"Imperialist Regulation: US Electricity Market Designs and the Problems it Creates for Canada"

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Background/Introduction

George W. Bush first proposed a "North American Energy Market" during his 2000 election campaign. This vision of a seamless energy market throughout the continent was reiterated in the *National Energy Policy*, the document produced by Vice-President Dick Cheney and Secretary of State Colin Power in May 2001. Since then the U.S. Federal Energy Regulatory Commission (FERC) has proposed a Standard Market Design (SMD) for electricity that would include not only all jurisdictions in the U.S., but also in Canada and Mexico.

The US plans for an integrated continental market are having consequences in Canada that will change the entire nature of the public electricity systems that exist within provincial boundaries. This is an important example of how very deep and radical regulatory changes in the U.S. can subvert the public provision of an essential utility in Canada.

This briefing note will argue that Canada need not follow this U.S. regulatory imperialism. NAFTA guarantees an ability to trade, without having an identical system, as FERC proposes. But Canada, strangely, does not exercise this right, primarily because Canada's federal regulatory body, the National Energy Board (NEB), does not assert itself with the same kind of vigor, as does FERC. In the absence of a strong federal regulatory body in Canada, FERC is setting the rules for both industry restructuring and reliability standards.

Key Issues.

U.S. Actions:

- Two main and related policy decisions in the U.S. influenced major changes in the electricity sector in Canada. One was the regulatory change that allowed U.S. electricity companies to invest in other electrical utilities throughout the world. The other was the re-regulation of the U.S. market to allow private competition. Both of

these events increased the power of large new private players in the energy sector (like Enron) and gave them strong incentives to ensure that the U.S. government pursues international agreements to meet their investment needs.

- No provinces in Canada had compelling economic reasons to shift from planned electricity systems to competitive markets. Integrated public utilities and highly regulated private utilities provided reliable electricity at low costs. The recent privatization and deregulation initiatives that are occurring in Canada in jurisdictions like Alberta, B.C. and Ontario, have been politically driven by governments that have a predilection for privatization. However, without the context of U.S. regulatory changes the pressures from the private sector to break up integrated public utilities (to allow private electricity generation) would not have occurred.

- The US regulatory agency, FERC, has become decidedly imperialistic since George W. Bush came to power. His appointee as Chair of FERC, Pat Wood, issued plans for a 'seamless' marketplace for electricity throughout the continent through Standard Market Design (SMD) with the intention of breaking up integrated utilities to allow competition in the electricity market. As Fitch Ratings business analysts noted, imposing a SMD for the electricity system in the U.S. 'is profound, amounting to a thorough redesign of the entire U.S. electricity market."[1]

- One key feature of SMD is the separation of transmission systems from the control of public utilities. FERC is extremely aggressive in pursuit of this objective because without access to transmission systems, private generators of electricity would have no markets. Since utilities usually own the transmission systems, removing utility control over transmission is crucial to privatization initiatives. FERC envisions very large transmission areas, or Regional Transmission Organizations (RTOs) that would control the transmission activity in specific areas of the continent.

- The creation of any RTO requires that all participants give up the operation and control of their transmission systems to the new RTO. Each new RTO will be controlled and operated privately and no utility will have a voice in its governance structures. This is a very radical change for public utilities and will have a particular significance for Canadian utilities because it will give over to a U.S. entity the control of the public electricity system. Any RTO will have authority to set prices, enact all interchange schedules, maintain system reliability and security, and plan for future expansion of the system. While the original companies may still own the assets, that is the transmission lines and controls centres, the RTO will be able to determine the extent of new investment and its nature.

[1] Ellen Lapson, Lina Santoro, Phylip Symth, "FERC Standard Market Design," *Fitch Ratings, October 1,, 2002.*

- In moving toward a SMD and Regional Transmission Organizations, FERC is invading the regulatory territory of both state governments within the U.S. and the regulatory powers of Canada and Mexico. Its plans for the North American market have encountered considerable resistance from state governments within the U.S., although no resistance from any governments in Canada.

- The opposition to FERC plans in the U .S. has come from consumer groups, public utilities and state officials of various kinds, including representatives to Congress. The main objections are to the imposition of a competitive market model of electricity supply that would force even integrated public utilities to break up their systems to accommodate private electricity producers. Because FERC currently only has jurisdiction over private utilities and the wholesale market, the objecting states argue that FERC is invading state regulatory authority.

Implications for Canada:

- All major electricity exporting provinces in Canada have complied in some measure with FERC orders. While the provincial governments in Canada seem to realize FERC is encroaching on their regulatory authority with the demands for the creation of RTOs, they appear to be cooperating with FERC to a much greater extent than many of their US counterparts in the hand-over of the control of their transmission systems to the RTOs.

- One of the major implications for both Canada and Mexico in the new design for the transmission market is that it will encourage both exports and imports of power and cause an escalation of domestic prices. If increased access to U.S. markets occur, as is the intention of the RTOs, all new private energy generation in both countries will have the option of selling within the province or selling in the U.S. This will result in domestic consumers competing with American consumers for power produced within the country.

- New investments in cross-border transmission lines could well turn out to be very expensive for provinces in Canada – particularly considering the constraints that exist between the possibility of considerably expanded private generation and the relatively small proportion of electricity that can now be exported through existing transmission lines. Since for the most part the wires will still be in the public sector in Canada, it very likely will be the public that will be paying for the expansion of the system – primarily to suit the requirements of the private sector.

Problems Created:

- Several important changes in electricity markets in North America have given rise to huge problems. One is related to the relentless increase in the sheer size of the electricity markets and the distances over which electricity is transported. The

electricity grids between Canada and the U.S. serve two main purposes: one is to ensure the reliability of the system and the other is to permit trading of electricity. But the main issue in the creation of continent-wide markets is the extent that the objectives of trade will over-ride other significant domestic objectives of delivering electricity -- social objectives of equity, low costs, regional development, aboriginal rights, reliability, and conservation. As trading areas extend thousands of miles across the continent, efficiencies are lost, reliability of the system is compromised, and meeting local needs can be superseded by the lure of large incomes from exports.

- A second problem created by the restructuring of the electricity sector is the startling increase in electricity trading by corporations that do not produce electricity, but buy and sell it to take advantage of different prices in different areas of the continent. While Enron's trading needs was the ignition that brought about the system redesign and the new rules to facilitate traders, its initiatives have taken a life of their own long after its activities have been discredited.

- A third problem related to restructuring comes from the attempts to deregulate some parts of the electricity business (generation), while retaining the monopoly aspects of other aspects (transmission and distribution). The technology of transmission has not changed its characteristic as a natural monopoly mainly because the construction of a transmission system is complex, expensive and does not efficiently allow for competing transmission lines. The result is a hybrid system with a competitive market in electricity generation that encourages increased supply coupled with a limited and monopolistic transmission system. The bottlenecks that are created, then, tend to limit the expansion of the generation market and have a tendency to increase the unreliability of the system itself. It is this problem that is most crucial in overcoming the barriers that now exist to a continent-wide electricity market.

Choices for Canadians

- The main issue before Canada is whether electricity systems should remain independent and controlled by Canadian governments, or subsumed within the US system. Integrating the US, Canadian, and Mexican electricity markets, which is the goal of FERC, will result in prices that are established by the US markets, and regulations that further the energy objectives of the US and private companies.

- The North American Free Trade Agreement (NAFTA) permits both trading and investment without instituting standard market designs. There is no requirement in international law that any entity in Canada has to completely change its system in order to export into the U.S. This is a fundamental protection that has been retained under NAFTA: according to the NAFTA Commission for Environmental Cooperation in its assessment of the cross-border electricity trade,

provincial decisions to acquiesce to FERC demands are voluntary – at least under NAFTA legal requirements:

'The demand for reciprocity from US producers has already become a prominent issue relating to cross-border trade. Under NAFTA, a Party is not required to provide reciprocity, but only national treatment for the goods of another Party. *Market participants in Canada, such as BC Hydro, have for the time being chosen to agree to reciprocity voluntarily rather than insist on their rights."* (my emphasis).[2]

- Under NAFTA no province in Canada is required to have exactly the same kind of organization of its market or industry as exists in the US. Canada must, however, grant 'national treatment' to foreign firms. What this means is that as long as a government treats domestic and foreign firms in the same way, it is not contravening NAFTA.

- In order to use the protections of NAFTA, Canada would need to have a National Energy Board that is pro-active in protecting Canada's interests. The absence of a strong Canadian regulator of electricity becomes glaringly evident in the negotiations with the US over SMD and RTOs. Each province is basically on its own in determining its relationship with the US. This is unfortunate because the impression FERC projects in its drive to control the entire North American electricity industry, is that Canadian electricity systems will have to mirror developments in the US in order to have access to the U.S. market.

Flash-Points

Two significant developments are proceeding immediately that need much more public attention than they are receiving.

- Activities to develop a Regional Transmission Organization are proceeding at a rapid rate in the western part of the continent. B.C. Hydro, for example, is currently proposing specific regulatory measures to comply with becoming a part of the RTO 'Grid West' in the near future. The proposals will be presented to the B.C. Utilities Commission this fall and should be monitored closely. The changes being proposed will fundamentally alter the nature of the electricity industry in this province. Similar changes are occurring in Ontario (with Bill 100).

- Most worrisome is that FERC is attempting to get increased powers from the U.S. Congress. Currently FERC has regulatory control only over wholesale markets and private power producers. But it is a trying now to get regulatory authority over grid reliability and the activities of public utilities. FERC argues that its

[2] Commission for Environmental Cooperation (CEC), *Electricity in North America: Some Environmental Implications of the North American Free Trade Agreement (NAFTA)*, March 1999, p. 290.

market restructuring approaches have not worked in the past because it has had limited authority. An expanded FERC mandate would mean even greater threats to Canadian independence on electricity issues.

Options:

Canada has a strong legal position to maintain public provision of electricity. Among some important actions that would need to take place would be the following:

- Electricity policy is currently treated completely as a provincial issue. But with the increased internationalization of U.S. regulatory design, a strong national voice needs to be present in negotiations with the U.S. Electricity is no longer confined by provincial boundaries and in the face of U.S. regulatory imperialism, Canada needs a strong voice in the re-design of the North American Market.

- The federal government should adamantly resist the complete integration of provincial electricity systems with the U.S. system. Canada has had important economic and social advantages that have come from the collective use of resources. The privatization of these assets will have significant and negative implications for the people of this country. The re-design of the North American system is occurring to meet U.S. system flaws and U.S. objectives. Canadian objectives are currently not part of the discussion.

- Canada should use the protections NAFTA to allow Canadian provinces to pursue their own best interests in the electricity sector. While some provinces are actively privatizing electricity because of political and ideological reasons, others are feeling the might of U.S. regulatory design and currently do not feel they have the means to resist FERC directives.

- The federal government should encourage greater integration of the Canadian electricity sector. Currently each province has greater ties with the U.S. than it does with other provinces. This is partly a result of the regulatory vacuum at the national level. With the need for market reliability and for new investments in electricity generation increased inter-provincial planning would make a lot of sense. The U.S. has a regulator that deals with national and international issues. It is time that we in Canada had one too.