of reasons for this: Ontario is self-sufficient in electricity and the market has not yet been opened. Steps have also been taken by government to cushion consumers from possible service disruptions and price spikes during a transitional period, and for a time after the projected market opening date of May 2002. The Province has put in place a complex mechanism to limit revenue increases known as the Market Power Mitigation Agreement. While this framework is focused on curbing the market dominance of OPGI, its net effect is to provide some degree of price protection in the transition period. However, as OPGI meets the divestiture requirements of this Agreement, this protection will be lost. Once this occurs, Ontario residents will find out if the Province's new system will have the regulatory capacity to protect customers from the kind of market manipulation that plagued California; a state now embroiled in lawsuits to recover an estimated \$8.9 billion in overcharges from electricity generators and marketers.<sup>21</sup>

Another major constraint, cushioning Ontario from the full impact of the changes thus far introduced, is the limited capacity of the transmission connections linking the province to other jurisdictions, both in Canada and the US. However, the expansion of these connections, which is part of the Government's long term plan for deregulation, will significantly reduce this constraint. This, in turn will integrate Ontario more closely with the electricity markets in adjacent jurisdictions and particularly New York State, Ohio and Michigan.

Recent experience in California, as well as in Alberta, suggest that implementing a deregulated, market driven electricity system is not a simple proposition. The nature of electricity itself; the complexities of the regulatory system needed to manage both the physical and financial aspects of a competitive system; and, the apparent opportunities for market abuses - all underscore the dimensions of the task the Province has undertaken.

Arguably the most significant impression to emerge from this overview of the present framework for a competitive market model for Ontario's electricity sector, is the critical importance of adequate regulatory control. While the principal concern of the Government appears to have been the mitigation of OPGI's market power - in delaying the market opening it now seems to be acknowledging the threat of possible supply disruption and unstable and escalating energy costs. Moreover, as we will see, the issue of compatibility of the current model with the commitments Canada has made under NAFTA and WTO trade regimes, seems to have been largely ignored in constructing this new model for the Ontario's electrical power system.

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<sup>21</sup> See FERC Docket No. EL00-95-031 or the FERC News Release of July 25<sup>th</sup>, 2001. An earlier case may also be of interest. See: Complaint of California Electricity Oversight Board vs. All Sellers of Energy and Ancillary Services, FERC Docket No. EL00-104-000, Aug 28<sup>th</sup>, 2000.

### **PART III: THE FRAMEWORK OF INTERNATIONAL TRADE DISCIPLINES**

#### **Electricity and International Trade Rules**

For over four decades, the basic framework of international trade agreements was embodied in the General Agreement on Tariffs and Trade (GATT) which was limited in its application to trade in goods. Because it couldn't be stored and for other reasons, electricity was not generally considered to be a commodity subject to GATT rules.<sup>22</sup>

Since the advent of the Canada-US Free Trade Agreement in 1989 the terrain of international trade law has undergone a dramatic transformation. During this period the ambit of international trade rules has grown to encompass broad spheres of policy, programs and law that have heretofore been entirely matters of domestic and local concern.

Unlike the GATT, the new generation of international trade agreements are binding and enforceable. Moreover, under NAFTA investment rules, foreign corporations have for the first time been accorded the right to unilaterally invoke binding international arbitration to enforce their rights under a trade agreement to which of course they are not parties. The explicit extension of these disciplines to provincial and municipal government, Crown Corporations, and non-governmental organizations represents another significant departure from the traditional norms of international trade law.

Assessing the potential impact of international trade rules concerning investment, services, procurement, intellectual property and technical regulations is a difficult challenge, given the unprecedented and largely untested character of these international rules. However, the consequences of misapprehending or failing to comply with these requirements are likely to be punishing, costly, and difficult to correct.

#### **Application**

##### Provincial and Local Governments

Unless otherwise exempt, most NAFTA and WTO disciplines apply to federal, provincial and local

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<sup>22</sup> The non-storability of electricity has caused some to assume that electric power should not be classified as a commodity, although some storage is available for hydraulic resources. In addition, with respect to Article XX(g) of the GATT, the general exception relating to the conservation of exhaustible natural resources, the New York Drafting Committee Report noted that "as it seemed to be generally accepted that electric power should not be classified as a commodity, two delegates did not find it necessary to reserve the right for their countries to prohibit the export of electric power." See, *GATT, Analytical Index: Guide to GATT Law and Practice*, Updated 6th Edition (1995).

government measures.<sup>23</sup> While challenges or claims can only be made against the federal government, it is obliged under NAFTA Article 105 to:

*... ensure that all necessary measures are taken in order to give effect to the provisions of this Agreement, including their observance, except as otherwise provided in this Agreement, by state and provincial governments.*

Article 201 of NAFTA further stipulates that *unless otherwise specified, a reference to a state or province includes local governments of that state or province.* Furthermore, NAFTA investment and services rules explicitly delineate the obligations of provincial and local governments. The GATS also applies to provincial and local governments.

### Regulatory Institutions, Monopolies and Crown Corporations

Both trade regimes also apply to the National Energy Board and the Ontario Energy Board and other institutions which exercise regulatory authority concerning the electricity sector. NAFTA and GATS disciplines also apply to Crown Corporations, which are obligated to observe many of the constraints that apply to governments. Several of these constraints also apply to the public entities established by *The Electricity Act* - Hydro One, OPGI, the Independent Market Operator (IMO) and Local Distribution Companies.

Thus Chapter Fifteen of NAFTA: *Competition Policy, Monopolies and State Enterprises* sets out disciplines the purpose of which, *inter alia*, is to ensure that any privately owned monopoly that it designates or any government monopoly that it maintains or designates, act in a manner consistent with NAFTA requirements in the exercise of any regulatory, administrative or other government authority that has been delegated to it. Such monopolies are also prohibited from using their monopoly position to engage in anti-competitive practices.

Similarly, GATS Article VIII : *Monopolies and Exclusive Service Suppliers*, provides that:

- 1. Each Member shall ensure that any monopoly supplier of a service in its territory does not, in the supply of the monopoly service in the relevant market, act in a manner inconsistent with that Member's obligations under Article II and specific commitments.*
- 2. Where a Member's monopoly supplier competes, either directly or through an affiliated company, in the supply of a service outside the scope of its monopoly rights and which is*

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<sup>23</sup> Under NAFTA, "measures" are defined to mean *any law, regulation, procedure, requirement or practice.* Under the Services Agreement of the WTO, "measure" means *any measure by a Member, whether in the form of a law, regulation, rule, procedure, decision, administrative action, or any other form.*

*subject to that Member's specific commitments, the Member shall ensure that such a supplier does not abuse its monopoly position to act in its territory in a manner inconsistent with such commitments.*

Finally, certain NAFTA and WTO rules also apply to non-governmental organizations. For example, the GATS applies to measures taken by *non-governmental bodies in the exercise of powers delegated by central, regional or local governments or authorities* [GATS Article 1:3].

### **NAFTA Energy Rules**

While the NAFTA and WTO Agreements are both established on the foundation provided by the GATT, there are several features that distinguish the two regimes. Among the more important of these are rules concerning trade in energy goods which are set out in Chapter 6 of the NAFTA.<sup>24</sup>

Article 602 of this Chapter describes the scope of its application as follows:

*This Chapter applies to measures relating to energy and basic petrochemical goods originating in the territories of the Parties and to measures relating to investment and to the cross-border trade in services associated with such goods, as set forth in this Chapter.*

Measures concerning investment in this sector, and the delivery of energy services would also be subject to NAFTA investment and services disciplines. However, in the event of conflict between NAFTA investment rules concerning the energy sector and those set out in Chapter 6, the latter prevails.

With respect to export controls, and unlike the trade in goods provisions of the WTO, NAFTA energy rules prohibit the use of charges or taxes on energy goods [Article 604]. In other words, NAFTA precludes the adoption of a two price energy policy that would distinguish between domestic and export users in any class of energy consumers.

Another critical departure from GATT and WTO principles is set out in Article 605 which effectively guarantees export consumers a proportional share of Canadian energy resources in perpetuity. While export controls are allowed to relieve domestic shortages, they may only be applied proportionately, with a continuing share being guaranteed to export markets reflecting flows for a 36 month period before supply restrictions were imposed. We will return to consider the application of these NAFTA rules more thoroughly in Part IV.

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<sup>24</sup> These largely replicate the provisions of its prototype in the Free Trade Agreement, with Mexico claiming reservations and exemptions from several of the more onerous obligations of these disciplines.

## NAFTA Investment Rules

Chapter 11 of NAFTA establishes a number of broadly framed constraints on government measures that may affect foreign investors. These include the obligations to ensure that such measures are consistent with the requirements of *National Treatment* [Article 1102], *Most Favoured Nation Treatment* [Article 1103] and a *Minimum Standard of Treatment* [Article 1105]. Chapter Eleven also establishes blanket prohibitions against certain *Performance Requirements* [Article 1106] and government measures that may be considered to represent expropriation [Article 1110].

Foreign investment is broadly defined by NAFTA to include virtually all forms of equity, debt and contractual interests [Article 1139]. Most provisions of Chapter Eleven apply only to “investors of another Party,” in other words - Mexico and the U.S. in Canada’s case. However, a European based transnational energy corporation such as British Energy, could readily structure its North American interests to gain the benefit of NAFTA based investor rights with respect to its operations in Canada.

### Dispute Settlement

In addition to these substantive obligations, another remarkable feature of Chapter 11 is the right of private enforcement it accords foreign investors. Under Articles 1121 and 1122 foreign investors of a NAFTA party have a virtually unqualified right to claim damages for violations of the broadly-worded constraints established by the chapter.<sup>25</sup>

These disputes are then decided, not by Canadian courts or judges, but by international arbitration panels [Article 1120]. These tribunals in turn operate under international law and according to procedures established for resolving international commercial disputes, and devised with no regard to third party rights of the broader public interest that is often at stake in NAFTA disputes.<sup>26</sup>

For example, the deliberations of these tribunals are, as a rule, held in camera. Moreover, should a dispute arise concerning actions by the Ontario Government, the Ontario Energy Board, or one of the newly created institutions in the electricity sector, none would be a party to the arbitral proceedings or be entitled to standing before the tribunal. Moreover, the rules of confidentiality that guide such proceedings are so restrictive that Canada has been admonished on at least two occasions

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<sup>25</sup> Under Article 1122, Canada has unilaterally consented to international arbitration of claims arising under the Chapter notwithstanding the absence of any contractual relationship with the foreign investor. While foreign investor must waive their rights to pursue similar claims before domestic courts they need not exhaust domestic remedies before resorting to international dispute resolution [Article 1121].

<sup>26</sup> C. Chinkin, *Third Parties in International Law*, (Oxford: Clarendon Press, 1993) at 248-249.

for sharing certain information with provincial governments implicated by such claims.<sup>27</sup> While the NAFTA partners have recently issued a statement which would provide more latitude for sharing of such information with affected sub-national governments, it is not yet clear that the NAFTA tribunals will accede to their views.<sup>28</sup>

Unlike the state-to-state dispute procedures of NAFTA and the WTO, investor-state claims under NAFTA include no element of reciprocity, because foreign investors are subject to no obligations under the treaty they have been given the right to enforce. The effect is to remove one the principal constraints that limits recourse by nations to dispute procedures concerning obligations which they must also observe.<sup>29</sup> In our view, because of their amenability to unilateral enforcement, NAFTA investment disciplines are likely to become the flashpoint of conflict with the public policy, programmatic and regulatory measures concerning Ontario's electricity sector.

### **International Investor Rights and Energy Corporations**

To this point, NAFTA rules have not been invoked to challenge Canadian measures directly concerning the energy sector. We have already described the dynamics that have insulated the electricity sector from such claims. For oil and gas there has simply been no need for the US to invoke NAFTA rules, given the fact that the federal government and several provinces are fully committed to exploiting Canadian energy resources for US markets. However, Canada's enthusiasm for dedicating the lion's share of its energy resources to US markets may wane if supply shortages develop, international prices rise out of reach, the environmental costs of new development are unacceptable, or the imperatives of climate change finally dictate some constraint on our growing use of energy resources.

Rather, if international trade rules are likely to come into play over the near term, that is most likely to occur in the form of investor-state claims to assert the more parochial interests of foreign corporations with investments in Canada's energy sector. It is relevant in this regard to note, that the codification of foreign investor rights in treaty form has in many ways been driven by the interests

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<sup>27</sup> Pope and Talbot v. Canada, Decision of Feb. 14, 2000, at para 6, and S.D. Myers and the Government of Canada, Procedural Order No. 16, May 13, 2000, at para. 14.

<sup>28</sup> See the statement released to the media under the heading "Free Trade Commission Clarifications Related to NAFTA Chapter," 11 July 31, 2001: *NAFTA Parties Agree On New Limits To Investor-State Disputes*.

<sup>29</sup> Howard Mann, *Private Rights, Public Wrongs*, International Institute for Sustainable Development, 2001.

of US based energy corporations seeking to protect their interests in the Middle East and elsewhere.<sup>30</sup>

However, the constraints imposed on government actions under NAFTA investment disciplines go well beyond those typically found in international investment treaties, which were usually limited to claims concerning expropriation. As this assessment reveals, not only has NAFTA substantially expanded the concept of expropriation, but has also added a substantial catalogue of administrative and policy measures to its list of prohibited government actions.

### **Electricity Related Services**

The other category of international trade rules that are relevant to the privatization of Ontario's electricity sector are those concerning services. These are set out in Chapter 12 of the NAFTA and in the GATS. The rules of these services regimes are both built on the basic framework provided by the GATT and include similar requirements with respect to *National Treatment, Most Favoured Nation Treatment, Transparency and Market Access*. Both regimes also engender elements that go well beyond those of the GATT, by imposing constraints on non-discriminatory measures - i.e., policies and laws which treat domestic and foreign services providers precisely in the same manner.<sup>31</sup>

However, the status of electricity under these regimes is uncertain and neither may apply to delivery of electricity as a service per se. While some energy products clearly fall in the goods category, the case for electricity is unclear for several reasons.<sup>32</sup> It is significant, however, that the US takes the unqualified position that power generation is a service.<sup>33</sup> Nevertheless, whether electricity is considered a good, service or both, it is clear that the supply of electricity involves many service activities including those related to: mining coal and uranium; drilling for oil and gas; designing and building power plants and other generation facilities; establishing and operating transmission and distribution networks; trading bulk electricity; marketing, supply and metering; managing related financial services and transactions, and operating customer billing and accounting systems.

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<sup>30</sup> M. Sornarajah, *The Settlement of Foreign Investment Disputes*, Kluwer International Law, 2000, at pp. 151 - 170.

<sup>31</sup> NAFTA Articles 1207 and 1213, and GATS Articles VI and XVI.

<sup>32</sup> See note 22.

<sup>33</sup> WTO: *Communication from the United States, Energy Services*, 18 December 2000, S/CSS/W/24.

As was the case in Ontario, in many jurisdictions most of these services were provided by vertically integrated utilities, engaged in the production, transport and distribution of energy products. This left little margin for trade and competition. However, the recent trend toward privatization and liberalization in the sector has now isolated or unbundled several of these service activities bringing into play the trade disciplines that apply to such services.

While the GATS and Chapter 12 have similar features, there are significant differences in the coverage of these regimes. Under Chapter 12, coverage is universal for traded services subject to few exceptions and certain reservations for non-conforming measures. The GATS also applies universally to traded services except those delivered “in the exercise of government authority” [GATS Article I:3(c)]. However, only certain GATS provisions apply across the board to all services. *National Treatment, Market Access, Domestic Regulation* and certain other key provisions apply only to service sectors with respect to which Canada has made specific commitments.

Another distinction between the two regimes concerns their respective definitions of trade in services. The GATS includes within the ambit of this definition delivery of services through the commercial presence of the service provider in the jurisdiction where the service is provided. In other words, it includes the right of establishment for foreign service providers and, for that reason, has features analogous to NAFTA investment rules. This explains why the WTO has described it as the first multilateral agreement on investment.<sup>34</sup>

This point is fundamental to understanding the relevance of the GATS to Ontario’s electricity sector. For example, the operations of a US based energy service company in Ontario could be considered trade in services under the GATS even where power was generated and consumed in the province. Of course such an undertaking would also represent an investment under NAFTA investment provisions which is likely to render the application of GATS disciplines of secondary importance.

Another significant difference between the GATS and NAFTA services regimes is that the latter includes a broad reservation for all non-conforming measures of both provincial and local governments that were in place when NAFTA was proclaimed on Jan. 1, 1994. This distinction is critical to both provincial and municipal governments, if they wish to preserve their historic public policy and regulatory options under this exemption. We return to consider this important issue further under Part VI.

Finally, we should note three other exceptions set out by these services agreements that are germane to this inquiry. The first is set out in Annex V to the NAFTA and reserves Canada’s right to maintain

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<sup>34</sup> [www.wto.org/wto/services/services.htm](http://www.wto.org/wto/services/services.htm)

a quantitative restriction under Article 1207, namely the right of the National Energy Board to approve international transmission lines. Another is set out in Article XIV *bis* of the GATS which includes certain security exceptions, including measures “relating to fissionable and fusionable materials or the materials from which they are derived.” Finally, Ontario has stipulated a reservation to the GATS, that applicants and holders of a water power site development permit be incorporated and resident in Ontario.<sup>35</sup>

### Canada’s Services Commitments

Under NAFTA services rules, unless otherwise reserved or exempt, all government measures concerning services are subject to these binding disciplines. We have already noted the few reservations that might apply in this context. The most important of these would be the broad reservations established for non-conforming measures that were in place in 1994. In our opinion, the transformation of public policy and law concerning the electricity sector has undermined and may ultimately nullify these safeguards if present plans to open Ontario’s electricity market to full competition proceed further.

However, they may still provide significant shelter for the activities of local municipalities who maintain ownership of what were municipal electric utilities. The extent to which the activities of LDCs may be reserved from the full application of NAFTA disciplines is an important question which warrants further exploration. This may be an issue which municipal governments may wish to explore more thoroughly.

Given the breadth of its application, and when considered in the context of NAFTA investment and energy provisions, the GATS recedes somewhat in importance. Nevertheless the GATS would multilateralize the principles which it shares with the NAFTA, and does probably go further in some areas, notably domestic regulation, than do NAFTA services disciplines. It is also currently under negotiation, and is providing a platform upon which the US is asserting global proscriptions intended to address the question of US energy security.

### **Canada’s GATS Obligations**

As noted, the extent to which government prerogatives may be subject to GATS constraints depends upon the services it has listed in GATS schedules.<sup>36</sup> The United Nations Provisional Central Product

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<sup>35</sup> GENERAL AGREEMENT ON TRADE IN SERVICES, GATS/SC/16, 15 April 1994, (94-1015) - CANADA, Schedule of Specific Commitments.

<sup>36</sup> The GATS listing process is complicated and allows a country to specify which precise GATS disciplines it is willing to embrace with respect to a particular sector. Commitments fall into three broad categories:

Classification (UNCPC), upon which Canada has relied in listing its commitments under the GATS, does not list energy services as a separate category. However, as is the case for most services sectors, there are a number of other services classifications that have relevance to the energy sector. A review of Canada's GATS schedule accordingly reveals an extensive number of commitments relevant to the energy sector, these include:

Engineering design services for civil engineering construction, industrial processes and production;

Services incidental to mining, including drilling and field services and rental of equipment with operator and including site preparation;

General construction work for civil engineering;

Construction work for civil engineering, including for ... dams, ... mining and manufacturing, power and communications facilities, pipelines ....

Communications services, including on-line data and information retrieval;

Wholesale trade services;

Environmental Services including waste management and air pollution control;

Nature and landscape protection services; and

Financial Services

One of the ways to appreciate the significance of the obligations that attach to listed services is to consider the nature of the reservations that have been declared by the federal government and some provinces to qualify the commitments that Canada has made. For example, Alberta, Newfoundland and Nova Scotia have all declared reservations that would allow them to require that preference be given to local goods, services and workers with respect to large scale energy projects.<sup>37</sup>

But with the exception of construction services for hydraulic stations, Ontario has listed no reservations. Its failure to do so may reflect the fact that in 1994, when such reservations were

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*Market Access, National Treatment and Additional Commitments.* Moreover, with respect to each of these categories, a country may qualify or limit its commitments to certain modes of supply (e.g. cross border); a certain time frame; or, with respect to particular types of regulatory elements (e.g. controls on the number of service suppliers). While the complexity of this regime provides ample opportunity for missteps, correcting an error is difficult and likely to be costly. In all of this, a country is to be guided by GATS classification schedules which characterize services as belonging to particular sectors or sub-sectors. We return to consider the challenges presented by service sector classification regimes further below.

<sup>37</sup> Horizontal reservations apply across the board to all services listed by a particular jurisdiction. In addition to these reservations of general application, there are also much more specific reservations which have been listed for specific services and even modes of supply. The two reservations cited, apply only to cross border supply and consumption abroad.

nominated, it did not foresee the transformation of Ontario's electricity sector that would occur years later. However, once Canadian commitments under the GATS are declared, it is difficult to subsequently retract or qualify them.

### The Current Round of GATS Negotiations

There are commitments related to energy services that Canada has not yet made. The most important of these for present purposes concern those relevant to the electricity sector are for *Services incidental to energy distribution*<sup>38</sup> and because of the importance of natural gas as a fuel source for power generation *Transport services via pipeline: transportation of petroleum and natural gas*.<sup>39</sup>

However, it is questionable whether this status quo will persist in the face of determined efforts by the United States to have all energy related services included within the scope of GATS disciplines. In a proposal tabled with the WTO GATS secretariat in December 2000, the US explicitly seeks commitments to market access, national treatment and regulatory disciplines for all energy services.<sup>40</sup>

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<sup>38</sup> (CPC 887). While some uncertainty exists about the extent of this category, the WTO secretariat is of the view that it includes transport and distribution of electricity and gas, when these services are operated by an independent services supplier and not by a vertically integrated manufacturer. See WTO: *Energy Services: Background Note by Secretariat S/C/W/52*.

<sup>39</sup> (CPC 71310).

<sup>40</sup> See note 33.

#### **PART IV: SECURITY OF SUPPLY**

The reliability of Ontario's electricity system depends upon a stable balance of supply with demand. This balance will require regulatory intervention by the IMO and the OEB. However, like any other supply/demand management regime, this necessarily entails the control of imports and exports which might otherwise de-stabilize the equilibriums carefully established between domestic producers and consumers.

It is significant in this regard that greater integration of Ontario's electricity system with those of its neighbours is an important priority of the current restructuring agenda. Foreign producers will have much greater access to the Ontario grid and the consumers served by it, and this right of market access is to be reciprocal for Ontario generators in the US.

As we have seen, the primary purpose of NAFTA energy provisions is to prohibit the imposition of export and import controls on energy goods and services. These free trade principles will surely facilitate system integration with the US, but they also conflict with the needs of supply/demand management to control flows both within and across provincial and international boundaries. This conflict raises a serious question about the compatibility of current trade rules with the imperative to ensure system reliability.

#### **Import and Export Controls**

As noted, several NAFTA provisions constrain the capacity of governments to control energy imports and exports. The most important of these are delineated in Chapter Six of NAFTA: *Energy and Basic Petrochemicals*.

Article 603 incorporates the provisions of the *General Agreement on Tariffs and Trade* (GATT), with respect to prohibitions or restrictions on trade in energy. Critical in this regard is the general prohibition against all export and import controls concerning trade in goods, which is set out by Article XI of the GATT. While Canada is permitted to maintain import and export licensing for

energy, these controls must respect the constraints imposed by the provisions of this Chapter,<sup>41</sup> as must Canadian regulators, crown corporations and public sector monopolies.

Exports controls can only be imposed under the limited circumstances provided by certain exceptions to the general prohibition imposed by Article XI on such quantitative controls, such as:

- *preventing or relieving critical shortages on a temporary basis* [GATT Art. XI:2 (a)];
- *conserving exhaustible natural resources* [GATT XX(g)];
- *ensuring essential supplies for domestic industries as part of a domestic government stabilization plan* [GATT XX(i)]; and,
- *dealing with matters essential to the acquisition or distribution of products in short supply* [GATT XX(j)].

It is arguable that these safeguards could be of assistance in defending regulatory measures established to ensure system reliability requirements in the limited circumstances contemplated by these provisions.<sup>42</sup> However, given the exceedingly narrow ambit that trade dispute bodies have consistently accorded these safeguards, it would be unwise in our view to place reliance upon them at least until much greater certainty is provided about the extent of their application.

However, the importance of ascertaining the actual ambit of these safeguards is greatly diminished by Article 605 which imposes the further constraint that even where these exceptions apply, such measures may be adopted or maintained only if:

*(a) the restriction not reduce the proportion of the total export shipments of the specific energy or basic petrochemical good made available to that other Party relative to the total*

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<sup>41</sup> Article 608.2 provides that Canada and the United States but not Mexico shall act in accordance with the terms of Annexes 902.5 and 905.2 of the *Canada United States Free Trade Agreement*. Annex 905.2 eliminated the least cost alternative test as a criterion to be applied by the NEB with respect to energy exports, and constrained the application of surplus tests in accordance with the requirements of Articles 902, 903, and 904 of the FTA. Annex 902.5 established the primacy of the International Energy Program which is an emergency energy sharing arrangement between Canada and the United States. The only reservation explicitly relevant to the electrical energy sector is for quantitative restrictions under Annex V of the NAFTA which preserves the requirement of the National Energy Board Act to approve the construction and operation of international electricity transmission lines.

<sup>42</sup> Robert Howse and Gerald Heckman, *The Regulation of Trade in Electricity, A Canadian Perspective*, in *Ontario Hydro at the Millenium*, ed. Ronald J. Daniels, McGill Queens University Press, 1996 at p. 126-128.

*supply of that good of the Party maintaining the restriction as compared to the proportion prevailing in the most recent 36 month period for which data are available prior to the imposition of the measure .... ;*

*(b) does not impose a higher price for exports of an energy or basic petrochemical good to that other Party than the price charged for such good when consumed domestically, .....and; by means of any measure such as licenses, fees, taxation and minimum price requirements. The foregoing provision does not apply to a higher price that may result from a measure taken pursuant to subparagraph (a) that only restricts the volume of exports; and*

*(c) the restriction does not require the disruption of normal channels of supply to that other Party or normal proportions of the specific energy ... supplied to that other Party.*

In other words, notwithstanding reliability and supply problems that might cause brown outs or black outs in Ontario, Article 605 requires that exports to the US be maintained in the relative proportion that such exports represented of domestic supply prior to the imposition of such controls, but only if justified by the limited exceptions allowed under the GATT.

Indeed the incompatibility of these trade constraints and electricity export controls was formally acknowledged under the *Power Corporations Act* which stipulated that Ontario rules concerning the export of electricity by Ontario Hydro would prevail in the event of conflict with the free trade rules.<sup>43</sup>

### **Export Taxes**

While generally permitted under WTO rules, export taxes, which would otherwise provide an effective mechanism for export control are, as we have noted, prohibited under NAFTA.

Article 603 also precludes the use of pricing as a substitute for quantitative export or import controls by proscribing: *in any circumstances in which any other form of quantitative restriction is prohibited, minimum or maximum export - price requirements and, except as permitted in enforcement of countervailing and antidumping orders and undertakings, minimum or maximum import-price requirements.*

Article 604 further provides:

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<sup>43</sup> Power Corporation Act, R.S.O. 1990, c. P.18, s. 85(4) which refers to the substantially similar constraints of the Free Trade Agreement of 1988.

*No Party may adopt or maintain any duty, tax or other charge on the export of any energy or basic petrochemical good to the territory of another Party, unless such duty, tax or charge is adopted or maintained on:*

- a) exports of any such good to the territory of all other Parties; and*
- b) any such good when destined for domestic consumption.*

### **National Treatment of Foreign Energy Goods**

In addition to NAFTA provisions which deal explicitly with import and export regulation, other trade disciplines impose constraints that are also likely to undermine efforts to balance supply and demand in Ontario's electricity market. Take, for example, the challenge of ensuring that Ontario not become too reliant upon export suppliers to meet its energy needs.<sup>44</sup>

Any effort to establish a quota for either export or domestic private power providers would clearly offend *National Treatment* obligations. These are set out in NAFTA Article 301 which provides in part:

*1. Each Party shall accord national treatment to the goods of another Party in accordance with Article III of the General Agreement on Tariffs and Trade (GATT).....*

*2. The provisions of paragraph 1 regarding national treatment shall mean, with respect to a state or province, treatment no less favourable than the most favourable treatment accorded by such state or province to any like, directly competitive or substitutable goods, as the case may be, of the Party of which it forms a part.*

While Ontario's power system was controlled by Ontario Hydro, would-be foreign competitors were accorded no less favourable treatment than their domestic counterparts - all were denied market access. But once access to the grid is provided to domestic producers and suppliers, the same competitive rights must be accorded to foreign suppliers. Nor could the relative proportion of the domestic market which might be acquired by out of province energy providers be limited. The net effect of these requirements may place Ontario increasingly at the mercy foreign power suppliers to supply its energy needs.

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<sup>44</sup> While Ontario currently enjoys a surplus of supply, this status quo depends upon the continued performance of its nuclear facilities, and other factors which may shift over time, particularly if interconnection capacity is increased substantially.

## **National Treatment for Investors and Service Providers**

Similar *National Treatment* obligations are delineated under NAFTA investment and services rules [Articles 1102, and 1202], as well as under the GATS for those services for which commitments have been made [Article XVII]. With respect to foreign investment, further constraints on export and import controls are established under the *Performance Requirements* provisions of NAFTA Article 1106. While these constraints are largely redundant with those delineated by the NAFTA and WTO disciplines noted above, their amenability to private enforcement procedures considerably elevates their importance.

While diplomatic and strategic considerations may obviate the possibility of state initiated trade challenges to Canadian export or import controls, these factors have little relevance to the more parochial concerns of foreign investors. When Canadian electricity systems were largely impervious to foreign investment interests, the risks posed by NAFTA investment procedures were of much less concern. However as foreign investment in this sector is welcomed, this picture will substantially change in light of the considerable leverage that even the threat of a Chapter 11 claim can exert.<sup>45</sup>

### **In Sum**

Under free trade disciplines, neither the IMO nor the OEB can limit the extent to which domestic producers can sell into the US. Conversely foreign producers must be accorded the same access to Ontario consumers as is available to their Canadian competitors. The effect of these constraints is to undermine the entire premise upon which the day to day reliability of Ontario's electricity system must depend - effective regulation of supply and demand.

Furthermore, it is difficult to see how the imperatives of system reliability can be reconciled with the constraints imposed by trade agreements on the imposition of import and export controls. Moreover, the inherent lack of predictability associated with open borders undermines the capacity to make reliable predictions of future system needs, or to plan for them. This, in turn, is likely to compromise the long term reliability of the system as well.

One of the fundamental problems with a free trade model when coupled with the de-monopolization of the power system is that it fails to provide rules or institutions capable of managing systems across international boundaries.<sup>46</sup> There is an obvious asymmetry between the geographic jurisdiction of the regulatory authority, which is limited to Ontario, and the geographic boundaries within which economic activity can take place.

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<sup>45</sup> See note 29.

<sup>46</sup> Note 42, at pp. 132-134.

Yet another way to understand this fundamental problem is to appreciate that system reliability depends upon sophisticated and responsive regulatory control in which all supply and demand transactions are carefully managed - but trade disciplines superimpose a regime of de-regulation whenever those transactions cross international boundaries.

In the United States the Federal Energy Regulatory Commission (FERC) has recognized and responded to this problem with respect to transmission, by mandating the establishment of Regional Transmission Groups (RTGs) as adjuncts to de-monopolization of transmission to provide for inter-jurisdictional system management and administration.<sup>47</sup> But the problem we describe is even broader.

In our view, there is no way to ensure system reliability without either being able to impose export and import controls, or in an open market, being able to manage supply and demand without being constrained by political boundaries.

Therefore, if system reliability is to be maintained, Ontario regulators would have to ignore NAFTA and WTO prohibitions against import and export controls. The result will be exposure to trade challenges and claims for damages by foreign corporations where investments have failed to generate the profits entirely unregulated markets would have delivered. While this may address short term reliability issues the cost might well be prohibitive. Moreover, the problem of long term planning would remain.

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<sup>47</sup> Idem.

## PART V: CONSUMER PROTECTION AND PRICE REGULATION

As noted, initial government proposals took competition induced price reductions almost as a given, and used cheaper electricity prices as a major selling point for the privatization agenda. However, recent experience in other jurisdictions, fluctuating natural gas prices and other developments have called this assumption into question.

Now one of the principal concerns associated with the present privatization of electricity system is the question of price. Because the cost of power in several neighbouring US jurisdictions is significantly higher at the moment than the cost of power in Ontario, the obvious concern is that, once privatized, Ontario generators will seek more lucrative contracts in the US. This, in turn, may not only create supply and reliability problems for Ontario consumers, but will also surely exert upward pressure on Ontario electricity prices.

Given the constraints on establishing export controls we noted, the only effective limit on export flows, and concomitant pressure on domestic prices, would be the current physical limits of interconnection facilities, but which the province has committed to increasing.

In order to cushion consumers from sharp increases in the cost of energy during the transition period, the Province has imposed a revenue cap on OPGI to limit price increases to Ontario customers in the first years of the market opening. However, as OPGI meets the divestiture requirements of the Market Power Mitigation Agreement, this protection will be lost and the market will be open to the oligopolistic "gaming" that has been a feature of other electricity markets, most notably, California's.

Thus, the related price pressures which Ontario consumers may bear have to do with the machinations of the spot market in electricity. The hourly spot market price for electricity can be subject to wide variations because the rates charged are based on the marginal cost of the last unit of electricity bid into the system for that hourly period. Price spikes - short term price jumps which may sharply increase hourly prices and occur over a period of days - have become a major concern since the recent debacles in Alberta, and California.

To avoid this problem, the OEB, under the heading *Abuse of Market Power*, has been empowered to establish minimum and maximum prices at which electricity may be sold as conditions to any license it may issue [Section 70(5)].<sup>48</sup> Of course, the notion of price regulation is antithetical to the idea of a free market where price is set by supply and demand. Naturally, electricity sellers affected by such regulations, and who have profited from the status quo, have raised strong objections to the

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<sup>48</sup> See also price controls that may be stipulated with respect to supply of rural or remote consumers under s. 79 of the *OEB Act*.

practice. While they are likely to be out of luck in the domestic political context, NAFTA investment rules provide alternative recourse. The question, then, is whether such price regulation is consistent with Canada's international trade obligations and in particular the rights of foreign investors.

### **Price Controls as Maximum Import Price Requirements**

The imposition of price caps whether to deal with short term market fluctuations or longer term price differentials would clearly conflict with certain trade rules.

To begin with, and as noted, Article 603:2 proscribes the use of *minimum or maximum import-price requirements* .... in any circumstances in which any other form of quantitative restriction is prohibited. We also know that Article XI of the GATT establishes a blanket prohibition against all export and import controls but in exceptional circumstances - none of which apply to consumer protection.

While price caps are not import measures per se, they would effectively establish a maximum price at which electricity imported to Ontario could be sold. Moreover, the fact that price caps are applied on a non-discriminatory basis to both domestic and foreign generators is no defense against such a complaint. For, unlike Article 604 which prohibits only discriminatory export taxes,<sup>49</sup> Article 603:2 applies to both import and export measures, even when applied in a non-discriminatory manner. In other words, Article 603.2 might have excepted maximum import price regulation when applied in conjunction with similar domestic price controls, but it does not.

### **Price Controls and Investor-Rights**

Price regulation may also be seen as offending the rights of foreign corporations as defined by NAFTA investment rules. Take, for example, the problem of controlling prices while ensuring adequate supply to the system.

The imposition of price caps can result in shortages if suppliers choose not to offer electricity for sale in Ontario during the periods when the controls are in place. This, in turn, can threaten the reliability of the system and may result in supply disruptions.

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<sup>49</sup> Article 604 sanctions the use of export taxes adopted and maintained on: a) exports to all other Parties, and 2) any such good when destined for domestic consumption.

To be effective then, price regulation must be accompanied by other measures designed to ensure that an adequate supply of electricity is available to the system. However, this means forcing sellers to provide electricity at prices lower than they might otherwise sell at.<sup>50</sup>

Whether alone or in tandem with mandatory supply obligations, the denial of the revenues that would otherwise be available in an unregulated market, could trigger compensation claims under NAFTA investment rules. The question, then, is whether such measures might be justified given the considerable constraints imposed by Chapter Eleven disciplines. Three particular provisions of Chapter 11 are problematic: *Expropriation and Compensation* [Article 1110]; *Performance Requirements* [Article 1106]; and *Minimum Standard of Treatment* [Article 1105].

#### Article 1110

Article 1110 concerning *Expropriation and Compensation* provides as follows:

*No Party may directly or indirectly nationalize or expropriate an investment of an investor of another Party in its territory or take a measure tantamount to nationalization or expropriation of such an investment ("expropriation"), except*

- (a) for a public purpose;*
- (b) on a non-discriminatory basis;*
- (c) in accordance with due process of law and Article 1105(1); and*
- (d) on payment of compensation in accordance with paragraphs 2 through 6*

It is important to recognize that measures may offend Article 1110 constraints even where justified by legitimate public purpose and applied in a non-discriminatory fashion to both domestic and foreign investors.

Given the absence of any meaningful constraint on recourse to NAFTA's private enforcement regime, this provision could readily be invoked to challenge price caps as representing an expropriation of investments in generating and marketing electricity. The damages would be the difference between the regulated price and what the market price would have otherwise been. (See discussion of the *Metalclad* case below).

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<sup>50</sup> Mandatory service obligations would be set out in a Standard Service Supply code that would be a condition to distribution licenses when such licensing requirements are implemented. However, under present proposals the consumer prices will be determined by the market.

### Pope and Talbot

An investor-state claim against Canada, by Pope and Talbot, a Canadian subsidiary of a US lumber company illustrates the way in which NAFTA investment disciplines might come into play in this context.<sup>51</sup> In this case, Pope and Talbot complained that the export quota it was allocated under the *Softwood Lumber Agreement* offended several NAFTA investment provisions.<sup>52</sup>

Canada lost the case for failing to meet its obligation under Article 1105 to accord the company “treatment in accordance with international law.” In coming to that conclusion, the Tribunal read an obligation of administrative fairness into Article 1105, which it then concluded Canada had failed to meet. We are reluctant to make too much into the Tribunal’s conclusions concerning Article 1105 because these were subsequently criticized by a Canadian Court,<sup>53</sup> and may have now been addressed by a statement by the NAFTA Parties indicating their intent to see this Article 1105 read more narrowly.<sup>54</sup>

On the question of expropriation, however, the Tribunal rejected the company’s argument that its quota allocation effectively expropriated its investment interests in selling lumber into US markets. It concluded that the interference with Pope and Talbot’s business activities which did result from the quota regime was not substantial enough in this particular case to be characterized as expropriation, but, according, to the Tribunal the failure was one of degree, not kind. A simple loss of profits was not, on the facts, sufficient to represent expropriation under NAFTA rules. The Tribunal left open the question of whether a loss in profits might in other circumstances have represented expropriation as defined by NAFTA.

Obviously price controls can negatively impact profitability. The question, then, is at what point could such controls be considered as having expropriated foreign investment in power generation - with damages representing the difference between the market and regulated price. In Pope and Talbot, the Tribunal made much of the fact that the company’s business remained vital and profitable

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<sup>51</sup> Pope and Talbot v. Canada, Interim Award of the Tribunal,  
<http://www.dfait-maeci.gc.ca/tna-nac/NAFTA-e.asp#P&T>

<sup>52</sup> Within quota limits, lumber could be exported to the US duty free. Above the limit, duties were charged and profits affected. Nevertheless Pope and Talbot was free to export as much lumber to the US as it could find a market for.

<sup>53</sup> See discussion *infra*, p.53.

<sup>54</sup> See note 28.

notwithstanding its quota allocation. Does this mean that rendering such investment unprofitable be sufficient to engender “creeping expropriation,” as the Tribunal put it?

The Tribunal also emphasized that Canada’s allocation of export quota did not interfere with the investor’s ability to control the company and its activities. But the imposition of price controls, coupled with mandatory service obligations would clearly interfere with a fundamental right in any market economy - i.e., to sell or not to sell at a particular price. In this case, a claim under NAFTA’s expropriation rule would be more formidable.

The Pope and Talbot case is also important because Tribunal ruled that the company’s “access to the US market is a property interest subject to protection under Article 1110”,<sup>55</sup> flatly rejecting Canada’s argument that US market access represented an abstraction incapable of founding a claim for expropriation. In other words, any attempt to limit energy exports, whether in conjunction with the imposition of price caps or otherwise, could interfere with a proprietary interest protected by Article 1110. This expansive definition of investment also transforms what would otherwise be a measure concerning trade in goods or energy services, into one also concerning investment, and by doing so, rendering it vulnerable to foreign investor damage claims.

In the Pope and Talbot case, access to US markets was unimpeded, the only question was whether exports would be exempt from import tariffs under the Softwood Lumber Agreement. In a case where foreign market access was actually denied, we believe a claim would have even a much better chance of succeeding.

Whether NAFTA’s expropriation rule might be successfully invoked to challenge price controls is an open question at this time. However, in defining investment to include access to markets, it seems clear from this case that, when coupled with mandatory supply obligations and/or export controls, a strong case could be made that such price controls breach Article 1110. We will return to the question of NAFTA’s rule concerning expropriation in Part V.

### Performance Requirements

Article 1106: *Performance Requirements* proscribes certain forms of investment regulation on both foreign and domestic investors alike. Article 1106 provides in part that:

- 1. No Party may impose or enforce any of the following requirements, or enforce any commitment or undertaking, in connection with the establishment, acquisition, expansion, management, conduct or operation of an investment of an investor of a Party or of a non-Party in its territory:*

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<sup>55</sup> Note 51, Para. 96.

*(e) to restrict sales of goods ....in its territory .... by relating such sales in any way to the value of its ....foreign exchange earnings; [emphasis added]*

While the imposition of a price cap is primarily a consumer protection measure, such controls obviously impact corporate earnings. It is not clear, however, that price caps would be regarded as restricting the sale of goods, rather than simply diminishing the profitability of those sales. In our view this would be a difficult argument to make. Nevertheless, we note the possibility of such a claim because this argument was in fact advanced by Pope and Talbot, where it was rejected only on the grounds that Article 1106:1(e) applied explicitly only to domestic sales - Pope and Talbot's complaint related exclusively to export markets. This leaves alive the question of how this Article might be applied in a case where the profitability of domestic sales was limited by government regulation.

Of course, it is impossible to anticipate the strategic, economic and other considerations that might prompt a foreign investor to make such a claim for damages. In our view, the threat of such litigation is much more likely with respect to regulatory and price controls. In light of the open-ended access provided to NAFTA dispute procedures, it would be unreasonable to discount the potential for such claims.

### **In Sum**

The concept of price regulation is fundamentally incompatible with the objective of establishing an unregulated free market for electricity. However, as we have seen in both California and Alberta, the failure to establish effective price regulation can result in unstable electricity prices and sharp increases in the cost of electricity. Moreover, market manipulation and other strategies can reap wind-fall profits for power generators who are willing to exploit the opportunity that poorly regulated markets present. Moreover, ensuring the electricity costs not rise out of reach for Ontario residents may require, as it has in the past, government regulation to control electricity costs.

While the imposition of price caps may make good sense from a public policy point of view, price regulation is difficult to reconcile with NAFTA disciplines that prohibit export taxes, maximum import price requirements, or government measures which directly or indirectly expropriate investments.<sup>56</sup> Moreover, each of these constraints apply to measures even where these are non-discriminatory in both design and application.

For price regulation to be effective, it must be coupled with restrictions on exports to prevent generators from simply redirecting output to export markets where higher prices may prevail. However as we have seen, NAFTA rules clearly prohibit all forms of export controls, whether

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<sup>56</sup> See discussion of the *Metalclad* case *infra* at p.53.

imposed through quotas or export taxes - a two-price energy policy would clearly offend the latter. When coupled with mandatory service obligations, price caps may also be challenged as: being equivalent to export controls; imposing a maximum import price, or as expropriating the value of foreign investments, with damages representing the difference between the regulated and market price.

Yet other provisions of NAFTA and the GATS might be invoked to discourage or challenge price controls including rules proscribing the imposition of performance requirements, or quantitative restrictions on service providers. In our view, the imposition of price controls either to deal with short term market fluctuations, or to prevent unreasonable price increases, is likely to be regarded as offending both the spirit and the letter of free trade disciplines.

## **PART VI: THE IMPACT OF TRADE DISCIPLINES ON POLICY AND LAW REFORM**

### **Tools for De-regulation**

The regulatory regime required to control Ontario's privatized electric power system will be distinguished by its sophistication and complexity. The demands and challenges of fashioning this new regime are arguably as formidable as any regulatory puzzle the province has ever had to solve. Furthermore, experience in other jurisdictions indicates that the regulatory framework will need to be modified to address unforeseen problems associated with a competitive electricity market. In addition to dealing with the problems of market manipulation and predatory pricing which bedeviled California's system, changes to the regulatory system will be needed simply to address technical problems related to the operation of the system itself.

We have described several of the ways in which such measures are vulnerable to international trade challenges or foreign investor claims. Often the constraints imposed by these trade regimes are broadly worded, ill-defined and untested. If experience to date is any guide, charting a safe policy and legal course through these uncharted waters will be very difficult.

As we have also seen, in addition to requiring non-discriminatory treatment to the goods, investments and services of foreign corporations, both NAFTA and WTO rules impose significant limits on the capacity of government to adopt or maintain certain categories of non-discriminatory regulations as well. While defenders of trade liberalization policies may dispute the characterization, it is clear that these disciplines entrench an agenda for de-regulation.

Finally, we have described the particular problems associated with NAFTA's investment regime and the unilateral right of enforcement it accords foreign investors. As we know, the configuration of the regulatory framework, and of changes that may have to be needed to it, can have significant impacts on the profits of companies that establish investments in the electricity sector. Moreover, because certain NAFTA rules apply to those merely seeking to establish investments in this sector, would-be investors may also have claims if government measures frustrate their incipient ambitions. Given the latitude that international tribunals have been given to define the scope of NAFTA investment disciplines, any regulatory measure that adversely affects the interests of foreign investors may found a claim under this regime.

When trade challenges and foreign investor claims do arise, Ontario's regulatory measures will be judged by standards that have no analogue in Canadian law. This is clearly the case for the scope of government measures that might be construed to have expropriated an investor's property (see discussion of Metalclad case following). But the same is true for other claims arising under NAFTA

investor-state procedures because Tribunals are directed to apply international, not Canadian law in deciding such law suits.<sup>57</sup>

### Challenging Environmental Regulation

Consider, for instance, how these regimes have been successfully invoked to challenge environmental law and regulation.<sup>58</sup> In fact the very first challenge to be resolved under the auspices of the WTO involved a successful challenge to US Clean Air Act regulations having to do with the reformulation of gasoline to reduce air pollution. Since then marine mammal conservation laws, and European food safety standards have also succumbed to WTO trade challenges. Similarly NAFTA investment rules have been invoked to challenge environmental, public health and conservation measures in all three NAFTA countries.<sup>59</sup>

While, as yet, there has been no great number formal challenges or claims, it seems clear that the threat of such actions is exerting a pervasive and chilling influence over governments contemplating new environmental or conservation policy and regulatory initiatives. A recent report published by the International Institute for Sustainable Development<sup>60</sup> documents both the public and less overt impacts of NAFTA investment rules on the environmental agenda of the federal government. It notes that since the advent of NAFTA, only two new federal environmental regulations have been established. Both have been challenged under Chapter Eleven rules - and neither survived.<sup>61</sup>

We believe that exposure to foreign investor claims and international trade challenges presents a significant risk to progressive environmental and conservation initiatives concerning the electricity sector. Environmental and conservation measures, such as those concerning: siting transmission lines; carrying out environmental assessments for new generation facilities; controlling emissions from power stations; or managing radioactive wastes - obviously entail significant costs. Such initiatives are never popular with the corporations that should, in accordance the principle of polluter-

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<sup>57</sup> Article 1131:1 provides that: *A Tribunal established under this Section shall decide the issues in dispute in accordance with this Agreement and applicable rules of international law.*

<sup>58</sup> Note 42, at pp. 132-134.

<sup>59</sup> See Trebilcock and Howse; *The Regulation of International Trade* (2<sup>nd</sup> ed) at p. 395-97 and 440; and note 40, *Private Rights and Public Problems.*

<sup>60</sup> *Idem.*

<sup>61</sup> After losing an important preliminary ruling Canada capitulated in the case of Ethyl Corporation's challenge to measures intended to ban the use of a toxic fuel which is banned in most OECD jurisdictions. In the other, a tribunal ruled against Canadian measures that banned the export of PCB wastes to the US.

pay, bear those costs. Now the rules of NAFTA and the WTO provide powerful new tools that may be enlisted to discourage or challenge unwanted policy and regulatory measures.

While the generation and transmission system remains predominantly in public hands, there is little risk of such measures becoming the victim of international trade or investment rules. But privatization of the power system, and the concomitant participation by foreign investors and services providers in the new market, opens the door to trade challenges and foreign investor claims. For reasons we have noted, including ease of access and lack of reciprocity, the threat of private Chapter Eleven claims is the more likely and problematic.

We have already alluded to cases which have successfully invoked NAFTA investor-state procedures to challenge environmental measures. Because of its importance as a precedent, one of these, the Metalclad case, is worth describing.

#### Metalclad vs. Mexico

In October 2000, the BC Supreme Court was asked to overturn an award made pursuant to NAFTA's investor-state procedures. The case was the first to consider a tribunal decision made under NAFTA investment rules. It arose from an appeal by Mexico of an award for more than \$16 US million that had been made against it, and in favour of US hazardous waste company - Metalclad Corporation.

The Tribunal had ruled that a local municipality had no right to deny the company a permit to built a hazardous waste facility because of environmental and public health concerns, or because the company had built much of its project before applying for a local construction permit. By doing so, the Tribunal concluded that the municipality had expropriated the company's investment in the hazardous waste plant. The tribunal came to a similar conclusion about a subsequent decision by the state government to establish an ecological preserve that included the company's property.

This is how the judge described the Tribunals interpretation of NAFTA's expropriation provision that founded its conclusion:

*The Tribunal gave an extremely broad definition of expropriation for the purposes of Article 1110. In addition to the more conventional notion of expropriation involving a taking of property, the Tribunal held that expropriation under the NAFTA includes covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use of reasonably to be expected economic benefit of property. This definition is sufficiently broad to include a legitimate rezoning by a municipality or other zoning authority.*

Nevertheless, given the very limited ambit of judicial review of such awards, the BC Supreme Court concluded that it had no authority to overrule the tribunal. It is clear that the concept of expropriation as applied in *Metalclad* and acceded to by the BC Supreme Court, goes far beyond any recognized by Canadian courts. In fact, in light of Mr. Justice Tysoe's comments, it would be difficult to identify a regulatory measure that would not be vulnerable to such a claim where the profitability of foreign investments was adversely affected.

The question of whether new or amended regulations are good public policy - or of benefit to the overall system - is not relevant in determining whether compensation must be paid to foreign investors under Article 1110. Given the complexity of the present regulatory system and the likelihood that changes to it will be required in the coming years, there is considerable risk of financial liability whenever such reforms adversely affect the bottom line of a market participant.

Moreover, when the NAFTA Parties agreed recently to address certain problems that had arisen with the implementation of NAFTA investment rules - the matter of expropriation was not among them. It appears that Mr. Justice Tysoe's observation will remain pertinent for some time.<sup>62</sup>

#### Environmental Protection and Conservation are No Excuse

Under GATT rules, governments may rely upon certain listed exceptions as justification for departing from the strict constraints imposed by that trade regime. These are set out in Article XX of the GATT and include two exceptions that are particularly important for environmental, public health and conservation purposes. These concern measures that violate GATT constraints but are either:

*necessary to protect human, animal or plant life or health, or*

*[relate] to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production and consumption*

As interpreted by WTO dispute bodies, these exemptions have been given narrow application. However, neither of these exceptions is permissible under NAFTA investment rules.<sup>63</sup>

It might, nevertheless, be argued that such measures would be permitted under Article 1114:1 concerning Environmental Measures, which provides:

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<sup>62</sup> See note 28.

<sup>63</sup> See Article 2102:2.

*Nothing in this Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure otherwise consistent with this Chapter that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns. [emphasis added]*

Because this provision only applies to measures “otherwise consistent” with Chapter 11 it would not apply to a measure otherwise found to be in breach of the expropriation or other investment rules.<sup>64</sup> A similar problem exists with respect to NAFTA services disciplines.<sup>65</sup>

In the case of the GATS, certain Article XX exceptions are imported by Article XIV. But noticeably absent from this transposition is a counterpart to the conservation exception established by GATT Article XX(g). While this conservation exception has yet to be successfully invoked, the WTO has been willing to accord it putative support. It is also very clear that without the benefit of this exception, a host of conservation measures have no safeguard whatsoever.

Accordingly under the GATS, and the NAFTA investment and services regimes, governments are substantially denied recourse to the modest opportunity that GATT rules allow to defend government measures as being necessary for environmental or conservation purposes. In our opinion, the only conclusion that can fairly be drawn from these provisions is that they reflect a deliberate intent to subsume environmental and conservation goals to those of trade liberalization for services and investment.

### **Is the Electricity Competition Act Trade Compliant?**

It is beyond the scope of this opinion to document the many and varied constraints imposed on government regulations which in the nomenclature of NAFTA and the WTO are characterized, *prima facie*, as *technical barriers to trade*.<sup>66</sup> As we have seen, similar and often redundant constraints are expressed as elements of other parts of the NAFTA or agreements to the WTO.

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<sup>64</sup> It is also unclear that environmental concerns would include public health measures, which are explicitly referenced in Article 1114:2. Accordingly, the omission of a similar reference to health in 1114:1 would likely be taken as deliberate.

<sup>65</sup> The application of Articles XX (b) and (g) are similarly not available to defend measures that may offend NAFTA services rules, notwithstanding Article 2101:2 which allows the Parties to adopt measures *that are not inconsistent with the provisions of this Agreement, including those relating to health and safety and consumer protection.*

<sup>66</sup> Rules concerning such regulations are set in under the heading *Technical Barriers to Trade* as Part III of the NAFTA and in a separate agreement by that name to the WTO.

For example NAFTA Article 606 provides that any regulatory measures concerning energy comply with:

- a) national treatment, as provided in Article 301;
- b) import and export restrictions, as provided in Article 603; and
- c) export taxes, as provided in Article 604.

This article further stipulates that each *Party shall seek to ensure that in the application of any energy regulatory measure, energy regulatory bodies within its territory avoid disruption of contractual relationships to the maximum extent practicable, and provide for orderly and equitable implementation appropriate to such measures.*

Another example would be the provisions of GATS Article VI: *Domestic Regulation* which sets out a number of subjective and broadly worded tests that regulatory initiatives must pass if they are to conform with the requirements of this WTO services agreement.

Both NAFTA and the WTO establish powerful new mechanisms that can be invoked to discourage or challenge broad categories of government regulations - whether implemented by government directly on by the institutions and corporations, such as the IMO, that are empowered by government to exercise such authority. Moreover, the greater the participation of foreign corporations in Ontario's power system, the greater the influence these rules will exert over the provinces environmental agenda for this sector.

We have canvassed the potential for NAFTA and GATS disciplines to conflict with measures needed to ensure system reliability and control prices. These conflicts are also apparent when one considers the specific elements of the current regulatory framework.

It is also beyond the ambit of our review to assess the provisions of the OEB and Electricity Acts for their compatibility with NAFTA and WTO disciplines. However, even a cursory review of these statutes reveals a number of obvious problems. For example, s. 66 of the OEB Act provides:

*If an application for a licence relates to electricity generated from facilities located in a jurisdiction outside of Ontario, the director or Board may, in determining whether or not to issue a licence, have regard to whether that jurisdiction allows for equivalent access to its electricity markets for electricity generated from facilities located in Ontario. [emphasis added]*

This requirement for reciprocity appears to clearly violate NAFTA *National Treatment* obligations which do not allow such considerations to derogate from the obligation to provide most favourable treatment to foreign investors and service providers.<sup>67</sup>

Similarly, s. 70 of this Act sets out a long list conditions which the Board may impose on licenses it may issue. Even if applied in a manner that is entirely non-discriminatory, any of these conditions may nevertheless offend NAFTA's absolute prohibitions against certain performance requirements, export/import controls, or expropriation under NAFTA's expansive definition of that term.

The *Abuse of Market Power* provisions of s. 70(5) provides other examples.<sup>68</sup> This section authorizes the Board to make orders:

..... (c) *restricting significant investment in or acquisition of generation facilities located in Ontario. 1998, c. 15, Sched. B, s. 70 (5).*

But government regulations concerning investment in, or acquisition of, generation facilities located in Ontario are subject to NAFTA investment disciplines. While Canada has declared certain reservations for the energy sector that would allow it restrict or condition such rights, those reservations are limited to the oil and gas sector.

However, there are two reservations that are relevant to the authority provided the Board under Section 70. The first concerns the sale of equity interests in or the assets of state enterprises such as Ontario Hydro. Here Canada, or any province, may depart from the constraints imposed by *National Treatment, Performance Requirements* and *Senior Management* rules.<sup>69</sup> Similarly acquisitions of Canadian businesses in excess of the threshold values delineated by the *Investment Canada Act* are subject to review under that legislation.<sup>70</sup>

However, neither of these reservations apply to the establishment of new businesses such as power generation facilities. Accordingly, an attempt by the Board to restrict investment in new generation

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<sup>67</sup> See note 42 at pp. 128-130 for a commentary on the question of reciprocity in the context of international electricity trade.

<sup>68</sup> We have already discussed the potential conflicts inherent in according the OEB the right under s. 70(5)(a) to establish *minimum and maximum prices or a range of prices at which electricity may be offered for sale or sold* .....

<sup>69</sup> See Canada's NAFTA *Annex I Reservation* concerning the disposition of equity interests or the sale of assets in state enterprises.

<sup>70</sup> *Idem* re the *Investment Canada Act*.

facilities would be difficult to reconcile with NAFTA constraints. The same would be true for the acquisition of existing facilities unless these are subject to the reservations we noted.

Other problematic provisions of the current regulatory framework include:

- S. 70(11) of the OEB Act which allows the Board to “*specify the area in which the distributor is authorized to distribute electricity*” - which may alternatively be seen as a constraint on the right of foreign investors to establish in Ontario [1102], or in a certain scenario, as a violating the prohibition against requiring investors to act as the exclusive supplier of goods or services to a specific region [Article 1106].
- S. 71 of the OEB Act which restricts the business activities that certain transmitters and distributors may engage in - may alternatively be seen as discriminatory in relation to public utilities and municipalities and therefore contrary to *National Treatment* [Article 1102], or as offending the constraints on quantitative restriction set in NAFTA services rules [Article 1207].
- the authority of the OEB to review acquisitions, transfers and sales of or relating to generation, transmission and distribution systems under ss. 82 and 86 of the OEB Act may similarly offend NAFTA *National Treatment* obligations with respect to investors [Article 1102] or service providers [Article 1202].
- the mandatory service obligations set out in s.29 of *The Electricity Act* may offend NAFTA disciplines concerning export controls, as we discussed in Part IV, and when coupled with maximum price controls, may also amount to expropriation under NAFTA as discussed in Part V.

We note these apparent conflicts with Canada’s obligations under NAFTA and the WTO to illustrate a problem that we believe is endemic to many of the provisions of Ontario’s new statutory and regulatory regime for the electricity sector. That problem is that the current policy and legal framework appears to have been crafted with little regard to the considerable constraints established by NAFTA and WTO disciplines on the policy and regulatory options available to government.

Thus, absent co-ordinated public control of generation and transmission such as existed under Ontario Hydro, managing the complexities of Ontario’s electricity system is a formidable challenge that requires sophisticated and flexible regulatory controls. However, as we have seen, international trade rules serve an agenda of de-regulation that, under the rubric of international investment and services agreements, reaches well beyond the traditional sphere of international trade regulation into areas of domestic policy and law that have never been the subject of international trade disciplines. The two agendas will, in our view, be very difficult to reconcile.

## Undermining Safeguards and Exceptions

Finally, we turn to a related problem which concerns the difficulties of changing course should Ontario's experiment fail to deliver the improved performance, in terms of price and reliability, that has been promised.

Regulatory and policy reform is contemplated and even encouraged by the trade disciplines of both NAFTA and the WTO but only where these are in accord with trade liberalization principles. Each of these regimes enlists several mechanisms to accomplish the self-described ratcheting effect<sup>71</sup> that prevents governments from establishing measures that cut against the grain of free trade policies, or attempt to retreat from de-regulation and privatization initiatives once committed.<sup>72</sup>

We have dealt with constraints on the policy, programmatic and regulatory initiatives that are incompatible with trade liberalization. Here we describe the rules that will make it difficult, costly, or just simply impossible for Ontario to retrace its steps should its experiment with privatization fail.

### Existing non-conforming measures

Article 1108 of NAFTA allowed Canada to declare various reservations that would obviate the need for it to comply with certain provisions of Chapter Eleven.<sup>73</sup> Pursuant to these provisions, on Jan. 1, 1996, a sweeping reservation was declared for all non-conforming provincial measures as were in place on Jan. 1, 1994. To be sustained, however, such measures must be maintained or promptly renewed. Moreover, while amendments to non-conforming measures are allowed, these must not decrease the conformity of the measure with NAFTA disciplines.<sup>74</sup> A similar regime is established with respect to services by Article 1206.

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<sup>71</sup> An apt description of the combined effect of such rules was offered in the commentary to a draft text for the Multilateral Agreement on Investment, which as we know, was patterned on NAFTA's investment rules:

*Rollback is the liberalisation process by which the reduction and eventual elimination of non-conforming measures to the MAI would take place. It is a dynamic element linked with standstill, which provides its starting point. Combined with standstill, it would produce a "ratchet effect," where any new liberalisation measures would be "locked in" so they could not be rescinded or nullified over time.*

<sup>72</sup> See Articles 1108 and 1206.

<sup>73</sup> Notably Articles 1102, 1103, 1106 and 1107.

<sup>74</sup> See Article 1108

Pursuant to these reservations, provincial measures concerning the electricity sector, as well as the activities of Ontario Hydro, were sheltered from the application of several of NAFTA's more onerous constraints. But in light of the limits imposed by Article 1108 on the ongoing viability of such reservations, the wholesale transformation of the policy and regulatory landscape concerning Ontario's electricity sector, will, if fully implemented, effectively abrogate the safeguards that such reservations established. Moreover, there is no opportunity under NAFTA rules to have them re-established.

Similar safeguards apply to municipal government measures such as those concerning the activities of municipal electrical utilities, now local distribution companies. These might include requirements that LDCs hire locally or accord preference to local goods and services. But these safeguards are similarly at risk if these utilities are privatized. It is impossible at this point to know how effective current safeguards will be, or to determine the precise point at which reforms will negate them. In our view, this is a question that local governments would be prudent to consider thoroughly before moving ahead with privatization measures that may result in unforeseen and unwanted consequences.

#### Public Services: From Exempt to Included Status

Another way in which the privatization of Ontario Hydro transforms the extent of Canada's obligations under international trade rules, concerns the application of the services agreement of the WTO. The only general exception to the comprehensive inclusiveness of the GATS is for services supplied *in the exercise of government authority* - a term which Article 1:3(c) defines this way:

*a service supplied in the exercise of governmental authority means any service which is supplied neither on a commercial basis, nor in competition with one or more service suppliers. [emphasis added]*

It is unclear whether energy services provided by a crown corporation or public utility would have fallen within the ambit of this safeguard. What is clear however, is that the privatization of electricity services would remove them from the protective umbrella of this GATS exemption.

#### Contracting In

Article VIII of the GATS - *Monopolies and Exclusive Service Suppliers* - provides that where monopoly rights are granted regarding the supply of a service covered by its specific commitments, a Member shall notify the Council for Trade in Services of its intention to do so and submit to arbitration any claims for compensation by other WTO members on behalf of their affected service providers. Failure to comply would justify the imposition of retaliatory trade sanctions. Only where "no affected Member has requested arbitration" would Canada be free to establish, or re-establish such a public sector enterprise without exposure to compensation claims.

While NAFTA explicitly acknowledges the rights of the Parties to designate monopolies, its investment rules would entitle foreign investors to compensation should such initiatives be considered to expropriate their investments. While compensation of affected private interests may be seen as good public policy, under NAFTA rules, the determination of when and to what extent such compensation should be paid is entirely removed from the purview of legislators and parliamentarians and, instead, invested in international tribunals obligated to apply international legal principles which are more protective of private property rights than is the case under Canadian law.

## CONCLUSION

The preceding assessment describes some of the conflicts that become apparent when present policy and law concerning the electricity sector are considered in light of Canada's international trade commitments. While it is impossible to predict just when or where such conflicts may erupt into full blown trade challenges or investor claims, it is only reasonable to expect that the rights of foreign investors and service providers will be vigorously asserted once they have been allowed to establish investments in Ontario's electricity system.

Even a preliminary consideration of the current regulatory framework raises serious questions about the viability of many key elements when measured against NAFTA and GATS disciplines. This, in turn, should raise serious questions about the capacity of Ontario governments or regulatory officials to maintain public control over this vital sector. Moreover, it would be prudent, in our view, to proceed no further along the path of privatization and de-regulation until there has been a thorough and public consideration of whether by doing so, Ontario might be irretrievably limiting its ability to ensure that Ontario consumers continue to have reliable and affordable electrical energy services.