RECIROCITY: FAIR TRADE OR FREE TRADE?
CHALLENGING AMERICAN ELECTRICITY REGULATION UNDER NAFTA

Hugh Goodday*

ABSTRACT
Restructuring in the American electricity market by the United States Federal Energy Regulatory Commission (FERC) has had a pervasive effect on Canadian utilities and their provincial regulators. This article argues that FERC’s application of Order No. 888 and its market-based rate authorization to Canadian utilities violates the doctrine of national treatment, a core tenet of the North American Free Trade Agreement (NAFTA), and supplants the principle of free trade with the principle of fair trade. Order No. 888 effectively requires Canadian utilities that export electricity across American transmission systems to provide their American trading partners with reciprocal access on comparable terms to transmission systems located in Canada. This has significant implications for both cross-border transactions and transactions wholly within Canada.

This article outlines why NAFTA is the appropriate legal platform for a private party or government to challenge Order No. 888 and why NAFTA may provide a defense against future FERC initiatives that are found to restrict trade, undermine Canadian regulatory sovereignty or impede Canadian policy initiatives. The article concludes that Order No. 888: (i) is inconsistent with FERC’s national treatment obligation under NAFTA article 606(1)(a); (ii) risks violating article 606(2), which demands best efforts to ensure regulatory measures do not disrupt international contracts; and (iii) risks violating article 603(4), which prohibits regulatory measures from impacting industry arrangements within Canada.

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* Hugh Goodday is a third year student at Dalhousie University’s Schulich School of Law. He would like to thank Jane Loyer for her insightful comments and keen editorial eye.
Introduction

The Canadian electricity industry is no longer a collection of vertically integrated, provincially-owned monopolies. The current landscape is a patchwork of regulatory schemes that favour privatization and competition to varying degrees. Surprisingly, the Canadian public interest has not been the driving force behind this change. Instead, Canadian electricity markets, with the exception of Alberta, have restructured primarily in response to American regulation—most notably, the Federal Energy Regulatory Commission’s (FERC) Order No. 888. Order No. 888 and FERC’s discretionary market-based rate authorization have had the combined effect of dictating how transmission rights are granted across Canadian transmission systems.

Under Order No. 888, a Canadian utility can export electricity via an American utility’s transmission facilities only if that Canadian utility, or its affiliate, provides reciprocal service over its transmission facilities located in Canada. Reciprocal service is a key criterion in the market power analysis used by FERC in deciding whether to authorize a utility to sell electricity at competitive market-based rates. To achieve reciprocity across transmission systems and receive market-based rate authorization, Canadian utilities have applied to provincial regulators for approval of Open Access Transmission Tariffs (OATT). An OATT guarantees non-discriminatory access on minimum terms and conditions by a third party to transmission facilities owned by a utility. Thus, an important catalyst for regulatory reform in Canada has been a perceived need to comply with Order No. 888 to maintain access to lucrative American markets.

Insofar as Order No. 888 acts as a trade measure, one must ask if it violates the North American Free Trade Agreement (NAFTA). Professor Owen Saunders, an expert in international trade law and energy law at the University of Calgary, claims that FERC’s insistence on reciprocity violates the doctrine of national treatment, a basic tenet of NAFTA, and replaces the principle of free trade with the principle of fair trade.

Whether or not Order No. 888 is NAFTA-compliant has not been adjudicated and it is not the subject of extensive academic debate. The issue is uniquely important to

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3 Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities, Order No 888 Final Rule, 75 FERC 61,080 (1996) (18 CFR § 35 and § 385) at 156 [Order No 888]. Order No 888 has subsequently been revised by the 890 series of Orders and Order No. 1000. These revisions are not germane to this paper’s thesis.
8 Saunders, supra note 2 at 171.
Canadians because NAFTA may provide the necessary legal foundation to challenge Order No. 888 if it is found to undermine Canadian regulatory sovereignty and impede Canadian policy initiatives. Beyond Order No. 888, NAFTA might be used to oppose future efforts by FERC to integrate North American electricity markets in a manner that is incompatible with Canadian interests.

This paper investigates Professor Saunders’ claim and concludes that Order No. 888 is vulnerable to a NAFTA challenge on more than one ground, the strongest being that mandatory reciprocity is inconsistent with NAFTA’s national treatment obligation. The paper begins with a discussion of Order No. 888, its immediate impact on Canadian utilities, and why this pervasive American regulation may be of concern to Canadian citizens and policymakers. Next, the paper surveys NAFTA provisions relevant to the electricity trade and identifies those with which Order No. 888 may fail to comply. A detailed discussion of national treatment and reciprocity highlights the inconsistency between these two principles that provides the soundest platform for a NAFTA challenge. The paper then moves from a high-level analysis of reciprocity and national treatment to discuss the concept of “comparability” and what reciprocity means in practice. Finally, the dispute resolution mechanisms available under NAFTA are explored and the question of NAFTA paramountcy over domestic law is addressed.

**Deregulation in the United States and Canadian Electricity Exports**

On April 24, 1996, FERC issued Order No. 888, containing its Final Rule titled *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities.*¹⁰ The Order is a comprehensive effort to encourage competition in America’s electricity markets. Its most striking requirement is that American public utilities file a transmission tariff with FERC that is consistent with the pro-forma OATT set forth in Order No. 888.¹¹ Prior to Order No. 888, FERC viewed discriminatory transmission service as the foremost barrier to fair competition.¹² Ordering utilities to implement a tariff that is consistent with the pro-forma OATT guaranteed that transmission systems could no longer be controlled by vertically integrated utilities and that service would be provided to all generators and customers on fair terms.

FERC’s jurisdiction is limited to public utilities engaged in interstate commerce. As a creation of Congress, its jurisdiction flows from article 1(8)(3) of the United States Constitution, which gives Congress jurisdiction over commerce “among the several states.”¹³ FERC’s enabling statute, the *Federal Power Act* (FPA), establishes that FERC’s authority to impose an OATT extends only to public utilities that own, control, or operate facilities used for transmitting electric energy in interstate commerce.¹⁴ This narrow scope of regulatory authority threatens the viability of a wide-open electricity market, as a truly open market requires non-public¹⁵ and foreign utilities to adopt the

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¹⁰ *Order No 888*, supra note 3 at 1.
¹¹ *Ibid* at Appendix D.
¹² *Ibid* at 3.
¹³ US Const art I, § 8, cl 3.
¹⁴ *Federal Power Act*, 16 USC 12 § 824(b) (1920) [FPA].
pro-forma OATT. FERC’s solution to this dilemma was two-fold. First, FERC included a mandatory reciprocity provision in its pro-forma OATT. Second, FERC relied on its authority to remedy undue discrimination under section 205 of the FPA and effectively made the OATT a prerequisite to selling power at market-based rates.

Section 6 of the pro-forma OATT is the reciprocity provision. Under section 6, access to a utility’s transmission facilities is contingent on the customer agreeing to provide reciprocal access to its own transmission facilities or those belonging to an affiliate. Simply put, those who want access must give it, and the result is that competition among generators and customers is simultaneously achieved in two service areas.

Section 6 applies to any “Eligible Customer,” a term defined broadly enough to include Canadian utilities. FERC expressly confirmed the applicability of section 6 to foreign utilities in Order No. 888:

To the extent that [a foreign utility] obtains access...we emphasize that it would be subject to all of the terms and conditions of the applicable open access tariff, including the requirement that it provide reciprocal service.

The effect of reciprocity is far-reaching. A Canadian or non-public American utility must file an OATT (or enter a bilateral agreement that provides for reciprocal service on comparable terms) prior to trading with an American public utility, at which point the reciprocity provision imposes that same requirement on all of the Canadian or non-public American utility’s other clients.

In addition to making reciprocity a prerequisite to accessing a public utility’s transmission system, FERC made the pro-forma OATT an essential component of its market power analysis and, therefore, a prerequisite to selling electricity at market-based rates. The FPA requires public utilities to charge “just and reasonable rates.” In Elizabethtown Gas Co v FERC, FERC asserted that market-based prices, in lieu of cost-of-service regulation, would achieve a just and reasonable result in a competitive market.

The ability to sell electricity at a market price means that a utility can exploit short-term price fluctuations across markets, buying low and selling high. Market-based rates are an attractive profit-making opportunity for Canadian utilities that may otherwise be subject to strict cost-of-service regulation in their domestic markets.

American and Canadian electricity markets are highly interdependent, and the two countries have enjoyed a mutually beneficial trade relationship for many decades. The non-durable nature of electricity means that Canada’s excess of stored hydropower is critical to the functioning of American power grids during periods of increased demand. Reciprocal peak seasons, such as summer in New York and winter in Quebec, and extensive north-south electricity infrastructure are factors that bolster a meaningful

16 Order No 888, supra note 3 at Appendix D at 25.
17 FPA, supra note 14 § 824-d.
18 Order No 888, supra note 3 Appendix D at 25.
19 Sanderson, supra note 8 at 5.
20 Order No 888, supra note 3 Appendix D at 10.
21 Ibid at 156.
22 FPA, supra note 14, § 824-d(a).
25 Ibid.
electricity trade. Canadian utilities typically export only 5–10% of generated electricity.  

However, if that small amount of electricity is sold when demand is high, it can represent a significant portion of annual revenue. In 2001, during the California deregulation crisis, electricity sales from British Columbia to California accounted for 69% of BC Hydro’s total revenue, compared to a more typical range of 10–30% among provinces that share a border with the United States. These figures indicate that exporting electricity at market-based rates provides a reliable revenue stream and allows Canadian utilities to capitalize on extraordinary short-term opportunities.

Before a Canadian utility is authorized to sell at market-based rates, it must first satisfy FERC’s market power analysis. The framework for the analysis was first set out in *Heartland Energy Services Inc (Heartland).*  

The analysis requires proof that neither the applicant nor any of its affiliates (i) have transmission or generation dominance, (ii) are capable of erecting barriers to market entry, or (iii) are guilty of affiliate abuse or reciprocal dealing. FERC has deemed the presence of an OATT integral to mitigating transmission dominance.

On October 3, 1995, prior to issuing Order No. 888, FERC denied Energy Alliance Partnership’s (EAP) application to sell at market-based rates. FERC reasoned that EAP failed to prove that Hydro-Québec, owner of a one-third interest in EAP, had mitigated its transmission and generation dominance in Quebec. Hydro-Québec did not have an OATT. EAP protested, arguing that Hydro-Québec’s generation and transmission facilities were irrelevant to FERC’s analysis.

EAP further argued that an OATT was not necessary because a utility seeking access to Hydro-Québec’s transmission facilities could negotiate a transmission agreement according to Canadian law. FERC was not convinced: it needed to be certain that EAP competitors who wished to locate in Canada could access Hydro-Québec’s transmission facilities on non-discriminatory terms.

EAP’s failed application is significant in that it demonstrates FERC’s willingness to impinge on the jurisdiction of Canadian regulators. FERC acted as if it had the right to compel Canadian utilities to pressure their provincial regulators into approving an OATT, thereby guaranteeing reciprocal access for transmission-owning American utilities and simultaneously mitigating vertical market dominance in Canada. The alternative to an OATT receiving regulatory approval was for FERC to place sanctions on investments made by Canadian utilities in the United States.

FERC’s refusal to approve market-based rate applications by the British Columbia Power Exchange Corporation (PowerEx) and Ontario Hydro Interconnected Markets

26 Ibid.
29 Ibid.
31 Ibid at 61,028.
32 Ibid at 61,025.
33 Ibid.
34 Ibid.
35 Ibid.
Inc. (Ontario Interconnected) further exemplify its insistence that Canadian utilities have an OATT. On January 15, 1997, PowerEx, a power marketing affiliate of provincially-owned BC Hydro, had its application denied because FERC found BC Hydro’s transmission tariff to be unsatisfactory as judged against the pro-forma OATT. On March 31, 1997, Ontario Interconnected, a subsidiary of Ontario Hydro, had its application denied because Ontario Hydro chose not to include a reciprocity provision in its proposed transmission tariff. In the PowerEx ruling, FERC sought to persuade Canadian regulators that it was not acting outside its jurisdiction:

[T]he Commission seeks to assure reciprocal service into and out of Canada when Canadian entities seek access to US markets, but the Commission is not seeking to open intra-Canada electric markets through the imposition of open access tariffs for transactions wholly within Canada.

Despite FERC’s stated intention, the inevitable effect of mandating reciprocity was to capture transactions wholly within Canada. The most glaring example of this is the Nova Scotia Utility and Review Board’s approval of an OATT for Nova Scotia Power Incorporated (NSPI). The Utility and Review Board cited the following claim by NSPI as a justification for its approval:

The [New Brunswick] Power OATT contains a reciprocity provision that would deny NSPI and its affiliates access to the New Brunswick Transmission System if Nova Scotia does not have a comparable OATT. [...] Losing access to NB Power’s transmission would decrease the value of our exports and increase the cost of our imports, as we would be required to complete these transactions at the border between New Brunswick and Nova Scotia. This impact to costs…puts upward pressure on the rates payable by all customers of NSPI.

By February 2009, all Canadian electric utilities, with the exception of Newfoundland and Labrador Hydro, had filed and received approval of OATTs nearly identical to FERC’s pro-forma OATT. On June 21, 2007, Order No. 697 codified the Heartland market power analysis in Market-Based Rates for Wholesale Sales of Electric Energy, Capacity and Ancillary Services by Public Utilities. The pro-forma OATT and its reciprocity provision remain an integral part of the transmission market power analysis.

The proliferation of OATTs across Canada is evidence that a perceived need to comply with FERC’s reciprocity requirement to satisfy the market power analysis has been the impetus for opening provincial markets. It is only a perceived need to comply

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38 PowerEx, supra note 36 at 61,030.
40 Ibid at para 7.
41 Blue, supra note 5 at 355.
43 Ibid at para 21.
because compliance is voluntary under the law. Reciprocity is not a requirement of international trade law and FERC does not have the authority to dictate the structure of Canadian electricity markets, as international trade is not interstate trade.

**Canadian Concerns**

This paper is not a treatise on the merits or demerits of a deregulated electricity industry. Nevertheless, it is important to acknowledge the issues that arise when the Canadian electricity industry is captured by, and restructured according to, regulations designed for the United States. These same issues may provide the incentive for challenging Order No. 888 under NAFTA.

Firstly, the benefits of regulation are lost in a deregulated market. Regulation seeks to guarantee the security of future supply, low and stable prices, equitable electricity distribution, and environmental impact monitoring. Decisions are guided by the public interest and not market forces. Price, supply, and environmental concerns fuelled deregulation in the US, whereas in Canada none of these factors weigh heavily in favour of deregulation. Conversely, the economies of scale that result from vertically integrated monopolies have typically been Canada’s competitive advantage.

Secondly, security of price and supply may be lost in a competitive market. Competing locally and internationally for electricity may drive prices up and could result in inequitable distribution. Shortsighted investment targets may take precedence over long-term supply objectives. The deregulation crisis in California is evidence that legislators may not know what a deregulated electricity market should look like or how it ought to work. Ontario suffered a similar experience in 2002. The provincial government froze prices after poorly designed price controls led to volatile rates and consumer backlash, with elements of price smoothing and subsidy remaining through to 2008. Simply put, deregulation is unproven and there is no consensus that it is in the best interest of Canadians.

Finally, the continued emphasis on north-south transactions may impede the development of an east-west national energy strategy. Distressingly, Alberta and Nova Scotia continue to import and burn expensive and environmentally destructive fossil fuels while an abundance of inexpensive and clean hydropower exists in neighbouring provinces. A Canadian energy strategy may be thwarted if provincial markets are flooded with inexpensive American electricity generated by coal and natural gas. A strong Canadian dollar and the shale gas glut in the United States make this a foreseeable reality.

Tailoring the electricity industry to appease FERC’s standards may not be in the best interests of Canadians. Allowing FERC to strong-arm the imposition of OATTs in each exporting province may not be beneficial in the long run. Of course, a strong argument can be made in favour of both OATTs and a seamless North American elec-

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44 Cohen, “From Public Good to Private Exploitation”, supra note 7 at 138.
46 Blue, supra note 5 at 343.
47 Carr, supra note 27 at 7; Blake, Cassels & Graydon LLP, “Overview of Electricity Regulation in Canada” (March 2008), online: Blake, Cassels & Graydon LLP <http://www.blakes.com> at 8 (accessed 24 March, 2013) [Blakes].
48 Cohen, “From Public Good to Private Exploitation”, supra note 7 at 107.
tricity grid. However, in the event that deregulation pursuant to FERC regulations becomes problematic, NAFTA is a viable platform on which to bring an action.

**NAFTA: A Shield**

**Threshold Issues: NAFTA and Electricity**

The North American Free Trade Agreement came into force on January 1, 1994.49 The treaty governs trade relations between Canada, the United States and Mexico, and represents a sweeping commitment to trade liberalization between the three parties. Whether electricity exports fall within the scope of NAFTA, and whether electricity is a good or a service, are two threshold issues that must be addressed before delving into the particulars of a potential NAFTA challenge.

Chapter Six: Energy and Basic Petrochemicals is the starting point for determining whether electricity exports are protected under NAFTA. Article 602 sets out the scope and coverage of Chapter Six.50 Article 602(2) incorporates classification 2716 of the World Customs Organization’s Harmonized Commodity and Description Coding System.51 Classification 2716 is the standardized customs code for “electrical energy.”52 Article 602(1) states that Chapter Six applies to measures relating to both investment and the cross-border trade in services associated with electrical energy.53 Thus, electricity exports and related investments are within the scope of NAFTA.

Historically, there has been no distinction between electricity as a good or as a service.54 Consequently, the precise definition of goods and services within the electricity sector has yet to be determined.55 This consideration is relevant because it will dictate how electricity is treated under NAFTA’s dispute resolution provisions. On one hand, electricity is intangible, indivisible and consumption is usually simultaneous with production, qualities suggesting that it is a service.56 On the other hand, Chapter Six is located in Part Two: Trade in Goods. Chapter Three: National Treatment and Market Access for Goods, also located in Part Two, applies to all items covered by the World Customs Organization’s harmonized tariff schedule referred to above, which includes electrical energy.57 These indicia suggest that electricity is more likely to be treated as a good under NAFTA.58 This paper proceeds under the assumption that electricity is a good.

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50 Ibid, art 602.
51 Ibid.
53 NAFTA, supra note 49, art 602.
54 Horlick & Schuchhardt, supra note 52 at 3.
55 Ibid.
57 NAFTA, supra note 49, art 300.
58 Howse & Heckman, supra note 56 at 126.
NAFTA and Order No. 888

Professor Saunders correctly acknowledged that Order No. 888 is most susceptible to a NAFTA challenge on the grounds that its reciprocity requirement is inconsistent with national treatment. Article 102 sets out the key objectives and defining principles of NAFTA, and article 102(1) identifies national treatment as one of those principles. Article 301(1) refers to article III of the General Agreement on Tariffs and Trade (GATT) for the definition of national treatment. GATT article III(2) states: “national treatment shall mean…treatment no less favourable than the most favourable treatment accorded …to any like, directly competitive or substitutable goods.” National treatment can be succinctly stated as the principle that a NAFTA party will adopt its own commercial rules and apply them equally to domestic and foreign companies. Reciprocity means that companies must receive the same treatment in a foreign country as in their home country. Reciprocity is not a recognized trade principle under NAFTA.

Articles 606 and 609 capture Order No. 888. Article 606(1)(a) affirms that energy regulatory measures are subject to national treatment. Article 609 defines “energy regulatory measure” as “any measure by federal or sub-federal entities that directly affects the transportation, transmission or distribution, purchase or sale, of an energy or basic petrochemical good.” Article 201: Definitions of General Application defines government “measure” as “any law, regulation, procedure, requirement or practice.” The Final Rule in Order No. 888 is a regulation made by a federal entity that directly affects the transmission of electrical energy. Order No. 888 is therefore subject to NAFTA’s national treatment provisions.

Before embarking on a detailed analysis of national treatment and reciprocity, it is important to identify other NAFTA provisions that may be engaged by Order No. 888. Article 606(2) is relevant to Order No. 888 as it obliges each party to “seek to ensure” that the application of any energy regulatory measure avoids disrupting contractual relationships “to the maximum extent practicable.” Although the language in the provision does not create an affirmative legal obligation, it does compel FERC to make best efforts to apply Order No. 888 in a manner that is least disruptive to existing contracts. In 1997, Ontario Hydro and FERC became embroiled in a bitter dispute that had substantial contractual implications. Ontario Hydro could have invoked article 606(2), but did not. This dispute is discussed in greater detail below.

Finally, article 603(4) states that any party that adopts a restriction on imports shall “consult with a view to avoiding undue interference with or distortion of pricing, mar-

59 Saunders, supra note 2 at 171.
60 NAFTA, supra note 49, art 102.
61 Ibid, art 301.
62 General Agreement on Tariffs and Trade, 30 October 1947, 58 UNTS 187, Can TS 1947 No 27 art III(2) (entered into force 1 January 1948) [GATT 1947].
63 Carr, supra note 27 at 8.
64 Ibid.
65 NAFTA, supra note 49, art 606.
66 Ibid, art 609.
67 Ibid, art 201.
68 Ibid, art 606.
marketing and distribution arrangements in another Party.”

Article 609 defines “restrictions” as “any limitation, whether made effective through quotas, licenses, permits, minimum or maximum price requirements or any other means.”

FERC’s insistence that Canadian utilities adopt an OATT as a condition of selling at market-based rates across American transmission facilities could be construed as a limitation that interferes with pricing, marketing and distribution arrangements in Canada. The presence of an OATT changes the dynamic of intra-provincial and interprovincial electricity transmission. Provincial utilities need to adjust pricing and distribution arrangements to accommodate independent power producers and utilities from neighbouring jurisdictions. If reciprocity is viewed as a trade restriction, FERC is obliged to consult with Canadian utilities and regulators to avoid undue interference with pricing, marketing and distribution in and among the provinces. FERC solicits comments from stakeholders prior to passing regulations, but there is no evidence that meaningful consultations have ever taken place between FERC and provincial regulators.

On August 3, 1995, Canada’s Minister of Economic and Trade Policy, Brian Morrisey, wrote a letter to FERC in response to its Notice of Proposed Rulemaking pertaining to Order No. 888. The letter contained the following comments:

> The requirements for comparability and reciprocity in the proposed rulemaking should be implemented in a manner that is sufficiently flexible to permit Canadian utilities to have fair and competitive access in the U.S. electricity market. As you move to implement the proposed rulemaking, we expect that Canadian entities will continue to be allowed access to U.S. electricity markets and all aspects of the U.S. regulatory process in keeping with our mutual obligations under the North American Free Trade Agreement.

Minister Morrisey’s letter lends credibility to the prospect of using NAFTA as the legal foundation to challenge FERC’s pervasive regulation. FERC did not publish a reply to the Minister and made no reference to NAFTA in its Final Rule, inviting speculation as to whether it appreciated the tenuous position of Order No. 888 vis-à-vis NAFTA.

**National Treatment and Reciprocity**

National treatment and reciprocity are two distinct concepts. As stated above, national treatment means that a party to NAFTA will adopt its own commercial rules and apply them equally to domestic and foreign companies. Reciprocity means that companies must be treated the same in the foreign country as they are in their home country. Theoretically, national treatment would allow Canadian utilities to transmit energy on American transmission systems because that is what American utilities are allowed to do. Under national treatment, the only grounds for complaint that an Ameri-
can utility or FERC might have is if an American company was not treated the same as a Canadian company when doing business in Canada.\(^7^6\) This simplification highlights an important difference between national treatment and reciprocity: national treatment focuses on domestic law applied domestically, while reciprocity focuses on domestic law applied internationally. Put another way, national treatment is concerned with the treatment of foreign companies operating under domestic law, while reciprocity is concerned with how closely foreign law mirrors domestic law and how that affects the treatment of domestic companies operating abroad. Arguably, the drafters of NAFTA implicitly rejected reciprocity in favour of national treatment because reciprocity is unworkable where regulatory asymmetry exists—whose laws should be reciprocal to whose?\(^7^7\) However, the fact remains that these two concepts have not been tested against each other before a court or arbitration panel, and there is very little jurisprudence on either principle standing alone.

FERC is adamant that Order No. 888, including section 6 of the pro-forma OATT, applies equally to foreign utilities.\(^7^8\) FERC insists that competition is best served by placing the same reasonable and fair conditions on domestic and foreign utilities’ use of transmission services.\(^7^9\) FERC’s position is problematic because NAFTA does not mandate equal treatment, only national treatment. In 1989, a GATT arbitration panel addressed national treatment in the context of a domestic law being applied equally to foreign companies:

Formally equal treatment to domestic and foreign products may not satisfy the national treatment obligation. *De facto* discrimination may be present where the application of formally identical legal provisions results, in practice, in less favourable treatment of imports. What must be provided is effective equality of opportunities for imported products.\(^8^0\)

Equal application of Order No. 888 results in *de facto* discrimination against Canadian utilities. It is discriminatory to place the same conditions on both American public utilities and Canadian utilities, then bar Canadian utilities from competing in American markets when those conditions are not satisfied. The regulatory diversity that exists between Canadian provinces and American states makes the equal application of regulatory measures unworkable. This is especially true in the increasingly complex electricity industry.

Logic suggests that reciprocity is inconsistent with national treatment. To date, the most informative jurisprudence is a dispute between Ontario Hydro and FERC that saw Ontario Hydro vigorously oppose the legality of reciprocity. On May 2, 1997, Ontario Hydro submitted a motion to FERC requesting that enforcement of the reciprocity provision against transmission-owning foreign utilities be stayed.\(^8^1\) The stay would allow

\(^{7^6}\) *Ibid.*  
\(^{7^7}\) Sanderson, *supra* note 8 at 11.  
\(^{7^8}\) Order No 888, *supra* note 3 at 156.  
\(^{7^9}\) *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities, Order Denying Motion For Stay,* 79 FERC 61,367 at 61,383 (1997), online: FERC eLibrary <https://www.ferc.gov/docsfiling/elibrary.asp> [FERC Order Denying Motion].  
\(^{8^1}\) Ontario Hydro Motion, *supra* note 69.
Ontario Hydro to fulfil its existing export obligations while awaiting the outcome of a judicial review of the provision.\textsuperscript{82} In its brief, Ontario Hydro argued that reciprocity would void or render voidable $235,000,000 worth of export contracts.\textsuperscript{83} Ontario Hydro stated that it was unable to provide reciprocal open access until the province of Ontario had solved the complex financial and technical issues associated with restructuring the electricity industry.\textsuperscript{84} In the meantime, Ontario Hydro would be forced to sell its power at cost-of-service rates. Ontario Hydro argued that FERC had confused reciprocity with national treatment.\textsuperscript{85} Ontario Hydro believed that national treatment meant that it should receive the same transmission grid access as American utilities, regardless of transmission arrangements in Ontario.\textsuperscript{86} FERC responded by reiterating comments made in Order No. 888-A, a rehearing to clarify certain terms and conditions contained in the initial Order:

Ontario Hydro is in plain error in arguing that application of the reciprocity condition to foreign entities would result in less favourable treatment than that accorded to United States citizens. Ontario Hydro’s reading of NAFTA would place transmission-owning Canadian entities in a better position than any domestic entity; not only would Canadian entities not be subject to the open access requirement, but...they would be able to use the open access tariffs we have mandated without providing any reciprocal service. Ontario Hydro has cited no precedent demonstrating that NAFTA imposes such an unreasonable requirement.\textsuperscript{87}

Judging from this statement, Ontario Hydro is correct and FERC has confused reciprocity with national treatment. National treatment is not concerned with equal application of domestic law in foreign jurisdictions—that would be reciprocity. National treatment entails that foreign companies file a pro-forma OATT with FERC to prove that they mitigated transmission market dominance \textit{in} the United States.

The application of Order No. 888 to foreign utilities must not exceed the scope of its application to American public utilities because this would likely result in less favourable treatment contrary to NAFTA article 606(1)(a). Order No. 888 applies to public utilities that “own, control, or operate facilities used for transmitting electric energy in interstate commerce.”\textsuperscript{88} Order No. 888 extends only to facilities used in interstate commerce and not international commerce. This interpretation is supported by FERC’s jurisdiction, discussed above, which is limited to commerce among the American states. Jurisdiction over electricity imports and exports belongs to the Department of Energy.\textsuperscript{89} Canadian utilities must adhere to Order No. 888 only as it applies to transmission facilities that they own, control or operate in the United States and are engaged in interstate commerce. Transmission dominance in Canada is an immaterial consideration.

\textsuperscript{82} Ibid.
\textsuperscript{83} Ibid.
\textsuperscript{84} Ibid.
\textsuperscript{85} Ibid.
\textsuperscript{86} Ibid.
\textsuperscript{87} Ibid.
\textsuperscript{89} Order No 888, supra note 3 at 4.
\textsuperscript{90} Department of Energy Organization Act, 42 USC 84 § 7101 (1977) §§ 301(b), 402(f).
In its motion, Ontario Hydro complained that the reciprocity requirement would disrupt longstanding and mutually beneficial trade relationships, including those with American border utilities.\footnote{Ontario Hydro Motion, supra note 69.} FERC stated that the reciprocity provision does not apply to Canadian utilities trading with American border utilities, so long as the power is resold by the border utility to a U.S. customer that has “no affiliation with, and no contractual or other tie to, the Canadian utility.”\footnote{Order Clarifying Order No 888 Reciprocity Condition and Requesting Additional Information, 79 FERC 61,182 at 61,186 (16 May 1997), online: FERC eLibrary <https://www.ferc.gov/docs-filing/elibrary.asp>.} Ontario Hydro had entered into 40 contracts with American buyers that were not border utilities.\footnote{Ontario Hydro Motion, supra note 69.} The common practice among Canadian exporters was to sell power at the border, buy it back from the border utility, and then resell it to the final customer on terms previously negotiated between that customer and the Canadian utility.\footnote{Re RM94-7-005 Response of Ontario Hydro to Commission Order Clarifying Order No 888 Reciprocity Condition and Request for Information, (23 May 1997), online: FERC eLibrary <https://www.ferc.gov/docs-filing/elibrary.asp>.} FERC’s position implies that Canadian utilities must deal only with a select group of utilities that own transmission interties at the Canadian border. If this were the case, Canadian utilities would be unable to sell to a thriving collection of power marketers seeking low-cost, reliable sources of electricity.\footnote{Ibid.} Such an arrangement would ignore the reality of electricity exports and significantly restrict trade. Furthermore, stifling Canadian exports at the border defeats the overarching goals of increased competition: low prices and security of supply.

Surprisingly, during the course of its dispute with FERC, Ontario Hydro chose not to invoke NAFTA article 606(2). Article 606(2) obliges FERC to take steps towards ensuring that Order No. 888 avoids disrupting contractual relationships to the maximum extent practicable.\footnote{NAFTA, supra note 49, art 606.} There is no evidence that FERC made any efforts to mitigate the effect of Order No. 888 on pre-existing contracts to which Canadian utilities were privy.

On June 20, 1997, FERC denied the motion.\footnote{FERC Order Denying Motion, supra note 79 at 61,367.} Shortly thereafter, Ontario Hydro abandoned its pursuit of judicial review and began an aggressive restructuring of the Ontario electricity market. In its decision, FERC held that Ontario Hydro “cannot at the same time claim the benefits of open access transmission and object to one of the provisions [reciprocity] the Commission included in Order No. 888 to ensure that competition takes place on fair terms.”\footnote{Ibid at 61,376.} FERC emphasized that Canadian utilities with transmission dominance in Canada trade on preferential terms.\footnote{Ibid at 61,381.} While this may be true, the preferential terms are the result of provincial regulatory schemes designed to accommodate political, economic, environmental, and geographic considerations specific to Canada. FERC cannot justify placing conditions on Canadian electricity exports solely because Canadian regulators are content with the status quo or are proceeding towards a restructured market on their own terms.
In 2002, FERC proposed to further integrate Canadian and American markets by way of a Standard Market Design.99 Michael Kergin, the Canadian Ambassador to the United States, wrote a letter to Pat Wood, Chairman of FERC, which said:

[T]he imposition of a reciprocity requirement across international borders …is inconsistent with the national treatment provisions of NAFTA. [...] National treatment does not permit the treatment of imported goods, including the transportation and distribution of those goods in domestic markets, to be conditioned on how the owners of such goods behave or are regulated in non-domestic markets. [...] [R]eciprocity rules could have the effect of erecting additional barriers to trade.100

Ambassador Kergin understood that restricting trade on the basis of how Canadian utilities are organized in Canada is unfounded in law. Non-reciprocity is the natural result of regulatory diversity and it is entirely legal under NAFTA.101 If American utilities are at a competitive disadvantage, it is because FERC has forced them to abandon their economies of scale. Contrary to both the letter and spirit of NAFTA, FERC prefers reciprocity to national treatment, and fair trade to free trade.

Reciprocity Applied: Comparability

Conceptually, reciprocity appears to be inconsistent with national treatment. Is this still the case when reciprocity is put into practice? When can reciprocity exist? What standard must Canadian utilities meet to satisfy section 6 of the pro-forma OATT? Regulating the electricity industry is as much an art as it is a science.102

Prior to Order No. 888, market-based rate authorizations by FERC proceeded on the grounds that transmission market power is mitigated when utilities provided each other with “comparable transmission services.”103 This approach was continued in section 6 of the pro-forma OATT: “[a] Transmission Customer receiving transmission service under this Tariff agrees to provide comparable transmission service to the Transmission Provider on similar terms and conditions.”104 In both the EAP and PowerEx decisions, FERC held that reciprocity would be determined on a case-by-case evaluation of what tariffs meet basic comparability standards, as judged against the pro-forma OATT.105

Comparability is relevant to deciding whether or not Order No. 888 violates NAFTA for two distinct reasons. First, a flexible, case-by-case approach to reciprocity may bring FERC closer to complying with its national treatment obligation under NAFTA. Second, applying a flexible standard to non-public American utilities makes it

100 Letter from Ambassador Michael Kergin to FERC Chairman Pat Wood in regards to Standard Market Design Rules, FERC Docket RM01-12-000 (6 December 2002), online: FERC eLibrary <https://www.ferc.gov/docs-filing/elibrary.asp>.
101 Howse & Heckman, supra note 56 at 130.
102 Sanderson, supra note 8 at 11.
103 E/ AP, supra note 4 at 61,029.
104 Order No 888, supra note 3 Appendix D at 25 [emphasis added].
105 PowerEx, supra note 36 at 61,030.
difficult to identify the most favourable treatment accorded to domestic companies. National treatment requires that a foreign company be treated no less favourably than the most favourably treated domestic company.\textsuperscript{106} Therefore, a foreign company must know with certainty what the most favourable treatment is.

The authority on comparable transmission service is \textit{Consumers Energy v FERC (Consumers Energy)}, a case decided on May 14, 2004 by the United States Court of Appeals for the District of Columbia Circuit.\textsuperscript{107} The central issue was whether Ontario’s Independent Electricity System Operator (IESO) provided comparable transmission service to Consumers Energy (Consumers), a public utility serving Michigan. Consumers brought the action against FERC upon learning that FERC authorized Ontario Energy Trading International Corporation (Ontario Energy)\textsuperscript{108} to sell at market-based rates.\textsuperscript{109} Consumers’ position was that the IESO did not provide comparable transmission services and so Ontario Energy’s application must be denied.\textsuperscript{110}

IESO is a creation of the functional unbundling that took place pursuant to Ontario’s \textit{Electricity Act} of 1998.\textsuperscript{111} The provincial government’s free-market ideological tenor under Premier Mike Harris influenced the \textit{Electricity Act}, but it can also be characterized as Ontario’s response to Ontario Hydro’s failure to have the enforcement of Order No. 888 stayed.\textsuperscript{112} The IESO controls the bulk and wholesale electricity market. It operates the market on a bidding system in which power is sold into the market at point A and repurchased from the market at point B at a market price.\textsuperscript{113} The IESO adjusts the market price depending on congestion at interties.\textsuperscript{114} Consumers argued that under the pro-forma tariff, utilities must offer point-to-point transmission at a definite price regardless of congestion.\textsuperscript{115} FERC argued that non-discriminatory access and the availability of instruments to hedge against price risk resulted in a comparable service from the IESO.\textsuperscript{116} Consumers countered:

\begin{quote}
Either the Commission believes its standards of market power mitigation and open access transmission service are the right standards, or it doesn’t […] it should not matter in that context that the affected entities at issue are Canadian.\textsuperscript{117}
\end{quote}

The Court of Appeals endorsed FERC’s position and stated:

\begin{quote}
We think it reasonable for the Commission to acknowledge the reality of an international border in deciding whether to insist on compliance with the minutiae of its regulatory requirements; it was certainly open to FERC to
\end{quote}

\textsuperscript{106} \textit{GATT} 1947, \textit{supra} note 62.
\textsuperscript{107} \textit{Consumers Energy Company v Federal Energy Regulatory Commission}, 367 F 3d 915 (DC Cir 2004) [Consumers].
\textsuperscript{108} Ontario Energy and the IESO are affiliates.
\textsuperscript{109} \textit{Consumers}, \textit{supra} note 107 at 3.
\textsuperscript{110} \textit{Ibid}.
\textsuperscript{111} \textit{Blakes}, \textit{supra} note 47 at 8.
\textsuperscript{112} \textit{Consumers}, \textit{supra} note 107 at 5.
\textsuperscript{113} \textit{Ibid} at 6.
\textsuperscript{114} \textit{Ibid} at 7.
\textsuperscript{115} \textit{Ibid} at 11.
\textsuperscript{116} \textit{Ibid} at 13.
\textsuperscript{117} \textit{Ibid} at 15.
decide [on] a flexible approach requiring comparability on a case-by-case basis...\textsuperscript{118}

This decision is significant because both FERC and the Court endorse a flexible application of the reciprocity requirement to foreign utilities. Patricia Paredes, writing for the George Washington Law Review, applauded FERC’s recognition of Canadian sovereignty and went so far as to state: “FERC has reasonably concluded that it cannot dictate to foreign entities how to conduct their transmission systems.”\textsuperscript{119} This is not entirely accurate: although FERC will not prescribe that a Canadian utility comply with Order No. 888 “to the minutiae,” it still demands some degree of restructuring to meet the vague comparability standard. Consumers Energy suggests that comparable transmission service requires a restructured, unbundled industry in which non-discriminatory access is provided pursuant to legislation like Ontario’s Electricity Act. FERC violates the principle of national treatment by requiring positive action by Canadian regulators to satisfy its comparability threshold.

A second consideration that is relevant to NAFTA is the application of comparability to non-public American utilities. National treatment dictates that a foreign company must receive no less favourable treatment than the best treatment enjoyed by a domestic company.\textsuperscript{120} Consumers Energy stands for the principle that a case-by-case approach to comparability is applied to utilities outside FERC’s jurisdiction—foreign and non-public. In the absence of strict standards, it is impossible to gauge whether a Canadian utility is receiving the most favourable treatment accorded to a domestic utility. Employing a flexible approach to how a non-public American utility mitigates transmission market power may result in a domestic company transacting on more favourable terms than its Canadian competitor. A Canadian utility may be forced to take additional, onerous steps to mitigate transmission dominance, resulting in less favourable treatment than domestic companies that violates NAFTA.

FERC’s case-by-case approach to comparability allows it to pick and choose which regulatory schemes appease its vision of a seamless and competitive North American energy market. Comparability, although applied flexibly, does not detract from a strict insistence on reciprocity. Furthermore, a flexible standard risks violating national treatment in that it causes the most favourable domestic treatment to become unknowable. Regardless of how reciprocity is interpreted and applied, conditions are still placed on Canadian electricity exports and Order No. 888 moves no closer to complying with NAFTA.

**Dispute Resolution Under NAFTA**

Dispute resolution under NAFTA varies depending on who brings the challenge. If the Canadian federal government chooses to act, perhaps through the Federal Minister of Trade or the National Energy Board, the challenge will proceed pursuant to Chapter Twenty: Institutional Arrangements and Dispute Settlement Procedures. If a corporate entity, for example a Canadian utility or its affiliate, chooses to proceed against FERC,

\textsuperscript{118} Ibid.


\textsuperscript{120} GATT 1947, supra note 62.
the matter will be handled under Chapter Eleven, Section B: Settlement of Disputes Between a Party and an Investor of Another Party. Both of these avenues are viable options in the context of electricity exports and Order No. 888.

Chapter Twenty provides for government-to-government consultation. The dispute settlement provisions in Chapter Twenty are engaged when a party considers that an actual or proposed measure of another party is inconsistent with the obligations of NAFTA or causes impairment in the sense of Annex 2004. Annex 2004 includes any impairment to a benefit that a party could reasonably expect to accrue by way of investment under Chapter Six. A representative of the Canadian federal government can therefore plead that Order No. 888 is inconsistent with the national treatment obligation under article 606(1)(a) and impairs investment opportunities associated with the trade in electricity. Once a prima facie claim has been established, articles 2006, 2007 and 2008 dictate a three-stage process involving consultation, mediation and arbitration. Each stage proceeds under the supervision of the Free Trade Commission. The objective at each stage is to reach an agreement by which the discriminatory measure or impairment is removed, or compensation is provided. If no settlement is reached, an arbitration panel will make an order against the offending party. If an order is made and not complied with, the Canadian government is authorized to impose retaliatory trade measures.

Chapter Eleven: Investments has its own procedure for dispute resolution. Section B of Chapter Eleven provides for investor–state arbitration. Article 1116 and article 1117 allow a natural person or corporation to submit to arbitration a claim that the other party has breached a provision of Section A and caused harm to its investment. “Investment” is defined broadly enough to capture the activities of Canadian utilities affiliated with power marketers, distributors or companies that own transmission or generation facilities in the United States. This is a powerful tool for Canadian utilities seeking to protect their American investments from discrimination. National treatment applies to investments under article 1102(1):

Each Party shall accord to investors of another Party treatment no less favourable than that it accords, in like circumstances, to its own investors with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments.

127 Ibid.
129 NAFTA, supra note 49 arts 1116, 1117.
130 Ibid, art 1139.
131 Ibid, art 1102.
Under this provision, Hydro-Québec could have challenged FERC’s denial of the EAP market-based rate application. EAP made efforts to prove to FERC that it mitigated both transmission and generation dominance, and that it would deal only at arm’s length with Hydro-Québec, the owner of a one-third interest in EAP.\(^\text{132}\) FERC denied EAP’s application because of how Hydro-Québec was organized in Canada. Hydro-Québec might have succeeded in arguing under article 1102(1) that FERC’s decision, which harmed Hydro-Québec’s investment by placing EAP at a competitive disadvantage, would have been different had all of EAP’s owners been American.

Procedurally, Chapter Eleven empowers a panel of three arbitrators to rule on whether the United States government has acted inconsistently with its obligations under Section A of Chapter Eleven.\(^\text{133}\) The panel cannot strike down NAFTA-infringing measures, but it can deter future breaches by awarding damages and costs.\(^\text{134}\) If the panel’s order is not complied with, government-to-government consultations are initiated under Chapter Twenty.\(^\text{135}\)

**Paramountcy: NAFTA and FERC Regulations**

If Order No. 888 is argued to contravene NAFTA, jurisprudence suggests that a NAFTA arbitration panel would hold NAFTA provisions to be paramount over domestic law in the event of an inconsistency. In the Matter of Cross-Border Trucking Services was a Chapter Twenty dispute in which the arbitration panel cited article 27 of the 1969 Vienna Convention on the Law of Treaties, which states: “A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty.”\(^\text{136}\) The panel explained that article 27 directs it to examine international law, not domestic norms.\(^\text{137}\) The panel further explained that since it derives its authority from NAFTA, it would give the terms of the Agreement precedence over any inconsistent domestic legislation.\(^\text{138}\) FERC would therefore be unable to argue that reciprocity is integral to the functioning of Order No. 888 or essential to the regulation’s scheme or objective. Reciprocity would be judged in isolation against NAFTA provisions, and FERC would be unsuccessful in arguing that reciprocity can be interpreted to comply with NAFTA. Consumers Energy demonstrates that the practical application of reciprocity, as determined by the nebulous comparability standard, is also inconsistent with NAFTA.

**Conclusion**

FERC’s unilateral goal of a competitive North American electricity market has fuelled its indiscriminate application of Order No. 888 to foreign utilities. Contrary to FERC’s obligations under NAFTA, Order No. 888 subordinates free trade to fair trade and places illegal restrictions on Canadian electricity exports. Order No. 888 violates the

\(^{132}\) EAP, supra note 4 at 61,021.

\(^{133}\) Horlick & Schuchhardt, supra note 52 at 21.

\(^{134}\) NAFTA, supra note 49, art 1135.

\(^{135}\) Ibid, art 1136.


\(^{137}\) Ibid.

\(^{138}\) Ibid at para 246.
principle of national treatment under article 606(1)(a); risks violating article 606(2), which demands best efforts to ensure regulatory measures do not disrupt international contracts; and risks violating article 603(4), which prohibits regulatory measures from impacting industry arrangements within Canada. Order No. 888 may be essential to the success of FERC’s regulatory vision, but it cannot be imposed across international boundaries.

Ironically, NAFTA is not responsible for prying open Canadian electricity markets and it may prove to be the best tool for keeping them closed. However, if the provinces choose to further deregulate, NAFTA may accelerate the process while simultaneously ensuring that provincial monopolies no longer serve a policy function. Article 1502(3)(b) illustrates why open markets may be forced to stay open under NAFTA:

Monopolies must act solely in accordance with commercial considerations in the purchase or sale of the monopoly good or service in the relevant market, including with regard to price, quality, availability, marketability, transportation and other terms and conditions of purchase or sale.\textsuperscript{139}

The term “commercial considerations” is defined in article 1505 to mean actions “consistent with normal business practices of privately-held enterprises in the relevant business or industry.” Thus, a monopoly must react to market forces and shareholder interests and cannot be steered by public policy. Marjorie Griffin Cohen, a professor at Simon Fraser University who has written extensively on electricity deregulation, offers fair warning: “[e]lectricity is the infrastructure for every industry and virtually every job in the country. The significance of who controls this industry cannot be understated.”\textsuperscript{140}

\textsuperscript{139} NAFTA, supra note 49, art 1502(3)(b) [emphasis added].

\textsuperscript{140} Cohen, “Deregulation in the Semi-periphery”, supra note 1 at 234.