CANADIAN NATURAL GAS DEREGULATION

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ABSTRACT

Canadian natural gas deregulation has terminated government price setting in favour of prices determined by market forces. However, the transportation of the commodity remains regulated due to the monopolistic nature of the distribution system and the Canadian economies of scale which preclude business rivalry. This paper attempts to discern whether the transition to a new regime is following the legal principles underlying public utility regulation.

Promotion of the public interest is therefore a pervasive theme of this paper. While regulatory law allows certain forms of discrimination in the setting of rates and the provision of services, it prohibits undue or unjust discrimination. The thesis proposed herein focuses on regulatory theory and the possibility that incidents of undue discrimination may have been exacerbated by the deregulation process.

The examination begins with a review of the discrimination provisions of section 92A of the Constitution Act 1867, the so-called "Resource Amendment". More attention is directed to public utilities theory given its compelling application to the natural gas industry. Deregulation is then discussed including an analysis of "direct sale" contracts involving the commodity as well as the "bypass" of the local pipeline distribution systems.

Some conclusions are then made concerning competition and changing commercial conditions. Grave doubts are voiced as to whether the National Energy Board is properly applying the principles of public utility regulation during the transition to a more market oriented natural gas environment. One important conclusion is that direct sale contracts should be encouraged in the core market as well as in the industrial market by the National Energy Board in order to promote upstream competition among gas producers in the public interest. Finally, it is hoped that these doubts will be resolved by the Board in its new (RH-1-88) public hearing which will address issues related to deregulation, including direct sales and the ancillary self-displacement and operating demand volume (ODV) methodology.

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1. INTRODUCTION

Promotion of the public interest is a pervasive theme in public utilities regulation. Canadian natural gas utilities are presently in a state of flux which is inducing regulators to clarify the meaning of the public interest in light of new commercial conditions. In particular, these exigencies have been brought about by the so-called deregulation process where the formerly prescribed price of natural gas has been terminated in favour of commodity prices determined by market forces. However, the transition to a more market-oriented regime has not been effected without difficulties.

Inherent in these difficulties is the fact that the transportation of the commodity remains regulated out of necessity. The present monopolistic interprovincial pipeline system and local distribution companies all require regulation since the Canadian economies of scale preclude business rivalry. Therefore, it is the role of natural gas transportation regulators to act as a substitute for competition and to attempt to mirror the supply and demand controls of the free market.

However this role is inhibited to some extent by a legacy of the old regime. For instance, TransCanada Pipelines Ltd.(TCPL) is the monopolistic interprovincial carrier who also acts as a broker of the commodity. While there will always be a relationship between the marketing and

transportation segments of the industry, it seems that the pre-deregulation supply contracts of TCPL have locked consumers into inordinately high prices. Although lower gas prices might now be obtained in the deregulated environment, consumers are precluded from benefitting because the distribution system tends to be fully contracted.

Several provisions pertaining to competitive gas pricing are contained in the October 31, 1985 intergovernmental Agreement that commenced the deregulation process. Two salient provisions include the bypass and direct sale concepts. The former refers to the ability of certain end-users to sever connections to the local distribution companies (LDC) and obtain cheaper service from the main trunk line. Even though this downstream competition appears prudent, its effect will actually be discriminatory to the remaining LDC users who will have to absorb higher rates. Concern over the affect of bypass on the public interest has been intense. Appellate decisions against the federal government confirm provincial jurisdiction over the enterprise yet an interesting constitutional battle for legislative competence continues enroute to the Supreme Court of Canada.

The latter concept refers to the ability of end-users to negotiate less expensive commodity sales directly from producers. Although direct sales dispense with the broker functions of TCPL and the LDC's, it is nevertheless thought that these companies could profit with fair carriage charges. They could adjust to the new competitive environment in their

brokerage capacity by renegotiating existing contracts to reflect changed commercial conditions. Furthermore, this could promote a healthy upstream competition. In Manitoba a direct sale initiative that might have brought lower gas prices to residential and commercial users has been rebuked by the federal National Energy Board. Since direct sales have only been allowed to industrial concerns, allegations have surfaced that the Board has unduly discriminated between customer classes.

This paper attempts to discern whether the deregulation process follows the legal principles underlying utility regulation. Incidents of undue discrimination in the setting of prices and the provision of services may have been exacerbated by the process. Thus, before addressing natural gas deregulation, it is thought important to present a jurisdictional overview and a discussion of the philosophy of public utility regulation. For instance, the new resource amendment to the constitution makes significant provisions concerning discrimination in prices or supplies by producer provinces. However, its impact has not yet been judicially considered.

Hence, a salient subject of regulatory theory is the consensus that discrimination in public utility rates and services will always occur yet should only be probibited when the discrimination becomes undue or unjust. For instance, preferential prices are sometimes afforded to industrial customers. A properly structured price advantage can inhibit

them from switching to another energy source. Contemporaneously, these customers contribute to the overall maintenance of the gas diststribution system thereby benefitting those who pay higher rates, such as residential and commercial users.

However, this preference can become unduly discriminatory if discounts in the industrial sector are, in effect, subsidized by unjustifiably high prices in the residential and commercial markets. Indeed there is an inherent tendency for a monopolistic marketer to charge as much as possible in those sectors of the market, such as the residential and commercial, where no effective competition exists. This discrimination topic will be extensively developed because of its more immediate and compelling relationship to the decisions of regulatory tribunals. Hopefully these topics will provide insight into the specific problems facing the Canadian regulation of natural gas services.

2. JURISDICTION OVER CANADIAN NATURAL GAS UTILITIES

Canadian constitutional law is a fundamental reference point for an analysis of the Dominion's natural gas utilities since both the federal government and the provinces have rights pertaining to the commodity and its transportation. This chapter concentrates on a relatively new element of the constitution that pertains to public utilities. In particular, the natural resource discrimination provisions in section 92A of the Constitution Act 1867 will be addressed because of their potential impact upon producing provinces as well as the ultimate determination of rates.

2.1 SECTION 92A OF THE CONSTITUTION ACT 1982: THE RESOURCE AMENDMENT

Other commentators have addressed the constitutional law relating to natural resources exploitation, including that of oil and gas.[1] Rather than re-iterating the basic jurisdictional parameters of the Constitution Act 1867,[2] this chapter addresses a relevant amendment following the

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1 Useful commentaries include: G.V. La Forest, Natural Resources and Public Property under the Canadian Constitution (U. Toronto, Toronto,1969); M. Crommelin, "Jurisdiction over Onshore Oil and Gas in Canada" (1975) 10 U.B.C.L.Rev. 86; J.B. Ballem, "Oil and Gas under the New Constitution" (1983) 61 Can. Bar Rev. 547; B.W. Semkow, "Energy and the New Canadian Constitution" (1984) 2 J.E.R.L. 107; A.R. Thompson, "An Overview of Oil, Gas, and Mineral Disposition Systems in Canada" (1986) 32 Rocky Mt. Min. L. Inst. 3-1.

2 Constitution Act, 1867, 30 & 31 Vict. c.3 (Imp.); formerly the British North America Act 1867, renamed by Sched.1 of the Constitution Act 1982, which is Sched.B of the Canada Act 1982, c.11 (UK).

patriation of Canada's constitution from the United Kingdom in 1982. Under section 92A, the so-called Natural Resources Amendments,[3] provincial power over natural resources was strengthened in a process whereby divergent interests were accommodated. On one hand, a basic tenet of Canadian federalism is the existence of free-trade throughout the nation.[4] On the other hand, changes were successfully sought by the producing provinces to balance the nationwide free-trade interest. By expanding provincial resource jurisdiction, it was hoped that regional control over their economic development would increase.[5]

Each province is exclusively empowered to make laws pertaining to the exploration,[6] development, management and conservation of forest resources, and non-renewable resources in the province,[7] as well as electrical energy facilities.[8] The Resource Amendments also convey non-exclusive powers in relation to additional subjects. Plenary provincial taxing power has been conferred in relation to their natural resources. However, such taxes must not differentiate

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3 Constitution Act 1867 as amended by ss.50 and 51 of the Constitution Act 1982, designated as s. 92A of the Constitution Act 1867 and Sched.6.

4 M.A. Chandler, "Constitutional Change and Public Policy: The Impact of the Resource Amendment (Section 92A)" (1986) 19 Can. J. Pol. Sci., 103 at 122-3.

5 R.D. Cairns, M.A. Chandler, W.D. Moull, "The Resource Amendment (Section 92A) and the Political Economy of Canadian Federalism" (1985) 23 Osgoode Hall L.J., 253 at 263.

6 supra note 3 at s.92A(1)(a).

7 Id. s.92A(1)(b).

8 Id. s.92A(1)(c).

between production of the resource retained in the province and that exported to other provinces.[9]

Whereas a province previously could only levy direct taxes, it is no longer ultra vires to indirectly tax resources subject to the the non-differentiation proviso.[10] Derogation of those provincial powers enjoyed before the Resource Amendments may not be made even though those powers have not been set out in the ameliorated Act.[11] Should a conflict arise, provincial laws would be rendered inoperative to the extent of competing, sui juris federal laws under the doctrine of federal paramountcy.[12]

This paper is concerned with Canadian natural gas deregulation in light of the legal principles underlying public utility regulation, including those pertaining to discrimination. Perhaps one of the more relevant Resource Amendments is the one providing for the export of resources from provinces.

> "s.92A(3) In each province the legislature may make laws in relation to the export from the province to another part of Canada of the primary production from non-renewable natural resources and forestry resources in the province and the production from the facilities in the province for the generation of electrical energy, but such laws may not authorize or provide for discrimination in prices or supplies exported to another part of Canada."[13] (emphasis added)

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9 Id. s.92A(4).

10 For authorities on the pre-1982 position, see: Can.Indust. Gas & Oil Ltd. (CIGOL) v. Saskatchewan, [1978] 2 S.C.R. 545, [1977] 80 D.L.R. (3d) 449; see also Central Can. Potash Co. v. Saskatchewan, [1979] 1 S.C.R. 42, [1978] 88 D.L.R. (3d) 609.

11 supra note 3 at s.92A(6).

12 Id. s.92A(3).

13 Id. s.92A(2).

"Primary production"[14] is defined in the Sixth Schedule of the Constitution Act 1867 and implicitly includes natural gas. While the provinces do not have jurisdiction to control international exports under section 92A, they can make laws applying to exports within Canada. Although section 92A has not yet been judicially considered, an example of its potential application exists with Alberta legislation concerning exports from that gas rich province.

Alberta enacted the Gas Resources Preservation Act in 1949 thereby introducing the requirement of a permit in order to remove natural gas from the province.[15] This Act[16] was successively repealed and replaced in 1956,[17] and again in 1984 with periodic tinkering to the present date.[18] Evidently, the controversy attaching to this statute involves the not unsubstantiated view held by commentators that it usurps federal jurisdiction.

Undoubtedly, the provinces have control over the conservation and production of their natural resources, including oil and gas.[19] While the Act makes prima facie valid conservation provisions for the present and future needs of Albertans,[20] criticism of its predecessor[21] remains apt to

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14 Id. s.92A(5).

15 For a discussion of the regulatory process involved, see note 64 and accompanying text infra.

16 S.A. 1949 (2nd Sess.) c.2.

17 Gas Resources Preservation Act, S.A. 1956, c.19.

18 Gas Resources Preservation Act, S.A. 1984, c.G-3.1, S.A. 1986, c.17 and c.D-18.1; S.A. 1987, c.23.

19 Spooner Oils Limited v. Turner Valley Gas Conservation Board [1933] S.C.R. 629, 4 D.L.R. 545, [1932] 3 W.W.R. 447.

20 Gas Resources Preservation Act, supra note 18 at s.8.

21 Crommelin, supra note 1 at 119-120.

the extent that it controls extraprovincial gas marketing. The impugned control mechanism involves terms and conditions that may be inserted in the removal permit by the Alberta government.[22] Significant to this issue are the so-called "self-displacement"[23] and "markets"[24] conditions. The former stipulates that extra-provincial distributors must honour their existing gas supply contracts. Invariably, these are arrangements with TransCanada Pipelines Ltd. (TCPL), a monopolistic interprovincial pipeline company which plays a dual role as a commodity broker.

The markets condition requires ministerial consent if a licensee wants to change the downstream arrangements of Alberta gas exports from those contained in the original permit application. These particular conditions had been promulgated by Alberta in reaction to unplanned incidents of the Canadian gas deregulation initiative that ended government price fixing of the commodity. Deregulation was supposed to let market forces determine the commodity's price, presumably lowering the cost to Canadian consumers while defraying the producer's lost revenue with increased exports to the United States. But these expected exports did not materialise due to an over supply situation, more colloquially known as the "gas bubble". Thus, the removal conditions seek to protect Alberta

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22 Gas Resources Preservation Act, supra note 18 at ss.4,13(2),6; this Alberta regulatory function is conducted by the Energy Resources Conservation Board (ERCB) and the Lieutenant Governor, note 72 infra.

23 S.6 of Alta. Reg. 271/87. N.B.- Both conditions apply to short-term permits.

24 S.4(1) of Alta. Reg. 271/87.

producers by inhibiting distributors from abrogating the long-term TCPL contracts and entering into cheaper arrangements.[25]

Except for the exclusive provincial exploration, development and conservation powers in subsection (1), Parliament can override or match the other provincial powers including section 92A(2) export competence. In the case of interprovincial exports, it can make laws under the trade and commerce heading which will typically be paramount to provincial legislation.[26] Hence, even before the 1982 Patriation and Resource Amendments, commentators have questioned the validity of similar legislation by using an orthodox division of powers analysis.[27]

Prior to section 92A, a province could not attempt to regulate trade which is properly a matter of interprovincial concern. Laskin, C.J.C. stated:

> "It is true that a Province cannot limit the export of goods from the province, and any provincial marketing legislation must yield to this."[28]

Accordingly, while the removal permit conditions may be valid contractually as regards the gas well producer-permittee, the Alberta Legislature does not enjoy privity with the downstream distributors and the conditions cannot be imposed upon them. Instead of preoccupation with production concerns, the current

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25 Deregulation is expounded upon in Chapter 4 infra.

26 Thompson, supra note 1 at 3.03[3-4]; s.92(2) supra note 2; P.W. Hogg, Constitutional Law of Canada (2nd ed., Carswell:Toronto, 1985) at 354.

27 J.B. Ballem,"Constitutional Validity of Provincial Oil and Gas Legislation" (1963) 41 Can. Bar Rev. 199 at 218-219.

28 Ref re Agricultural Prod. Marketing Act [1978] 2 S.C.R. 1198, 84 D.L.R. (3d) 257 at 319, 19 N.R. 361.

Alberta Gas Resources Preservation Act deals with consumption matters in general, and gas exports in particular. Nevertheless, since 1982, the permit conditions would not be ultra vires in the absence of discrimination between consumers as to prices or supplies.[29]

Not surprisingly, the removal permit system has been questioned as being unconstitutional to the extent that it may "authorise or provide for" section 92A(2) discrimination.[30] But despite the plethora of articles written[31] the legal nature of this type of discrimination remains unclear.[32] A promising technique that might crystallise the matter involves comparative law. One helpful definition is found in a work on European Community Law:

> "Discrimination always involves uneven treatment of subjects or objects in essentially similar situations by a single person or body..."[33]

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29 S. Blackman, Gas Removal Permits in Alberta: Constitutional Questions, (Faculty of Law, University of British Columbia: April 20, 1988) unpublished, at 5-7,17,10,58. S.92A discussion was influenced by the lucid comparative analysis of my colleague Susan Blackman.

30 M.Kay, "Deregulation And Interprovincial Trade: Direct Sales of Natural Gas" in J.O. Saunders (ed.), Trading Canada's Natural Resources (Carswell:Toronto, 1987), at 282.

31 supra note 1; other useful commentaries include: J.P. Meekison, R.J. Romanow & W.D. Moull, Origins and Meaning of Section 92A: The 1982 Constitutional Amendment on Resources (The Institute For Research On Public Policy, 1985); W.D. Moull "Pricing Alberta's Gas - Co-Operative Federalism and the Resource Amendment" (1984) 22 Alta. L.Rev. 348.

32 Blackman, supra note 29 at 19.

33 H. Smit & P. Herzog, The Law of the Eurapean Economic Community: A Commentary on the EEC Treaty,(Mathew Bender:New York, 1976) vol.3 at 556.

Like other federal systems[34] that might provide a useful comparison, the European Economic Community is predicated upon an unfettered flow of people, services, goods, capital and business enterprises between the Member States.[35] Its enabling treaty enjoins against discrimination on the basis of nationality.[36] Thus the European Community experience is similar to a federal or economic system such as Canada that is based on the non-discriminatory free flow of trade.[37]

Differential treatment based on nationality that results from legislation or administrative practises of a Member State is the type of discriminatory mischief that the treaty seeks to prevent, providing that there is a common Community policy in point. Thus disparities that arise from the legislation of Member States can exist in the absence of a common policy on the matter.[38]

For instance, in a fisheries case, Denmark prescribed the allowable catch on species within her waters thereby allocating quotas to Member States based on their history of fishing there. These measures were transitional, made in

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34 See Blackman, supra note 29, who compares the E.C., U.S.A., & Australia provisions to s.92A discrimination.

35 Smit and Herzog, supra note 33 at vol.1, p.17; see also Commission of the EEC v. French Republic, decision 167/73 [1974] E.C.R. 359 at 369, (1974) 14 C.M.L.R. 216 at p. 228.

36 Article 7, Treaty Establishing The European Economic Community, U.N.T.S. 298, No.4300 (1958).

37 On the necessity of nationwide free trade, see: B.W. Semkow "Energy and the New Constitution" (1985) 23 Alta L.Rev. 101 at 103.

38 Smit v. Commissie Grensoverschrijdend Beroeps Goederenvervoer, decision 126/82, [1983] E.C.R. 73 at 92, (1983) 38 C.M.L.R 106 at 123. See also: Criminal Proceedings v. Firma J. van Dam en Zonen, decisions 185-204/78, [1979] E.C.R. 2345, (1980) 27 C.M.L.R. 350.

consultation with the Commission pending a common conservation policy. The Court held that overfishing charges against a British ship captain were not discriminatory. The quotas were found to be objective, contemplating the needs of the littoral population and the need to temporarily preserve the status quo in the region during the period of transition.[39] While the transitional period reduces its usefulness, an analogy has been noted. Canadian deregulation is thought to have placed gas supply contracts in a state of flux until they expire. During this time, consumers are penalised according to their past history by the removal permit system.[40]

The question that could be addressed by section 92A is whether the province of Alberta is objectively conducting a conservation scheme, which incidentally protects these long term contracts. While proponents suggest that economic conservation justifies the scheme, an answer to the discrimination issue should address the effects in consuming provinces. Interestingly, Canadian deregulation is not a transitional phenomenon, but rather seems likely to stay until a change in the federal government alters the present laissez faire policy. Succinctly stated, the problems of deregulating the commodity price of natural gas have been exacerbated by an interprovincial pipeline transportation system that remains regulated and that is tied up with long term contracts.

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39 Anklagemyndigheden v. Jack Noble Kerr, decision 287/81, [1982] E.C.R. 4053 at 4076-4077; (1983) 37 C.M.L.R 431 at 453.

40 Blackman, supra note 29 at 49.

In my view, it seems unlikely that the current Progressive Conservative federal government will attempt to politically alienate Albertans and introduce legislation that would unequivocally prohibit the mischief reaped by the arguably ultra vires removal permit system. In fact, it seems that the policy of deregulation was strongly influenced by the lobbying of the oil and gas industry, a powerful western Canadian interest group. Thus, any attacks upon the alleged discrimination in natural gas prices that may be attributable to hiccups in the deregulation process, appear to be based upon traditional public utility concepts of discrimination. While discrimination in the broad constitutional sense remains a possible cause of action, those claiming unjustified differential treatment are thought to have a more immediate and probable cause of action in the public utility sense of the word.

3. ADMINISTRATIVE STRUCTURE AND THEORY OF PUBLIC UTILITY REGULATION

An important facet of natural gas public utility law is the formal structure of the principal federal and provincial agencies who are responsible for the resource's stewardship. This chapter identifies legislative characteristics of petroleum regulatory agencies in Canada, and the provinces of Alberta, Ontario, and Manitoba. All of them are tools of government having the common raison d'être of furthering the public interest. Although the philosophy of public utility regulation is relatively straightforward, the provision of equitable services to the public is problematic due to a number of technical economic and financial factors.

3.1 THE NATIONAL ENERGY BOARD

The National Energy Board (NEB) was created by Canadian Parliament in 1959 with the passing of the statute[41] bearing the same name. A major impetus to its creation was the decision by the federal government to promote the construction of an all-Canadian natural gas trunk pipeline from Alberta to central Canadian markets. The pipeline had been long delayed

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41 National Energy Board Act, S.C. 1959, c. 46; presently: RSC 1970, c.N-6, amended by: cc. 10,27,44,(1st Supp.), c. 10 (2nd Supp.), 1973-74,c.52, 1974-75-76,c.33, 1977-78,c.20, 1978-79,c.9, 1980-81-82-83,cc.80,84,116, 1984,c.18(s.209),c.40. (hereinafter referred to as the NEB Act).

by problems in obtaining the necessary private financing. These pecuniary difficulties arose from the reluctance of the American Federal Power Commission to allow the purchase of Canadian gas via the proposed branch line to the border town of Emerson, Manitoba. Eventually, the Dominion and Ontario governments agreed to advance loans and construct the pipeline through the rugged Canadian Shield north of the Great Lakes,[42] after which the company was allowed to purchase the segment once it had attained sufficient solvency.

Controversy over the construction and governmental assistance was accentuated following the use of closure to guillotine debate on the enabling Bill despite legitimate concerns for the timely financing of the project. Subsequently, the political result of the 1956 Pipe Line Debate saw the collapse of the Liberal Government headed by Prime Minister St.Laurent.[43] Although the all-Canadian pipeline was completed in October 1958, many questions remained unanswered from the debate which focused on the handling of the matter rather than its merits. These questions included uncertainty about the scheme as well as charges of profiteering on government contracts. They were addressed by two Royal Commissions whose findings led to the formation of the NEB.[44]

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42 H.G.J. Aitken, "The Midwestern Case: Canadian Gas And The Federal Power Commission" (1959) 25 Can. J. of Economics & Political Science, 129 at 130.

43 C.D. Hunt and A.R. Lucas (eds.), Canada Energy Law Service, (Richard De Boo: Toronto, 1981) at 10-1511.

44 B.D. Fisher,"The Role of the National Energy Board in Controlling The Export Of Natural Gas From Canada (1971) 9 Osgoode Hall L.J. 553 at 556.

In 1957, The Gordon Commission recommended the establishment of a comprehensive energy policy and a national energy authority with advisory powers on energy and supervisory powers over export contracts for gas, oil and power.[45] Afterwards, the new Conservative government lead by Prime Minister Diefenbaker appointed the Borden Royal Commission with a broad mandate to make recommendations on the regulation of pipeline company rates and operation, as well as those matters of energy policy falling under the legislative competence of Parliament. Given the vociferous nature and consequences of the Pipe Line debate, it was thought that a continuous regulatory framework was the best mechanism to depoliticize the matter and implement these policies.[46]

When the Commission issued its report,[47] the government responded quickly and passed the legislation in July 1959 which implemented its recommendations on the creation of the National Energy Board and the control of natural gas.[48] Under the Act, certain advisory functions were ascribed to the Board, including the present requirement that it make continuous studies and reports on Canadian energy sources to the Minister of Energy, Mines and Resources.[49] Other

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45 Canada, Royal Commission on Canada's Economic Prospects, Final Report, November, 1957. (Walter Gordon, Chairman).

46 I. McDougall, "The Canadian National Energy Board: Economic 'Jurisprudence' In The National Interest Or Symbolic Reassurance?", (1973) 11 Alta. L.Rev. 327 at 335-337 and Appendix B, III.

47 Canada, Royal Commission on Energy, First Report, October, 1958. (Henry Borden, Chairman). A second report was issued in July, 1959, concerning energy supply, demand and export.

48 B.D., Fisher, supra note 44 at 558.

49 NEB Act supra note 41 at s.22.

functions of an adjudicatory nature are prescribed which prohibit the construction and operation of international or interprovincial oil and gas pipelines and electrical power lines, without the approval of the Board. This approval issues in the form of a certificate of public convenience and is non-assignable in the absence of Board consent.[50]

Licensing and ratemaking are other quasi-judicial functions.[51] Licences must issue under the Board's authority in order to export gas from or import it to Canada.[52] Pursuant to the rate-making powers, all tolls are required to be "just and reasonable" and the Board may disallow rates and prescribe other rates in their stead. Significantly, the Act prohibits the setting of "any unjust discrimination in tolls, service or facilities, against any person or any locality." The normal evidential burden is reversed upon proof of such favouratism since the onus of proving justified discrimination rests with the natural gas company.[53] However, the problem of determining equitable rates and the ferreting out of unjustified discriminatory practices is not straightforward. This problem, inexorably intertwined with the complex economic nature of the industry, is discussed at length below.

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50 Id. ss.26,27,40,43(1),44,17(3).

51 R.C. Carter, "The National Energy Board Of Canada And the American Administrative Procedure Act: A Comparative Study", (1969) 34 Sask. L.Rev. 104 at 110-112. That commentator states that the "duty to decide" function will "affect rights or impose obligations": Security Export Co. v. Hetherington [1923] S.C.R. 539, 549-551.

52 NEB Act supra note 41 at ss. 81,82,17(3).

53 Id. at ss.50-57.

Various other adjudicatory functions have been identified.[54] The Act places limitations upon commercial pipeline transactions, such as the necessity of the Board to approve sales, amalgamation or abandonment of the enterprise.[55] Another adjudicatory function involves the procedure for the expropriation of pipeline rights of way.[56]

Altogether, these functions are facilitated by the Board's ability to make its own rules of practice and procedure.[57] With the approval of the Governor in Council, the Board may use its delegated powers to make pipeline safety rules and compel the production of books of account.[58] Given the detailed finances of the industry and the availability of creative accounting techniques, this latter provision is important in cost analysis verification. Finally, the statute appears to oust the jurisdiction of the courts to grant the prerogative remedies of mandamus, certiorari and prohibition[59] by providing that all Board decisions are "final and conclusive" except for a limited appeal which lies to the Federal Court of Appeal on a "question of law or a question of jurisdiction."[60]

Despite the extensive statutory control exerted upon the NEB, it is not accurate to describe it as a mere amenuensis of

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54 Carter, supra note 51 at 111-112.
55 NEB Act supra note 41 at s.63.
56 Id. ss.74-75.
57 Id. s.7.
58 Id. ss. 39(2),88.
59 Carter, supra note 51 at 112.
60 NEB Act supra note 41 at ss.19,18.

Parliament or the Minister responsible for the supervisory portfolio. This is exemplified in the milieu of policy.

> "Few NEB members admit that the Board in any way makes policy"...(but) "It is clear that the extremely general nature of these guiding government policies leaves considerable scope for policy formulation by the Board through decisions in particular applications and through interpretation in the establishment of proceedings and standard conditions. There can be no doubt that the Board makes Policy."[61]

Thus, the Board has an influence in policy development separate from the policy directives that it inherits through the Act. The impact of this influence can be formidable.

One illustration of this point may be drawn with the 1966 application by TransCanada Pipelines Ltd. to extend the main line via the United States.[62] Although Cabinet initially denied the application in the face of of public opinion against the proposal, it later back-tracked and accepted the view propounded by the NEB. Approval was granted following a re-evaluation of "political considerations", consultations with the Board and other interested parties and upon the condition that the Northern Ontario line handle 50% of the volumes destined for Canadian markets.[63] Therefore, it is possible that the decisions of the Board may have an influence upon contemporary policies of the federal government, including the policy underlining natural gas deregulation.

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61 A.R. Lucas & T. Bell, The National Energy Board: Policy Procedure and Practice (Law Reform Commission of Canada:Ottawa, 1977) at 35-36.

62 See (Canada) Report to Governor-in-Council, August, 1966.

63 Lucas & Bell supra note 61 at 37.

However, the probability and extent of such an influence is also a function of other factors and participants.

3.2 REGULATORY TRIBUNALS IN ALBERTA, MANITOBA AND ONTARIO

Provincial tribunals are the other important tier of regulatory participants which exert control over the Canadian natural gas industry. Like the NEB, their competence originates from the constitutional apportionment of legislative power in our federal state, as succinctly outlined earlier. Often, the tensions involved in the federal-provincial interplay are chanelled through them. Hence it not surprising that the oil and gas rich province of Alberta is the locus of a leading provincial natural resource management tribunal that has considerable impact upon the natural gas industry.

Originally created[64] in 1938, the Alberta Energy Resources Conservation Board (ERCB) is the present principal agency[65] whose powers have been progressively reformed and broadened over the years. Until 1970, its mandate under various provincial statutes included recovery measures that allowed adjacent land owners to receive a fair return from the fugacious underground petroleum pools, the promotion of safety and efficiency in exploration and exploitation as well as prudent conservation measures. In 1971, the Board was

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64 The Turner Valley Gas Conservation Act, S.A. 1932, c.6.

65 The Energy Resources Conservation Act, S.A. 1971, c.30, now R.S.A. 1980, c.E-11.

integrated to administer numerous statutes pertaining to oil and gas, hydro-electric power, coal and mineral quarries and inter-provincial pipelines. Much of the impetus for regulatory re-organization came from concern over the non-renewable nature of natural resources, especially oil and natural gas.[66]

Pursuant to the Oil and Gas Conservation Act the ERCB is given authority to make "just and reasonable orders and directions" to promote those purposes of the Act which are not specifically stated. These purposes include "economic, orderly and efficient development in the public interest" of oil and gas, in addition to the prevention of waste.[67] In order to facilitate these purposes, the ERCB is endowed with wide investigatory and advisory powers on petroleum related matters.[68] Consequently, the Board assists the formulation of government policy with the acquisition and dissemination of technical information with a view to determining supply and demand of the resources under its stewardship.[69]

Conservation practices of the ERCB are contractually augmented by the requirement of a specifically conditioned Board licence in order to conduct natural gas well drilling.[70] Control over natural gas is enhanced by the combination of both legislative and contractual provisions that are aimed at

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66 C.L. Brown-John, Canadian Regulatory Agencies (Butterworths:Toronto, 1981) at 44.

67 Oil and Gas Conservation Act, R.S.A. 1980, c.O-5, ss.4,7; as amended by the Oil and Gas Conservation Amendment Act, 1982, S.A., c.27.

68 Canada Energy Law Service supra note 43 at 30-3015.

69 Id. at 30-3019.

70 Id. at 30-3037. Oil and Gas Conservation Act, s.11(1).

preventing both physical and economic waste. Upstream examples of conservatory schemes include the separation or pooling of mineral interests and the unitization of reservoirs so as to generate the maximum efficient rate of recovery. Another scheme is called proration where production is equitably shared in relation to market demand. Equitable production sharing is also promoted by the Board's regulation of transportation whereby buyers of the commodity may be declared common purchasers, pipelines deemed common carriers, and processing plants deemed common processors.[71]

From both a provincial and a national perspective, one of the key functions of the ERCB is its control over the export of Alberta gas. In order to export gas, a removal permit may be obtained from the Board following an inquiry into all applications.[72] The licence may specify various terms and conditions including the daily and annual amount of gas to be removed from each location, permit term, the reasonably priced supply of gas to Albertans and the circumstances in which removal may be interrupted or diverted.[73] Among the considerations, the ERCB must assess the present and future needs of Albertans, the extent of established reserves and the

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71 D.E. Lewis & A.R. Thompson, Canadian Oil And Gas (Butterworths:Toronto 1954, revised by N.D. Bankes,1988) at ss.166-173.

72 Gas Resources Preservation Act, R.S.A. 1980 c.G-3.1, as amended by S.A. 1984, c.G-3.1, s.2(1), S.A. 1986 c.17, s.3, c.D-18.1 and S.A. 1987, c.23.

73 Id. s.5.

prospects for new discoveries as well as any other matter deemed relevant.[74]

This latter licence criteria was framed differently in the 1984 Gas Resources Preservation Act which expressly provided that "the expected economic costs and benefits" of removal be assessed in respect to the public interest.[75] Commentators opined that that provision allowed

> "the Board to regulate transactions such as direct sales, where the producer and end user are the same person, and ensure that the economic costs and benefits of such transactions are in the public interest of Alberta".[76]

Similarly, an additional 1984 provision expanded the removal permit criteria by allowing commodity price conditions to be attached to the licence as well as other conditions pertaining to the expected economic welfare of the province.[77] However these provisions are no longer law. Nevertheless, it is thought that the present plenary licence criteria of "any other matters considered relevant by the Board"[78] encompasses the former criteria and is sufficient authority to maintain their objectives.

Prima facie, it would appear that Alberta has comprehensive regulatory control of the downstream disposition

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74 Id. s.8. See also: Canada Energy Law Service, supra note 43 at 30-3076-86.

75 Gas Resources Preservation Act, 1984, c.G-3.1, s.5(3)(c).

76 R.P. Desbarats, L.W. Carson, D.E. Greenfield, "Recent Developments in the Law of Interest to Oil and Gas Lawyers", (1985) 24 Alta L.Rev. 143 at 190.

77 Gas Resources Preservation Act, 1984, c.G-3.1, s.6.

78 Gas Resources Preservation Act, s.8(c) supra note 72 (as amended by S.A. 1986 c.17, s.3).

of its natural gas resources, at least until such point as the commodity passes the provincial boundary. But there are other regulatory actors exerting authority on the commodity before it reaches the burner-tip in other provinces. In the case of east-bound gas, the commercial ramifications of this control may eventually flow to the consumer or end-user via the TransCanada Pipelines Ltd. main-line, and subsequently by local distribution companies.

The former entity has been shown to fall under the jurisdiction of the federal government and the NEB. The latter entities are purchaser-distributors who are subject to the laws of the province in which they are situated. Clearly, there is scope for legal tensions inter-partes as the provinces seek to assert their intra-provincial regulatory rights while the federal government attempts to assert its control over the inter-provincial trade of gas. Not surprisingly, the consumer interests of the buying provinces differ from the marketing interests of Alberta.

Two consumer provinces and their respective regulatory agencies that are pertinent to this study are the Ontario Energy Board (OEB)[79] and the Manitoba Public Utilities Board (PUB)[80] which regulate the domestic market in each respective jurisdiction. Within Ontario, the OEB is the principal energy regulatory and advisory tribunal having jurisdiction over pipelines[81] as well as the power to

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79 Ontario Energy Board Act, R.S.O 1980, c.33.

80 The Public Utilities Board Act, R.S.M. 1970, c.P280, as amended.

81 Ontario Energy Board Act, R.S.O. 1980, c.33, Part III.

> "make orders approving or fixing just and reasonable rates and and other charges for the sale of gas by by transmitters, distributors and storage companies, and for the transmission, distribution and storage of gas."[82]

Likewise, the Manitoba PUB has jurisdiction over intra-provincial pipelines[83] and the authority to "Fix just and reasonable rates...tolls or schedules" which must be followed by a public utility.[84]

Thus the structure of natural gas pipeline regulation and rate setting procedures are legislatively provided for in the consuming provinces of Ontario and Manitoba. Even though Alberta has a similar structure for its intra-provincial gas use,[85] it has a different structure for exporting as does the federal government pertaining to the inter-provincial trade of the commodity. Despite the different administrative structures and purposes, there seems to be a golden thread contemporaneously woven through each regulatory board which underlies the basic purpose of regulatory bodies.

3.3 THE NATURE OF REGULATION

Heuristically, the natural gas distribution industry in Canada may be broadly thought of as a public utility. Such entities have been the subject of considerable study in Canada

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82 Id. s.19(1).

83 The Gas Pipe Line Act, R.S.M. 1970, c.G50, as amended, ss.2,3,12.

84 Id. s.12; The Public Utilities Board Act, R.S.M. 1970, as amended, c.P280, ss.77,74.

85 Public Utilities Board Act, R.S.A. 1980, c.P-37; Gas Utilities Act, R.S.A. 1980, c.G-4.

and a fortiori, the United States given its huge and dynamic economy. Many of their concepts pertaining to this subject are helpful in understanding the related concepts existing in our country, including those of definitional and structural categories. Hence, a preliminary characteristic of a public utility has been described as the established right of the public to provide a special regulatory scheme for particular industries.[86]

Public utilities involve necessary public services which often result in a monopoly of the particular enterprise.[87] Theoretically, monopolies are the opposite of markets that enjoy perfect competition or the optimum efficiency brought about by competitive behaviour and performance. In a free market system, competition benefits consumers by eliciting an efficient distribution of resources amongst individuals thereby inhibiting the skewed realization of profits by a business without rivals. Occaissionally, the theory of competition is susceptible to failure. Sometimes it cannot work in practice due to the effects of industry costs and the size of the market which only permit the existence of a sole

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86 J.Bauer, Effective Regulation Of Public Utilities (MacMillan:New York, 1925) at 1. A lucid Canadian account of public utility regulation and natural gas contractual obligations in Ontario can be found in "Ontario Energy Board, EBRO # 410-1,411-1,412-1, December 12, 1986, reproduced in Canada Energy Law Service, supra note 43, OEB Decision 41.

87 E.W. Clemens, Economics and Public Utilities (Appleton-Century-Crofts:New York, 1950) at 25.

firm. This latter phenomenon is better known as a natural monopoly.[88]

The distinction between pure competition and a monopolistic enterprise has been criticised for being an over-simplification. While it is rare to find absolute "perfect" competition in the free market, public utilities may conversely experience forms of competition, such as the alternative or substitute fuels available to natural gas users. Nevertheless, the notion of natural monopolies is basically sound. Certain types of business such as a natural gas pipeline, are frequently affected by technical exigencies that would induce economic inefficiency if it were not for a monopoly of the market. Accordingly, nationalisation of the industry is one way of coping with the politically perceived failure of a market economy.[89] This study addresses another "substitute for competition",[90] namely that of natural gas utilities regulation.

Natural monopolies are associated with economies of scale, where the duplication of services by competitors is uneconomic because of the business' high fixed costs; and where one business can operate more effectively than those in a competitive environment could.[91] Although Canada does not have many natural monopolies, the downstream natural gas industry forms part of this category, at both the local

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88 E. Gellhorn & R.J.Pierce, Regulated Industries in a Nutshell (2nd ed., West:St.Paul, 1987) at 19-44.

89 J.C. Bonbright, Principles of Public Utility Rates (Columbia University Press:New York, 1961) at 10-11.

90 Id. at 10.

91 Gellhorn & Pierce, supra note 88 at 9-10.

distribution level and at the long distance pipeline level. For instance, the enormous size of the country and relatively small population are some of the factors preventing the entry of a competitor for TransCanada Pipelines Ltd., the monopolistic interprovincial natural gas pipeline. Therefore, direct governmental regulation of natural monopolies in general,[92] and the natural gas transmission industry in particular; appears necessary for a variety of reasons.

Regulation can inhibit the excess profits of a monopolist by providing a mechanism of restraint on the rates that it charges, as well as the type of activities in which it engages. Without regulation, an inefficient allocation of resources could result from the higher prices paid by consumers to the monopolist.[93] Invariably, public utilities are monopolies or partial monopolies which are controlled by statutory regulatory bodies that determine inter alia, charges for services as well as the type of services to be made available. Their enabling legislation tends to require "non-discriminatory" contractual provisions with customers and that the rates charged be "just and reasonable".[94]

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92 Economic Council Of Canada, Responsible Regulation: An Interim Report (Minister of Supply and Services Canada, 1979) at 46.

93 Economic Council of Canada, Regulation Reference: A Preliminary Report (1978) at 20.

94 T.G. Kane, Consumers and the Regulators (The Institute for Research on Public Policy:Montreal, 1980) at 3; see for example: s.321, Railway Act, R.S.C. 1970, c.R-2 as am.

One of the most compelling reasons in support of utilities regulation is the prevention of discrimination in pricing and provision of services. Broadly speaking:

> "Social norms of fairness may be violated when individuals are subject to different (discriminatory) treatment. Price discrimination, in effect, is a form of income redistribution resulting from the ability of the seller to separate consumers into different classes based on different intensities of preference (elasticity of demand).[95]

The extent of discrimination in the provision of services by Canadian natural gas utilities is believed to be a controversial question. It is also a problematic one which deserves a larger treatment than this overview of utilities regulation can provide. Hence its ramifications are elaborated below, both in a philosophical sense and later, with application to changes in the industry.

Another rationale for regulation is its use "as a proxy for fiscal policy".[96] This frequently occurs in the cross-subsidization of services where regulators allow certain prices to be offered below their actual cost, only to be offset by other services provided above cost.[97] An analogy to this latter reason may be seen with the system of uniform postage stamp rates which comprise the same price regardless of whether a letter is intended for a nearby location or for a distant one. Cross-subsidization is an effective tool that

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95 Regulation Reference:A Preliminary Report, supra note 93.

96 G.B. Doern, "Regulatory Processes and Regulatory Agencies," in G.B. Doern and P.Aucoin (eds.), Public Policy in Canada (Macmillan:Toronto,1979) 158 at 164.

97 Id.

provides a basic level of service to all persons within a particular jurisdiction, having been described by one commentator to be "taxation by regulation".[98]

Economic reasons for regulation are not necessarily the sole criteria since Canada has committed itself to well known regulatory measures for non-economic reasons such as cultural or social concerns. Historically, the building of this nation was at least partly achieved through regulatory support for the Canadian Pacific Railway to create a transcontinental railroad, and the implementation of protective trade tariffs to foster the nascent manufacturing industry. In contemporary Canada these objectives may be illustrated in the broadcasting industry. The Canadian Radio and Television Commission has a mandate to promote creative Canadian content there,[99] even though its success in preserving the elusive Canadian identity remains doubtful.

Other industries have been subjected to social policy objectives besides the communication industry. These objectives are not static but can change over time as is shown by the case of railway rates in Canada. From 1886 until the Railway Act of 1903, control over rates was vested in a federal cabinet sub-committee which was called the Railway Committee of the Privy Council. The Act created the Board of Railway Commissioners as the body with the requisite "detached

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98 R.A. Posner, "Taxation By Regulation," (1971) 2 Bell J. of Econ. & Management Science at 22-50.

99 Responsible Regulation supra note 92 at 52.

professionalism"[100] necessary for the daily supervision of the railways.

It was consumed in turn by the Canadian Transport Commission (CTC) pursuant to the 1967 National Transportation Act which recognised the diversity and growth in the various national transportation systems. The CTC was accorded extensive advisory and policy functions to compliment its strict regulatory capacity.[101] Attention was shifted to the national transportation system as a viable economic enterprise from the previous emphasis on it as an instrument used primarily to promote national policy objectives.[102] Hence the function of regulation is subject to change with the effluxion of time and with social, economic and political vicissitudes.

For instance, concern over trade and commerce, foreign take-overs of Canadian businesses and new businesses controlled by non-Canadians, resulted in the creation of the Foreign Investment Review Agency (FIRA) in 1973 by the former Liberal government led by Mr. Trudeau. The relative economic nationalism and stringent criteria of that federal agency was superseded by a new agency, Investment Canada, created in 1985 by the Progressive Conservative government headed by Mr. Mulroney. Parliamentary attitudes concerning the direct regulation of foreign investments had been affected inter alia, by an economic recession, as well as criticism from

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100 H.N. Janisch, "The Role Of The Independent Regulatory Agency in Canada" (1978) 27 U.N.B.L.J 83 at 90, 89-94.

101 Id.

102 Responsible Regulation supra note 92 at 52.

international financiers and the United States' government.[103] Under the capitalist ideology of the present government, "Canada is open for business again",[104] tacitally implying that previous regulatory measures had inhibited business.

Changes in the the political composition of the government thus tend to involve tinkering with the regulatory framework. Politically, it is a legitimate way in which to directly coerce desired behaviour from individuals. After all, regulation is "one instrument of governing from a range of other instruments".[105] It is a powerful instrument whose process can include the rendering of policy advice, resolution of disputes, the conduct of specialized research and the administration of subsidies. Advantages may be obtained from the delegation of responsibilities to a so-called quasi-independent regulatory board instead of having the same functions performed by regular government departments. The government can control the regulatory body's mandate without being as closely bound by the doctrine of ministerial responsibility for the regulatory decisions.[106]

The doctrine is one of accountability to Parliament based upon non-legal political conventions. Canadian regulatory history displays:

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103 E.J. Arnett, "From FIRA To Investment Canada" (1985) 24 Alta. L.Rev. 1 at 1-3.

104 See "Notes for a speech by the Prime Minister to the members of the Economic Club of New York, December 10, 1984".

105 Doern, supra note 96 at 160.

106 Id. at 172-174.

> "a constant process of working out the tensions inherent to our commitment to parliamentary responsibility and the need for regulatory tribunals which fall to some degree outside the sphere of immediate political control".[107]

In the United States, regulatory agencies are seemingly more independent than the Canadian model. Congress overviews their function and may frame legislation to reverse their decisions, yet they are otherwise distanced from congressional control. The President doesn't control or direct them since they are not part of the executive branch of government.[108] More public accountability accrues to the Canadian cabinet for their behaviour than accrues to the American cabinet because of the different government hierarchies.

Despite the benefits of utilities regulation, certain problems have been identified by critics of the process. The benefits may be outweighed by the costs related to the administration of regulatory programmes. Cost analysis and effective regulation is said to be impracticable due to the enormous size of some utilities. Adaptation to market or technological changes has caused problems in addition to the concern that private interests may unduly influence their nominal regulators.[109] Furthermore, some public finance commentators allege that government intervention in general,

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107 Janisch, supra note 100 at 87.
108 Id. at 87-91.
109 G.B. Reschenthaler, "Regulatory failure and competition" (1976) 19 Canadian Public Administration 466 at 470-471.

and regulatory agencies in particular, will not faire better in the event of the competitive market failing.[110]

A pernicious aspect of regulation has been identified as its inclination to stifle the competition which could otherwise challenge the regulated monopolies. An American commentator suggests that the detriments of a natural monopoly are exagerated and that regulation has an adverse social and economic impact.[111] It is nevertheless submitted that the regulatory process is worthwhile despite its deficiencies, especially in Canada which has a more limited economy than its neighbouring economic leviathan. Perhaps one of the leading problems with public utility regulation is in its attempt to levy equitable prices to customers for services rendered.

3.4 RATE DETERMINATION AND DISCRIMINATION

Natural gas utilities regulation is thought to be a substitute for the invisible hand and competitive prices of the free market. The regulatory process normally achieves this goal by determining the cost of the service to be provided by the regulated firm. These costs are estimated for a particular period and they may comprise the expenses inherent in running the business, such as depreciation, plant, financing, labour and other operating costs. A maximum rate scale is then set which simultaneously allows enough revenue

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110 B. Lesser, "Comments on 'Regulatory failure and competition' by G.B. Reschenathaler" (1977) 20 Canadian Public Administration 389.

111 R.A. Posner, "Natural Monopoly and Its Regulation," (1969) 21 Stan.L.Rev. 548 at 635-636.

to be generated from the utilities' customers plus a reasonable profit.[112]

Public utility rates have several important functions. Their role includes the setting of charges that allow a fair rate of return from the venture so that the company is in a position to attract further capital for expansion. These charges try to promote an efficient price through lower production costs, in substitution for the way in which competition encourages efficient pricing. Consumer demand may be purposefully influenced by the design of rates. A well structured design adjusts the prices and imitates the the adjustment in a competitive market where demand is generally expected to increase with lower rates or conversely lessen with higher rates.[113]

Inherent to these functions is the desire to economically provide a community with adequate utility service. A fourth, distinct function of utilities rates has the goal of transferring purchasing power or redistributing income from the consumers to the utility company, and eventually to its shareholders and creditors.[114] However, the standard used to determine this function is not entirely based on fiscal criteria since customers do not soley pay for what they consume. Various socio-economic and political factors tend to influence the process and induce one class of utility users to

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112 S.B. Bryer & R.B. Stewart, Administrative Law and Regulatory Policy (2nd ed., Little,Brown & Co.:Boston, 1985) at 223-224.

113 Bonbright, supra note 89 at 49-58.

114 Id. at 59.

subsidize the costs of another class. For example, income redistribution may occur when residential rates are more inelastic than those of industrial users. Although the cost of service for industrial users as a class may be less than for residential users, it has been argued that the former class should pay higher rates.[115]

Accordingly, it is the duty of regulatory tribunals to determine whether this type of bias constitutes undue or unjust discrimination. One way of answering this question is to consider the social and economic effects of various rate designs that set discriminatory prices. It is possible to give a price advantage to a certain customer class and inhibit them from switching to another energy source while at the same time contributing to the overall maintenance of the system thereby benefitting those who pay higher prices.

In order to calculate the maximum rates that a utility may levy, it is necessary to first determine its operating expenses and rate base. A firm's rate base is the value of its facilities and capital investments and assets employed in rendering the service. This figure is multiplied by another parameter called the rate of return which is a percentage of the former figure. The product of the equation is the amount or allowable return that a regulated monopoly will be permitted to earn and by implication, pass on to investors in

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115 J.P. Tomain, Energy Law In A Nutshell (West:St. Paul, 1981) at 111, 116.

the concern.[116] Thus a major issue in regulatory hearings is the equitable evaluation of the capital used in the venture.

Unlike Canada, the United States has provisions in its constitution protecting property rights, and these have presented unique constitutional challenges regarding the method of evaluating a firm's rate base. There, an early appellate decision held that owners of private property were protected from rate regulation that had the effect of expropriating it without just compensation or without due process under the Fifth and Fourteenth Amendments. The maximum rates were based upon the "fair value" test that included reference to the present replacement cost of the property, the original construction costs less depreciation, the market value of its stocks and bonds, as well as the estimated earning capacity under particular statutory rates.[117]

Most states do not continue to follow this rate base evaluation method which is itself a compromise between two other competing tests. The United States Supreme Court no longer requires a detailed rate base formulae predicated upon the "fair value" test. The prevailing rule states that it "is the result reached and not the method employed" that is the main factor in determining "just and reasonable rates".[118] Presently, the matter involves economics and the selection of

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116 A.J.G. Priest, Principles Of Public Utility Regulation (Miche: Charlottesville, 1969, vols.1 & 2) at 138-142.

117 Smyth v. Ames 169 U.S. 466 (1898) per Harlan J.

118 FPC v. Hope Natural Gas Co. 320 U.S 591, 601-603 (1944) per Douglas J.

a formula to cope with the effect of inflation on assets. One way is to determine the reproduction cost of installing equipment, but this technique can result in a book value greater than the original costs. The federal regulatory commissions and most state commissions espouse the calculation of the original cost of assets less depreciation even though it may tend to lower the book values.[119]

When viewed mathematically, the rate level of a firm may be expressed as its operating expenses plus, its rate base as multiplied by the percentage figure termed rate of return. A rate level does not comprise the specific rates that will be levied nor their inter-relationship as this parameter is found in the rate structure. This latter concept is also referred to as rate design, and it apportions the specific rates that are chargeable to various categories of customers.[120]

The objective of a utilities' rate structure is to meet its financial needs, yet distribute this burden equitably amongst its customers, while discouraging waste of the service and encouraging optimal use. Other criteria include rates that are simple, understandable, publicly acceptable and that eschew undue discrimination.[121] But these criteria often represent conflicting exigencies. Inevitably, the rate structure represents a compromise among these factors and it can be restructured from time to time to alter the distribution of the system's benefits.

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119 L.W. Weiss & A.D.Strickland, Regulation:A Case Approach (McGraw-Hill:New York, 1976) at 16.

120 Tomain, supra note 115 at 112-115.

121 Bonbright, supra note 89 at 291-293.

Individual rates involve the subject of microeconmics and the relationship between marginal cost and price. Marginal cost is that cost incurred from the production of another incremental unit or alternatively the savings gained by avoiding production of that commodial unit. Given that the economy has a finite capacity for production at any one time, an opportunity cost "for the alternatives that must be forgone"[122] exists from the choice to produce more or less of a particular service or good. By the fact of producing more of one particular service, society makes a corollary decision to produce less of another. A rate structure should reflect marginal costs if consumers are to make intelligent purchase decisions since demand for more or less of an item must reflect the supply cost of more or less.[123]

Marginal costs involve the variable production expenses that pertain to a to a particular service or item, such as a widget. The direct production expenses contemplated by the marginal cost formula is distinguished from the overall production or constant costs which are not affected by additional or reduced widget production. The latter costs are of a fixed character because they are not dependent on nor proportionate to variations in output. They are sometimes referred to as as joint costs and may include the indirect and non-attributable costs of two or more types of natural gas

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122 A.E. Kahn, The Economics of Regulation: Principles and Institutions (John Wiley & Sons:New York, 1970) Vol. 1 at 66.

123 Id. at 65-66.

service to various classes of customers from one pipeline system.[124]

Rate structures in use have tended to avoid the fully distributed or average cost measurement in the setting of rates, even though it provides a straightforward mechanism that can yield the required aggregate revenue for a firm. One disadvantage of the method is its relatively arbitrary allocation of joint costs among customers. Marginal cost rate-setting appears more desirable due to its efficiency in the allocation of resources.[125] Nevertheless, marginal cost pricing is difficult to apply to a regulated natural monopoly because it doesn't allow for the recovery of fixed costs when these are high and the marginal costs are very small. Some elements of marginal cost pricing may be used in the rate schedule in order to elicit more customers thereby keeping the overall costs down, however it can not be used as the sole pricing criterion.

Furthermore, it is not easy to calculate this parameter since regulated firms usually set "different prices for different classes of customers, different amounts of service purchased" and different time periods.[126] Components of natural gas marginal-cost rates include charges for the volume of gas purchased, and fixed administration costs such as connection and metering. These rates also proportionally

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124 W.K. Jones, Cases And Materials On Regulated Industries (2nd ed., The Foundation Press Inc.:Mineola N.Y., 1976) at 191-195.

125 Gellhorn & Pierce supra note 88 at 194-197.

126 Weiss & Strickland, supra note 119 at 18.

comprise the natural gas plant costs incurred in providing service capacity to the customer at peak periods such as winter-time when demand is greater than in summer.[127]

Hence, a pervasive criterion of public utility rates is that they cover the "value-of-the-service".[128] The difficulty in arriving at this value is the subject of public regulatory hearings where intervenors regularly utilise complex socio-economic and financial data to advocate the position of their respective interest groups. Much effort is directed to the examination of technical data in an attempt to tease out proof of undue discrimination.

Admittedly, discrimination can not be prevented entirely as shown by the disproportional contribution to aggregate revenues made by the divergent rates of different customer groups. Once all the considerations are made, discrimination may indeed be socially desirable, such as to distribute gas under postage stamp-like rates even when a cost analysis made between city and country users does not justify it.[129] Regulators must therefore decide when the analysis as a whole justifies discrimination and under what circumstances it does not.

Marginal cost-based rates are not the only alternative to fully-distributed rates. Certain discriminatory rates, block rates or multipart rates exist yet they do not have "all of the consumer-rationing advantages of un-qualified marginal-

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127 Id. at 20-21.
128 Priest, supra note 116 at 337.
129 Id. at 344-345.

cost pricing."[130] While marginal-cost rates may be theoretically more efficient in the short run, they must be qualified by the expectation of consumers that utility rates will remain stable for a relatively long time. Accordingly, some regulatory commentators and economists believe that a rate design should be based on persistent or long-run marginal costs. They argue that stability in rates would be encouraged but acknowledge the inherent problems in estimating cost functions for twenty years or more, and the long-term marginal cost assumption that the output rate will be enhanced indefinitely following an increase in plant capacity.[131]

Dissatisfaction with strict long-run or short-run marginal-cost pricing has resulted in the use of a notable ratesetting technique. This popular alternative derives from joint costs incurred by natural gas utilities in the capital intensive construction of pipelines, compressor stations, and acquiring of rights of way. Although their fixed overhead costs are relatively high, their incremental costs are relatively low.

> "In such an industry, prices set to equal to the incremental cost of increasing production or services by another unit will not earn enough revenue to cover fixed overhead costs,... A long run policy of incremental or marginal cost pricing will therefore not be possible in such an industry."[132]

In order to pay the the so-called wages of capital, and in order to minimize the inefficiency, regulators advocate

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130 Bonbright, supra note 89 at 395.
131 Id. 400-402, 319.
132 Bryer & Stewart, supra note 112 at 514.

discriminatory prices among various customer classes according to a structure that is the inverse of the normal demand elasticity curve.[133]

For example, natural gas utilities might set set low rates for industrial users because such customers may switch to alternative competing fuels if gas is priced at a higher rate. Despite making an allowance for the actual costs in serving divergent classes of customers, higher rates are usually levied to residential and commercial customers because their demand is less elastic.[134] Since these classes of customers place a greater value on gas service, they pay a higher share of the fixed costs than do industrial users who place a lesser value on the service. Given the inability of incremental costs to cover average costs (due to high fixed costs), the justification for this form of regulatory price discrimination is to minimise allocative waste while recovering or paying for fixed investment.[135]

Public utilities are often in an environment or economy of scale that fosters long run decreasing costs, with the unit cost decreasing as total output increases.[136] Thus another example of price discrimination that has been justified by regulatory agencies is the traditional declining block rate. This structure initially charges customers a rate sufficient to cover fixed costs as well a demand and customer costs. It is designed to pay for the entire service cost by both small

133 Id. at 516.
134 Weiss & Strickland, supra 119 at 22.
135 Bryer & Stewart, supra note 112 at 515-516.
136 Weiss & Strickland, supra note 119 at 22-23.

and large users, yet it encourages greater consumption by lowering the rates as more of the commodity is used.[137] Rate discrimination between classes of customers is therefore justified in many instances due to the economic exigencies of the natural monopoly.

Finally, the Canadian natural gas utilities invariably conduct discriminatory practices without being tainted by the connotation that the word "discrimination" normally affords. However, not all forms of discrimination in effect are acceptable, and indeed some types may be patently unfair to certain classes of customers while unjustly benefitting others. Regulators have a duty to identify and prohibit undue or unjust discrimination. The goal of regulation is to provide maximum cost savings to all natural gas users while ferreting out instances of undue price discrimination. Unfortunately, such instances may have been inadvertently exacerbated by the Canadian deregulation of prices for the commodity. Accordingly, a general discussion of the deregulatory process is thought to be necessary, in order to better understand the extent of alleged undue discrimination in the natural gas industry.

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137 Tomain, supra note 115 at 117-118.

4. DEREGULATION OF NATURAL GAS PRICING AND MARKETING REGIMES

Natural gas prices in Canada have been freed from direct government control since October 1986. The impetus for this legal change has come from various industry interests and certain economic exigencies. This impetus was facilitated by the election of a Progressive Conservative government in 1984 which dismantled the interventionist National Energy Program of the former Liberal government. Nevertheless, it seems that the long-term arrangements made under the former regime have left a continuing legacy. This legacy has the potential to inhibit the altruistic free-market principles involved in the commodity's price deregulation.

4.1 THE DEREGULATION PROCESS

The pricing and marketing of natural gas in Canada is undergoing a remarkable process of deregulation. This process began in March 1985 when the governments of Canada, Alberta, British Columbia and Saskatchewan recognized the need for a more market-oriented natural gas pricing mechanism thereby agreeing to establish the necessary market sensitive regime.[138] However the conditions required for such a regime

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138 The Western Accord: An Agreement between the Governments of Canada, Alberta, Saskatchewan and British Columbia on Oil and Gas Pricing and Taxation, March 28 1985.

were set forth in a separate document signed by the same parties.

On October 31, 1985, the intergovernmental Agreement on Natural Gas Prices and Markets[139] was executed with the express intention to create a "more flexible and market-oriented"[140] regime for the domestic pricing of Canadian natural gas. The Agreement declared an intent to:

> "foster a competitive market for natural gas in Canada, consistent with the regulated character of the transmission and distribution sectors of the gas industry".[141]

In other words, the transmission segment of the industry was not to be deregulated whereas the pricing of natural gas as a domestic commodity would be totally deregulated effective November 1, 1986.[142] Subsequently, the price of natural gas sold in interprovincial trade is determined by negotiation.

Significantly, the Agreement did not purport to derogate from Canada's constitutional authority over interprovincial and international trade.[143] Also protected were the powers and abilities of the provincial signatories in relation to the ownership and management of their natural resources.[144] The consuming provinces who were not signatories to the Agreement were encouraged to promote the effectiveness of the market-

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139 Agreement Among The Governments Of Canada, Alberta, British Columbia and Saskatchewan on Natural Gas Markets and Prices, October 31, 1985; (the so-called Hallowe'en agreement).

140 Id. Clause 1.

141 Id. Clause 4.

142 Id. Clause 2.

143 Id. Clause 21.

144 Id. Clause 22.

sensitive gas pricing regime. They are enjoined to enact legislation and direct their respective regulatory agencies in order to provide consumers with alternative supply sources, and distributors with greater flexibility in price determination.[145] Nevertheless, the efficacy of the deregulatory process seems to be influenced to some extent by the after effects of the previous regime.

Natural gas prices had previously been determined by market forces until the mid 1970's. The 1973 oil embargo and price hikes by the Organization of Petroleum Exporting Countries (OPEC), as well as increased demand and "extreme upward pressure"[146] on Canadian natural gas prices caused the federal government to intervene directly in the pricing of the respective commodities. The federal government, through the National Energy Board (NEB) regulated the export price of natural gas which in April 1977 was determined pursuant to the so-called substitution value method. This related the price of natural gas exported to the United States with the cost of replacing crude oil imported in eastern Canada.[147] On November 1, 1984, federal export policy was revised to allow exports to the U.S.A. at negotiated prices.[148]

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145 Id. Clause 26.

146 Pipeline Review Panel Report, A Review Of The Role And Operations Of Interprovincial And International Pipelines In Canada Engaged In The Buying, Selling, And Transmission Of Natural Gas June 1986, at 69.

147 Id.

148 Department of Energy Mines and Resources, Backgrounder document 85/162 (a) at 1.

Legislation[149] enacted in June 1975 enabled the federal government to unilaterally set domestic prices for petroleum or to conclude pricing agreements with the producing provinces. The threat of these overriding regulatory powers had the practical effect of keeping domestic oil and gas prices artificially low. Alberta, the largest producer in Canada, countered with similar legislation[150] that permitted the province to unilaterally set the minimum Alberta border price for gas sold outside its territory, or alternatively negotiate a price with the federal government.

Ultimately, both sides agreed upon the so-called "Toronto city gate"[151] formula which was a whole-sale reference price for commodity deliveries there, and which allowed for deduction of the pipeline carriers' transmission charges in order to derive the producers' field price. From November 1, 1975 the prices of Alberta natural gas sold interprovincially were determined by agreements between Canada and Alberta, and these prices were linked to crude oil prices.[152]

Following the 1984 defeat of the Liberal government headed by Mr. Trudeau, the present Progressive Conservative government led by Mr. Mulroney was elected with a mandate to dismantle the interventionist National Energy Policy of the former administration. When the 1985 collapse in the world market brought oil prices to approximately the same level as

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149 Petroleum Administration Act, S.C., 1974-75-76, c.47.
150 Natural Gas Price Administration Act, S.A. 1975, c.70; Natural Gas Pricing Agreement Act, S.A., 1975 c.38.
151 Pipeline Review Panel Report, supra note 146, at 70.
152 Backgrounder, supra note 148.

the Canadian regulated price, an ideal climate for deregulation of that commodity arose since no drastic price increase would reach consumers and engender political opposition.[153] Although the price of Canadian crude oil was deregulated June 1, 1985,[154] the "Hallowe'en" Agreement on Natural Gas Markets and Prices provided for a one year transition period for gas sold domestically.[155] The period of transition, November 1,1985 to November 1, 1986 allowed for the prescription of prices by the respective governments.

Afterwards, the former benchmark Alberta border price was eliminated by delegated legislation[156] which effectively implemented the market pricing regime. Instead of regulated producer prices, a netback pricing system was introduced whereby:

> "producers received the netback from the" (marketing arm of TransCanada Pipelines Ltd.) "Western Gas Marketing (WGML)-distributor negotiated wholesale prices rolled-in with the netback from export sales."[157]

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153 A.J. Black, "Comparative Licensing Aspects of Canadian and United Kingdom Petroleum Law" (1986) 21 Tex. Int. L.J. 471 at 492.

154 The Western Accord, supra note 138 at 3.

155 Natural Gas Markets and Prices Agreement, supra note 139 at Clause 3.

156 Order SOR/86-1049 dated October 30, 1986 which declared that ss. 53-65 of the Energy Administration Act (Canada) did not apply to any producer province effective November 1, 1986; and Regulation SOR/86-1050 dated October 30, 1986 which revoked the Energy Administration Act, Part III Regulations, CRC c.1261; and the Alberta Natural Gas Prices Regulations, 1986 SOR/86-838, which were revoked effective November 1, 1986.

157 R. Hyndman, Impact of Natural Gas Deregulation in Producing Provinces: Alberta (Alberta Dept. of Energy:1987) at 8.

This system was intended to give producers an input by requiring their approval of shippers' downstream negotiated netback prices.[158] During the transition period before complete deregulation, distributors could either make purchases from shippers at new or renegotiated prices, or directly negotiate purchases from producers providing that existing contacts are honoured.[159]

The governments undertook not to obstruct the resulting commercial transactions for the prices under existing contracts which were required to be renegotiated in good faith prior to November 1,1986.[160] Failure to renegotiate those contracts would result in the price being determined by arbitration.[161] Effective November 1, 1985 consumers were permitted to directly purchase from producers at negotiated prices or indirectly via buy-sell arrangements with distributors given the availability of contract carriage.[162] Unfortunately, problems were encountered in negotiating new natural gas carriage contracts due to the monopolistic nature of the downstream system and the continued existence of prior transmission arrangements.

For instance, TransCanada Pipelines Limited is the sole Canadian pipeline system transporting natural gas from western Canada to eastern markets, operating as both a commodity broker as well as a carrier. TransCanada both transports gas

158 Id.
159 Natural Gas Markets and Prices Agreement, supra note 139 at Clause 10.
160 Id. Clause 13.
161 Id. Clause 14.
162 Id. Clause 5.

volumes owned by others, and it purchases approximately 40% of Canada's production under long-term contracts with nearly 700 so-called system producers who are primarily located in Alberta. The production from the various gas pools of the system producers is then invariably resold under long-term contracts to distributors in Canada and the USA.[163] Therefore gas purchased directly from independent or non-system producers has the potential to displace or obviate those volumes which otherwise would have been purchased by a distributor from TransCanada.

Another difficulty encountered with deregulation deals with the termination of the Alberta border price for gas. Since many supply contracts made reference to this parameter, their contract prices became unascertainable.[164] Given the lack of certainty for this essential term, a binding arbitration procedure was promulgated by Alberta in order to set the prices of contracts bound by its lex loci.[165] However, those distributors who are parties to supply contracts with TCPL are not subject to Alberta's arbitration legislation if their respective agreements are governed by the law of a different jurisdiction. Hence, some distributors are questioning the validity of long term supply arrangements with TCPL in order to reap the benefits of deregulation, including the cheaper direct sales promised by the new regime.

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163 Annual Information Form, TransCanada Pipelines Ltd., March 24, 1987, at 3.

164 Natural Gas Marketing Act, S.A. (1986) c.N-2.8, s.12(1).

165 Id. s.12(2) and Arbitration Act, R.S.A. 1980, c.A-43 as am. by S.A. 1983 c.18 and S.A. 1986 c.10, s.17.

In addition to private contractual arrangements, broader policy matters are involved in the process from the regulated natural gas pricing regime to the new deregulated structure. For instance, both tiers of government anticipated that reviews would be made of the procedures used to determine how much gas is surplus to Canadian needs and the needs of the producing province.[166] These reviews of surplus tests would address the public interest in security of supply and presumably "result in significantly freer access"[167] to Canadian and export markets.

4.2 "SURPLUS GAS" AND THE SECURITY OF SUPPLY

Removal of natural gas from the province of Alberta is subject to legislation[168] which requires that an application be made to the Energy Resources Conservation Board (ERCB)[169] authorizing the removal. Issuance and amendment of removal permits may be made according to terms and conditions prescribed by the ERCB as approved by the Lieutenant Governor in Council.[170] However a removal permit will not issue unless the ERCB decides that it is in the public interest of Alberta having regard inter alia, to the needs of Albertans, particulars of reserves and any other relevant matters.[171]

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166 Natural Gas Markets and Prices Agreement, supra note 139 at Clause 16.
167 Id.
168 Gas Resources Preservation Act, S.A. 1984, c.G-3.1, as am. by S.A. 1986, c.17.
169 Id. ss.2, 1(1)(a).
170 Id. s.4.
171 Id. s.8.

One effect of the October 31, 1985 Agreement pertaining to the public interest was to require that the respective producing provinces of Alberta and British Columbia initiate a review of their so-called surplus tests.[172] Following a request made to the ERCB by the Alberta Minister of Energy,[173] a review was made[174] of the formulae and procedures used to ensure security of supply in that province. The Board concluded that the previously used gas surplus and deliverability tests did not suit the new deregulated environment. These tests, based upon a 25 year period, calculated those volumes of gas surplus to the present and future requirements of the province.[175]

Rather than rely solely on contracts, the ERCB devised a new 15 year based mandated surplus test that provides for the volume of gas needed to protect core users.[176] This group is defined arbitrarily to include residential customers, commercial customers and small industrial users. The new surplus calculation is an approximation to be used in conjunction with the ERCB's judgement in deciding whether or not new removal permits should issue.[177] Under this test, it is expected that the gas retained to protect Alberta consumers

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172 Natural Gas Markets and Prices Agreements, supra note 139 at Clause 23 (i).

173 Letter dated 2 December 1985, from Alberta Minister of Energy.

174 Alberta Energy Resources Conservation Board Report 87-A, Gas Supply Protection For Alberta: Policies And Procedures, March 1987.

175 Id. at v.

176 Id. at 20.

177 Id. at 17.

will not differ substantially from those volumes expected to be under contract.[178]

A further hearing[179] was conducted by the ERCB in conjunction with the Alberta Public Utilities Board following the directions of the provincial government.[180] The Boards recommended that residential and commercial customers be deemed to be a core market worthy of special protection because their:

> "dependence on natural gas is so fundamental that assurance of supplies is always a priority" ... and that "[T]hese customers may be protected either through reliance on gas utility companies...or through direct sales arranged with producers or brokers, provided that these directs sales involve long term commitments on both sides."[181]

These customers are to be protected by long term contracts of approximately 10-15 years.[182] Small industrial users were notably excluded from this definition of core customers as the Alberta PUB believed[183] that inclusion of that group would be contrary to its enabling legislation. Nevertheless, one noteworthy effect of the October 31, 1985 agreement has been to reassess the nature of public interest in the new deregulated pricing system.

This public interest issue was concurrently addressed at the federal level following a review by the National Energy

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178 Id. at v.
179 Alberta PUB/ERCB Report No.E87128/87-C, Gas Supply and Transportation Service Inquiry, Dec. 29, 1987.
180 Order in Council 484/87.
181 Alberta PUB/ERCB Report No.E87128/87-C, supra note 179 at 11.
182 Id.
183 Id. at 20.

Board (NEB) of the Canadian formula used in determining natural gas surplus.[184] Since the removal of natural gas from Canada is subject to legislation which requires an export order or licence[185] from the NEB, that Board must have regard inter alia, to foreseeable Canadian requirements and trends in discovering gas.[186] These national public interest requirements are reflected in the new "Market-Based Procedure"[187] which scraps the former regulated surplus test. The present procedure prevents interference with the market as long as the needs of Canadians are met while providing for regulatory interference should additional exports prevent supply of foreseeable Canadian demand.

The adoption of the Market-Based procedure supersedes the reserves-to-production-ratio procedure which required fifteen times the amount of reserves for each year's production. The former procedure complements the national energy policy of letting market elements determine prices, whereas the latter procedure might have induced restrictions in exports contrary to policy and the national public interest.[188] In

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184 National Energy Board Review of Natural Gas Surplus Determination Procedures, Reasons For Decision, July 1987. British Columbia has also reviewed its surplus determination procedures and has promulgated a 15 year surplus test: B.C. Ministry of Energy, Mines and Petroleum Resources, Review Of The British Columbia Natural Gas Surplus Determination Procedures, Reasons For Decision, July 1987.

185 The National Energy Board Act, R.S.C 1970, c.N-6.

186 Id. s. 83.

187 NEB Surplus Determination Procedures, supra note 184 at 26.

188 Backgrounder: National Energy Board News Release 87/44, "NEB Adopts New Natural Gas Surplus Determination Procedure", Sept. 9, 1987, at 1-2.

applications for licenced export of natural gas, the NEB will now protect security of supply by a two stage surplus gas test consisting of public hearings and the ongoing surveillance of the marketplace.

Monitoring of the marketplace will include publication by NEB staff of a biennial energy supply and demand analysis.[189] The public hearings stage will itself consist of three components. A complaints procedure will entertain grievances of Canadian users who are unable to contract for commodity purchases on similar, not identical terms to those of a proposed export.[190] If a complaint is meritorious, the NEB may deny the relevant export application or facilitate an opportunity to correct the situation by staying its decision.[191]

Additionally, an impact assessment of the proposed exports on the Canadian energy market must be filed with the NEB by all applicants for export licences. Finally,[192] export proposals shall continue to be vetted by the NEB having regard to the Canadian public interest as required by the Board's empowering Act.[193] However, some concern exists that the NEB would only be able to monitor exports and not utilise the complaints procedure if the recent Canada-US Free Trade Agreement is implemented. Indeed, one 1987 federal report disclosed that some export prices had fallen below their

189 NEB Surplus Determination Procedures, supra note 184 at 26.
190 Id. at 24.
191 Id. at 25.
192 Id. at 25-26.
193 The National Energy Board Act, R.S.C. 1970, c.N-6, s.83.

Alberta and British Columbia domestic counterparts, causing the federal government to assert indifference to such early results.[194]

4.3 THE COMMERCIAL NATURE OF A TAKE-OR-PAY CONTRACT

The new federal and provincial criteria for determining surplus gas volumes and security of supply are public law initiatives aimed at furthering the intention of the October 31, 1985 Agreement.[195] One important object of the Agreement states that:

> "Access will be immediately enhanced for Canadian buyers to natural gas supplies and for Canadian producers to natural gas markets while at the same time assuring that the reasonably foreseeable requirements of gas for use in Canada are protected."[196]

Despite this ideal the provisions of the Agreement are not privately enforceable by either consumers, producers, shippers or distributors, since the Agreement is a political document not a legal one.[197] Accordingly, it is thought that the practical effect of the deregulation process may be better

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194 Energy Pricing News, Natural Gas Report, Vol.7 No.10, Oct. 13, 1987. See: Free-Trade Agreement Between Canada and the United States of America, text as initialed by Chief Negotiators on December 10, 1987, Signature of the Agreement: January 2, 1988.

195 Natural Gas Markets and Prices Agreement, supra note 139.

196 Id. at Clause 2.

197 National Energy Board Reasons For Decision, MH-1-87, dated September 1987. Manitoba Oil and Gas Corporation, Application dated 25 May 1987, as amended, for Orders Directing TransCanada Pipelines Ltd. to Receive, Transport and Deliver Natural Gas and Fixing Tolls.

understood following an analysis of the contractual arrangements between some the major participants in the industry.

One salient aspect pertaining to the voluntary obligations between commercial buyers and sellers of natural gas is the ubiquitous take-or-pay clause. This type of provision stipulates that a buyer must purchase gas during a fixed term and pay for it despite not having taken delivery during that term, even though delivery may be had at a later time.[198] Many such arrangements predate the November 1, 1986 deregulation of prices at a time when most eastern Canadian consumers or end-users purchased gas from seven principal distribution companies. These distributors purchased the majority of their volumes from TransCanada Pipelines Ltd. (TCPL) under separate so-called CD Contracts. However, these distributor sales contracts do not match TCPL's producer supply contracts which are long term "take-or-pay" supply arrangements.[199]

The contracts between TransCanada and the distributors contemplate the existence of a commodity charge and a demand charge, except for those relatively few dealing with the transportation of gas volumes not owned by the pipeline company. The former charge is for gas actually taken by the

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198 Pipeline Review Panel Report, supra note 146 at 16.

199 TransCanada Pipelines Ltd v. National Energy Board (1986) 72, N.R. 172 at 174, (Fed. C.A.). Affirming NEB decision RH-5-85 which is reproduced in the Canada Energy Law Service, supra note 43, NEB decision 41, "TransCanada Pipelines Ltd - Availability of Services" Reasons for Decision, May 1986.

gas purchaser whereas the latter is a charge for the maximum amount that the buyer may take and is payable even if no gas is actually taken.[200] Demand charges, which are based upon the peak (either actual or estimated) usage of the buyer, may be thought of as a portion of the overall rate for gas service.[201] Another variation of take-or-pay contractual clause, also known as a minimum annual obligation, applies when a buyer obligates himself to take a minimum quantity of gas over a term certain for a fixed price. If deliveries are not nominated then the purchaser must nevertheless make minimum payments to the supplier.[202]

These type of clauses, which first appeared in the United States, owe their origin to the high fixed costs associated with a natural gas pipeline as well as the desirability perceived by producers in locating an assured market. Since acceptance of long-term supply contracts often prevented a carrier from exploiting other North American markets during the post World War II construction era, the take-or-pay clause consequently gave carriers a predictable cash flow and lessened the probability that their principal buyers would arbitrarily mistreat them.[203] Eventually difficulties developed with this contractual practice after the once continuously expanding natural gas market became the victim of

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200 H.R. Williams and C.J. Myers, Oil and Gas Law (Matthew Bender:New York, 1987) Vol. 8 at 151.

201 Id. at 233.

202 Id. at 979.

203 J.H. Foy, "Take-or-Pay Clauses in Gas Contracts: Why We Have Them and the Problems They Are Now Causing" 23 Exploration & Economics of the Petroleum Industry (1985) at 17.01{1-2}.

the 1973 and 1979 oil crises that precipitated the instable cycles of oversupply and shortage.[204]

Between 1970 and 1977, demand for Canadian natural gas outstripped supply and during that time TransCanada actively negotiated long term purchases from Alberta producers.[205] A surplus of supply then developed causing financial difficulties with the take-or-pay charges owed to producers for that period. Failure to take delivery of the minimum annual obligation by the carrier-purchaser then rendered prepayments due for the gas not taken. These considerable difficulties were addressed in 1982 by the so-called "Topgas" refinancing agreement and its subsequent amendment whereby TransCanada effectively borrowed money to meet its "take-or-pay" obligations.[206]

Indeed, the Alberta gas producers were induced by the over-supply situation to lobby for immediate and long term freer access to the United States export market. This concession was made in exchange for the risk of price decreases in a soft, deregulated domestic market. When the world price of oil recovered and U.S. gas reserves declined, it was forecasted that interfuel price competition would then upwardly drive gas prices.[207]

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204 Id. at 17.01(4).
205 Pipeline Review Panel Report, supra note 146 at 16.
206 J. Park, "Developments in Natural Gas Purchase Contracts" (1984), 22 Alta. L. Rev. 43.
207 Hyndman, supra note 157 at 3.

Therefore, the gas bubble rendered deregulation "politically possible"[208] as a result of the contracts problem which it had helped to create. Hence the Hallowe'en Agreement:

> "was predicated on the U.S. market opening up for additional exports in advance of, or in tandem with, Canadian deregulation. The failure of that to happen has put severe strains on the deregulation package."[209]

Some of these tensions and inadequacies of the resultant deregulation process are discussed below, pertaining to the the issues of direct sales and pipeline bypass. However, it is thought that an elaboration of the take-or-pay problem is in order at this juncture, including discussion of the remedial Topgas programme.

Topgas established two banking companies in conjunction with the producers and a consortium of lender banks which modified approximately 2400 of TransCanada's gas purchase contracts.[210] In 1982, arrangements were made with the "financial intermediary"[211] Topgas Holdings Limited and over 98% of TransCanada's contracted producers to refinance and make take-or-pay advances. This arrangement provided for a 60% reduction in the TransCanada's minimum yearly purchase obligations. In 1983 the over-contracted problem persisted and another financial intermediary, Topgas Two Inc. was

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208 Id.
209 Id. at 1.
210 Park, supra note 206.
211 TransCanada "Annual Information Form", supra note 163 at 9.

created in association with 93% of the producers and the syndicate of banks.[212]

Referred to collectively as the Topgas programme, both initiatives refinanced the prepayments owed by TransCanada prior to the agreement and then advanced the take-or-pay monies due to the producers by the over-contracted TransCanada, with provision for the advancement of subsequent payments.[213] Over $2.7 billion was advanced by Topgas to producers for the prepaid gas which shall be delivered to TransCanada over a 10 year period, the latter who will repay the loans upon resale.[214] In effect, the take-or-pay liabilities were shifted from TCPL onto the producers. The payment of principal and interest is based upon TCPL maintaining its downstream market share for which it had made upstream supply arrangements. Hence, when the markets expanded the producers would then obtain the revenue required to make these payments.[215]

Topgas also reduced the minimum annual obligation exposure that would otherwise be due from TransCanada. However, the refinancing arrangement further provided that interest on the unpaid balance be added to TransCanada's cost of service, which is a charge deducted from the price received by the producer at the Alberta border. This resulted in lower well-head gas prices.[216]

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212 Id. at 9-10.
213 Park, supra note 206 at 44.
214 TransCanada "Annual Information Form", supra note 163 at 10.
215 Hyndman, supra note 157 at 5.
216 Pipeline Review Panel Report, supra note 146 at 16-17.

While lower prices were received by the producers, the Topgas Agreement also resulted in the federal government losing tax revenue, Alberta losing both tax and royalty revenues, and both tiers of government notionally incurring some of the interest due from TransCanada's borrowed monies.[217] The Alberta government responded in 1986 with legislation[218] providing for a levy on Alberta Gas delivered to TCPL. Rather than the pipeline company collecting the interest carrying costs from its producers out of its cost of service charges, the Act designates TCPL to collect these costs from its customers and deposit them into a "take-or-pay costs sharing fund".[219]

The reality of the market place illustrates that commercial exigencies have the ability to effect and sometimes neutralise the contractual enforcement of long-term natural gas sales agreements.[220] For instance, successive modification and and renegotiation of long-term Canadian gas export contracts took place with buyers in the United States between 1979 and 1984. Even though Canadian natural gas was demanded in huge volumes during the 1970's, domestic American demand for the imports fell as domestic production rose in the 1980's. In some cases, the exposure to take-or-pay charges dropped nearly 50% or was forgiven entirely by producers who

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217 Id.
218 Take-Or-Pay Costs Sharing Act, S.A. 1986, c.T-O.1.
219 Id., s.3-5.
220 G.B. Greenwald, "Natural Gas Contracts Under Stress: Price, Quantity, and Take or Pay" (1987) 5 J.E.R.L. 1 at 8.

perceived the seriousness of the situation.[221] Therefore, natural gas transportation is not only affected by regulatory and contractual provisions since an interdependency clearly exists with business and commercial considerations.

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221 Id. at 8-10.

5. THE DIRECT SALES CONTROVERSY IN MANITOBA

Canada's deregulation process has promised cheaper natural gas for consumers via direct sales from producers. Interprovincial carriage would be made by the monopolistic TransCanada Pipelines Ltd. (TCPL) under more competitive arrangements than those involving gas sold to distribution companies by that carrier in its broker function. Nevertheless, there is a certain irony vis à vis the extensive take-or-pay contract renegotiations. Under the sanctity of contracts principle, local distribution companies are being forced to honour their long-term service contracts with TCPL and not obviate or "self-displace" them with direct sale arrangements. Hence, the dirigiste National Energy Board has refused to grant transmission orders to a third party co-operative association in Manitoba which wants to alleviate residential rates. This has resulted in allegations of unjust discrimination in prices and inefficient interference in the supposedly deregulated price of the commodity.

5.1 DIRECT PURCHASES OF NATURAL GAS

Following the October 31, 1985 Agreement,[222] the Province of Manitoba sought to take advantage of the

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222 Natural Gas Prices and Markets Agreement, supra note 139.

deregulated environment in order to obtain lower priced natural gas for Manitobans. It had created the Manitoba Oil and Gas Corporation (MOGC) by legislative fiat[223] to act as its agent in the brokering of natural gas for both present and future industrial, commercial and residential consumers in the province.[224] The Crown corporation MOGC then negotiated direct sales agreements with Alberta producers at a price that was $1 cheaper than the $3/Mcf price under existing contacts. This activity reflected the policies of the provincial government formed by the socialist New Democratic Party, which was adamant in its desire to provide cheaper natural gas for its 200,000 residential customers.[225]

Since negotiations for carriage had failed, in order to have TransCanada Pipelines Limited transport these gas volumes, MOGC was required to make application to the National Energy Board (NEB) for the statutorily prescribed[226] interprovincial gas transmission order. After a public hearing the NEB decided against the applicant in September 1987. The Board opined that the proposed:

> "gas volumes to be transported would in essence displace all volumes presently being purchased by each of the distributors - ICG and GWG" (Inter City Gas Utilities [Manitoba] Ltd. and Greater Winnipeg Gas Co.) "to serve markets in Manitoba. This would effectively result in the total replacement of the distributor's contracted firm supply..." and "constitutes self-displacement in substance and is not in the public interest..."[227]

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223 Manitoba Oil and Gas Corporation Act, C.C.S.M., c. 034

224 NEB Reasons for Decision MH-1-87, supra note 197 at 1.

225 R. Gage, Pawley vows to fight NEB on natural gas prices, The Globe and Mail (Toronto), September 29, 1987 at B6.

226 NEB Act, supra note 41 at s. 59(2).

227 NEB Reasons for Decision MH-1-87, supra note 197 at 6.

The Board further held that the proposal was inconsistent with the "orderly transition"[228] to a market oriented environment contemplated under the October 31, 1987 Agreement on Natural Gas Prices and Markets.

The decision invoked a vociferous response from Manitoba Premier Pawley whose cabinet then announced that it was appealing the NEB decision to the Federal Court of Appeal.[229] Subsequently, another noteworthy initiative involving the expropriation of the ICG Manitoba gas monopoly was dropped,[230] making the Appeal a principal instrument in obtaining the cheaper gas promised by deregulation. However, leave to appeal was refused by the Federal Court of Appeal on April 24, 1988.

Afterwards, Premier Pawley's New Democratic Party (NDP) government was resoundingly defeated in an April 27, 1988 general election, the Manitoba Conservative party having formed a minority government. The latter will now rule at the pleasure of the provincial Liberal and New Democratic parties;[231] obviously the nature of this coalition will affect Manitoba's natural gas policy. Significantly, provincial concerns over the availability of direct sales are being voiced in a new forum. Prior to the refusal for leave by the

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228 Id.

229 Energy Pricing News, Natural Gas Report Vol. 7, No. 12, December 8, 1987. On November 18, 1987, a Notice of Motion was filed filed for Leave to Appeal to the Federal Court of Appeal.

230 G. York, Manitoba drops plan to buy gas firm, The Globe and Mail (Toronto), January 5, 1988.

231 G.York, Manitoba NDP will permit Tories to assume power, The Globe and Mail (Toronto), April 28, 1988 at A1-A2.

Federal Court of Appeal, the National Energy Board ordered a new hearing (RH-1-88) which pertains to a wide range of matters including the direct sale controversy and its so-called self-displacement rule.[232]

These responses are respectively thought to reflect the underlying causes of the direct sale controversy. Since large commercial buyers have been able to negotiate direct sales as an incident of the deregulation process, allegations of discrimination towards small customers or the so-called core customers have been made when their attempts to seek direct sales have been thwarted. Conversely, some industry commentators have argued that Manitoba's bid to act as broker for the province would detract from the threshold of buyers and sellers necessary to make market sensitive pricing work.[233]

One industry insider was induced by the NEB's Manitoba transmission decision to question what the federal government meant by its definition of deregulation. He suggested that an elucidation by the parties to the so-called Hallowe'en Agreement might redress the present situation which allows direct sales to large industrial users but not others.[234] Accordingly, it is felt that the efficacy of the deregulation process should be studied to the extent that it

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232 National Energy Board, Hearing Order RH-1-88, February 17, 1988.

233 D. Slocum, Proposal by Manitoba Oil not in public interest: NEB, The Globe and Mail (Toronto), October 20, 1987.

234 See Gage, supra note 225, per Gary Hoffman, vice-president of ICG.

contemporaneously promotes a more market oriented pricing regime and affects private contractual rights and capacities.

For instance, the denial of Manitoba's access to the TCPL pipeline system was distinguished from earlier approvals of direct sales on the grounds that these approvals related to specific end-users and did not usurp all the market or supply arrangements of a distributor. The National Energy Board's decision largely turned on the concept of displacement gas as well as the stipulation that the existing long term contracts between TransCanada and the provincial distributors must be honoured.[235] While this pacta sunt servanda doctrine is an objective, its use appears designed to serve a particular set of interests, namely the protection of TCPL's marketing position. Deregulation is therefore forcing tough regulatory decisions between the new distributor-producer arrangements and the existing ones of the monopoly carrier.

5.2 CONTRACTUAL IMPLICATIONS OF DISPLACEMENT

A multiple layer of contractual relations exists in the distribution of natural gas from the well-head to the burner-tip. Implementation of the new regime's direct sales affected certain arrangements by the "inappropriate duplication of demand charges" to some of TransCanada's customers.[236] These difficulties were foreseen by the governments who were parties to the October 31, 1985 Agreement. They recognized the

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235 NEB Reasons for Decision MH-1-87, supra note 197 at 6-7.
236 TCPL v. NEB (affirming RH-5-85) supra note 199 at 172.

potential problems involved in direct sale displacing a "corresponding volume" that would otherwise be purchased by an end-user from a local distribution company.[237] An attempt to avoid this anomaly was made by enjoining the National Energy Board to facilitate direct sales through the prevention of inappropriate double demand charges that might arise from displaced gas volumes.[238]

One of the arguments being utilised by Counsel for the Manitoba Oil and Gas Corporation (MOGC) involves the submission that the October Agreement and subsequent NEB rulings authorize displacement simpliciter by direct purchases. However, the mischief that is to be prevented is the displacement by distributors of their Contract Demand (CD) supply contracts with TCPL.[239] This follows from the definition of self-displacement adopted by the National Energy Board in the RH-5-85 and RH-3-86 decisions:

> "Generally, self displacement occurs when a distributor replaces any portion of its presently contracted firm supply with an alternate supply or makes any other arrangement that accomplishes the same end."[240]

From this definition, the NEB in the Manitoba action listed the key issue as being whether the proposed arrangements

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237 Id. at 174.

238 Natural Gas Markets and Prices Agreement, supra note 139 at clause 7 and 10.

239 Manitoba Oil And Gas Corp. Notice of Motion For Leave to Appeal Order No. MH-1-87, Representations Supporting Leave to Appeal, Fed. C.A. Action No. 87-A-402 at 7; Andrew R. Thompson, Counsel for the Appellant.

240 National Energy Board decision RH-3-86, s.11.2, at 72. RH-5-85 is reproduced in the Canada Energy Law Service, supra note 43, NEB decision 41.

constituted, "in form and/or substance" self-displacement. While the Board did not find that the direct sale arrangements constituted "self displacement" in form, it held that they constituted the concept in substance.[241] Hence in their application for leave to appeal, the Appellants averred inter alia that the NEB made an error in law in applying these rulings to the present facts.[242]

Equitable natural gas cost allocation and toll design are the salient issues in the self-displacement controversy. For instance, when a previous customer of a local distributor concludes a direct sale, he is obliged to pay demand charges to TCPL for transportation service under that arrangement. But prior to November 1, 1988, the direct purchaser had to pay a duplicate demand toll to the distributor to indemnify its demand charges which were unabsorbed because of the latter's arrangement and volumes being displaced. Rather than burden the distributor's remaining customers with these demand charges payable for the untaken gas, provincial regulators had imposed the costs on the direct purchaser.[243] Thus, in response to the governments' request to prevent duplication of demand charges, the National Energy Board adopted a new cost allocation system.

Under the old system, the fixed costs and allowable investment return of TCPL were allocated with reference to the "contract demand" volumes specified in its gas service

241 NEB decision MH-1-87, supra note 197 at 6.
242 Notice of Motion, supra note 239 at 5-6.
243 RH-5-85, Canada Energy Law Service supra note 43, NEB decision 41, at 10-4422, para.2.2.

contracts. These contracts charge a buyer for those commodity volumes actually purchased and received from TCPL. The buyer concurrently owes fixed transportation charges for the maximum amount of gas that the carrier-broker agreed to sell and deliver, even though the buyer may have nominated and received less.[244] Present cost allocation is based on the operational demand volume (ODV) criteria.[245] This is defined as follows:

> "A distributors operating demand volume will be determined to be the contracted demand, as specified in the distributor's CD contract with TCPL, less the total amount by which the distributor's CD volumes are displaced."[246]

Rather than making a direct purchaser pay double demand charges, the new system stipulates that the distributor will pay for the amount of contract demand (CD) service that it receives from TCPL. Direct purchasers who displace system gas will likewise pay demand charges for the actual transportation service that it receives from TCPL. Hence, TCPL would recover all of its authorized fixed costs.[247]

Fundamentally, the operating demand volume methodology is intended to help free up natural gas markets in Canada pursuant to the meaning of the October 1985 Agreement.[248] Although the NEB does not have authority over TCPL's sale of gas as a commodity, it does have jurisdiction over the interprovincial pipeline company in its function as a

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244 TCPL v. NEB (affirming RH-5-85) supra note 199 at 177.
245 RH-5-85, Canada Energy Law Service supra note 43, NEB decision 41, at 10-4424, para.2.2.
246 TCPL v. NEB (affirming RH-5-85) supra note 199 at 177.
247 Id. at 178.
248 Canada, NEB News Release, 17 June 1987 at 2.

transporter or carrier of the commodity.[249] This power entitles the National Energy Board to make orders fixing transportation charges that have the effect of varying the contracts between TCPL and the local distributors.[250] Unfortunately, it is not always clear where a lawful variation of transportation charges becomes a wrongful variation of a commodity contract in arrangements that contemplate both functions. Thus, while the ODV's effect interfered with the contractual relations between TCPL and its distributors, it was an action entirely based upon the toll making power of the Board.[251]

Significantly, "self-displacement" by a distributor was made an exception in RH-5-85 and RH-3-86. The Board has denied operating demand volume (ODV) relief to distributors who displace their own gas volumes currently under contract to TCPL.[252] This particular rationale attempts to prevent direct sales from undermining "the sanctity of existing contracts" between TCPL and the ICG-GWG distributors in Manitoba.[253] Unfortunately, the reasons of the NEB do not state why the sanctity of these arrangements must be respected when the contractual interests of ordinary direct purchasers may otherwise be affected.

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249 NEB Act, supra note 41. Section 50 permits the Board to make orders relating to "traffic, tolls, or tariffs."

250 Saskatchewan Power Corp. et al. v. TransCanada Pipelines et al, [1981] 2 S.C.R. 688 at 702, 39 N.R. 595, per Laskin, C.J.

251 TCPL v. NEB (affirming RH-5-85) supra note 199 at 180.

252 Notice of Motion, supra note 239 at 16-18.

253 see: NEB decision MH-1-87, supra note 197 at 5.

When the NEB held that the Manitoba application would "in essence displace all volumes"[254] under contract between the distributors and TCPL, it arguably digressed from its earlier definition of "self-displacement." That definition referred to a distributor's attempt to conclude a direct sale whereas the applicant in the Manitoba hearing was clearly not one of the local distribution companies. It was MOCG, a separate corporate entity that was not a party to those arrangements. Saying that the application would amount to self-displacement of all the distributors volumes is a misnomer that requires a big imaginative leap in order to be convincing. First of all, as a matter of semantics, MOGC could not displace itself given its third party nature. Secondly, the arrangement included an "opting out" procedure so that MOGC would not displace all contractual arrangements. More importantly, the National Energy Board did not give explicit reasons for holding that this sort of constructive self-displacement was against the public interest.

Furthermore, it is thought that the Board may have preserved the TCPL-local distributor arrangements, while wrongfully applying its transportation jurisdiction in order to squelch MOGC's direct purchase of the commodity. Support for this argument is derived from the Hallowe'en Agreement of October 31, 1985 which contemplated changes in provincial legislation that might provide "alternative sources of supply"

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254 ID. at 6.

to consumers.[255] A fortiori, the former federal Minister who shepherded the Agreement publicly commented that "little customers" such as residential and commercial users would be free to arrange co-operative arrangements or deals in order to secure direct sales.[256] Thus, it would appear that the type of arrangement requested by Manitoba was supported by the public policy of deregulation.

Moreover, the NEB may have erred in law as regards the relationship between the public interest and self-displacement. For instance, the National Energy Board Act expressly prohibits unjust discrimination in the provision of services, facilities or the levying of tolls,[257] yet the Board did not find the denial of access to carriage services to fall under this heading. Rather, it distinguished the section 59(2) direct sale transmission orders that had been previously granted.

> "The effect of granting this application would be to permit self-displacement, would not be consistent with the orderly transition to market-sensitive pricing as contemplated in the Agreement and would be contrary to the public interest."[258]

Since all previous direct sale transmission orders were granted to large industrial users the Board's decision prima facie appears to unduly discriminate between classes of

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255 Natural Gas Markets and Prices Agreement, supra note 139 at clause 26.

256 Hon. Patricia Carney, Minister of Energy, Mines and Resources (Canada), press conference circa Oct.31,1985; which is RH-5-85 Exhibit B-29, as cited in: Notice of Motion supra note 239 at 15 et infra.

257 NEB Act supra note 41 at s.55.

258 NEB decision MH-1-87, supra note 197 at 7.

customers.[259] In other words, end-user discrimination such as this against residential and small commercial concerns is wrongful in the absence of acceptable cost criteria.[260] Thus although the Manitoba leave to appeal application involves alternative grounds that are both narrow and technical, it also entails the broader issue of marginal cost pricing and reasonable rates for gas.

Some of these issues were canvassed in a provincial hearing held by the Public Utilities Board (PUB) of Manitoba prior to the federal regulatory decision.[261] Basically, this hearing was convened in order to set Manitoba gas rates following a long-term commodity-carriage contract between TCPL and the local distributors GWG-ICG. In fact, an ancillary matter to the Manitoba direct sale affair involves the term of this arrangement. In particular, while that so-called CD contract was stipulated to expire October 31, 1995, the termination of the regulated Alberta Border price would have made it void for uncertainty if new pricing provisions were not made. These were made by a Gas Pricing Agreement (GPA), with an expiry date of October 31, 1988.

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259 Notice of Motion, supra note 239 at 20-21.

260 Bonbright, supra note 89 at 370-374.

261 Manitoba PUB Order 89/87, dated May 13, 1987; pursuant to a Public Hearing To Inquire Into The Applications Of Greater Winnipeg Gas Company And ICG Utilities (Manitoba) Ltd For An Order Or Orders Approving A Change In Rates And Other Matters, held in Winnipeg, Feb. 9 to 14, 16, 17 and March 16 to 20, 1987.

In the absence of vital pricing terms, it is thought that the CD Service contract would be unenforceable.[262] However subsequent to the NEB's Manitoba decision, the provincial gas utilities and the agent of TCPL entered into a one year contract with Manitobans paying less than before for gas yet more than the direct sale price of the commodity.[263] Given that the GPA contract was soon to expire, it is difficult to see why the NEB refused MOGC direct sale transmission orders which would otherwise be effective October 31, 1987 since there would be no other arrangements whatsoever to displace.[264] Therefore, it is thought that the NEB failed to advance the public interest in facilitating lower gas prices.

Included in the Gas Pricing Agreement are provisions for a Competitive Marketing Program (CMP) which is a price differential scheme whereby large end-users are afforded discounts. It is estimated that similar discounts in Ontario have resulted in residential users paying almost twice the price for natural gas at that time. Large end-users are discouraged from switching to non TCPL system gas by these

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262 A.J. Black, The Validity of the 1986 Natural Gas "Contract For Demand Service" between TransCanada Pipelines Ltd. and Greater Winnipeg Gas Co., unpublished Directed Research for Prof. Andrew R. Thompson, Faculty of Law, University of British Columbia, Jan. 18, 1988.

263 Janet Keeping, "Righteous Indignation, The Public Interest and Deregulation of Natural Gas" (1988) 21 Resources 5 at 7; (The Newsletter of the Canadian Institute of Resources Law). The new rate is $2.30/Mcf, down from approximately $3.00.

264 The November 1, 1988 situation is what is now before the NEB in the RH-1-88 Hearing. No pricing arrangements have yet been made by TCPL and it now appears generally accepted that if no new agreements are made then the CD Contracts will not be enforceable after Nov. 1, 1988.

concessions which are set forth in special long term commodity supply contracts.[265] Accordingly, one commentator considered these discounts to be "unduly discriminatory because they are not cost based."[266] Hence, discounts of this nature are anti-competitive to the extent that they inhibit the large industrial users from concluding direct sales with non-system users.

Indeed, the Manitoba PUB considered that these discounts might result in unduly discriminatory rates.[267] For instance, due to the Canadian economy of scale, the monopolistic nature of natural gas transportation may only be economically efficient if regulation attempts to mirror the competitive free market and marginal cost principles.[268] Thus the Manitoba Board concluded that:

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265 M.J. Trebilcock, Manitoba Hearing supra note 261, "Pre-filed Evidence on Behalf of the Ministers of Consumer and Corporate Affairs and Energy and Mines" submission of Professor Michael J. Trebilcock, at 13 & 9.

266 Id. at 14. N.B.: A new buy-sell contracting arrangement, called a PRC, is being used by TCPL to support the CMP. Following a series of paper transactions, end-users in Ontario pay a uniform price and obtain their discount in Saskatchewan. This legal "slight of hand" appears to have the effect of eliminating the jurisdiction of the Ontario Energy Board to to make a finding of price discrimination.

267 Manitoba PUB Order 89/87, supra note 261 at 22. The PUB can investigate public utility tolls or charges. If it opines these to be excessive, unjust, unreasonable or unjustly discriminatory, it has plenary power to fix just and reasonable rates: Public Utilities Board Act, R.S.M 1970, as am., c.P280, ss. 64(1)(2),74,77.

268 For a thorough discussion of rate design and marginal cost pricing, see: Bonbright supra note 89 at 49-59, 291-293, 395; Bryer & Stewart, supra note 112 at 223-224, 514-516.

> "Due to a number of constraints, there is not a free competitive market for natural gas sales to distributors for resale to core customers in Manitoba. ... The Board does not consider that the Companies were able to negotiate on a voluntary basis ... because of the constraints levered against them and the overwhelmingly superior bargaining power of TCPL."[269]

Some of these restraints to market oriented competition were identified as sanctity of contracts, the self-displacement rule and double demand charges. Other constraints included the gas removal permit system in the province of Alberta and contractual constraints associated with TCPL. But much to its chagrin, the Manitoba Board did not see any plausible alternative to the prices that were set forth in the Gas Pricing Agreement (GPA).[270]

Hence, the Manitoba Public Utilities Board and other provincial regulatory boards are thought to be in a predicament largely caused by the long term CD Contracts existing between TransCanada and the local distribution companies. Although there is an obligation to pay a fixed transportation charge (CD toll) the CD Contracts are not take-or-pay since there is no obligation to take or pay for gas as a commodity. However, these distributor sales contracts do not match TCPL's take-or-pay producer supply contracts. Since TransCanada is over-contracted to producers, it is reluctant to renegotiate the CD Contracts since it would receive less revenue to repay the producers.

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269 Manitoba PUB Order 89/87, supra note 261 at 17 & 19.
270 Id. at 18 & 19.

Regulatory boards must therefore vet the rates of local distributors in an economically efficient manner. They are concerned about losing large industrial customers to alternative fuels with the result that the remaining "core" residential and small commercial users will have to bear higher rates. Therefore they are willing to approve the streaming of gas by the competitive discounts offered to large industries as an incentive for them to remain connected with the local distribution system.

Furthermore, there does not seem to be much economic sense in protecting local distributors from the competition of third party direct sales. Any opposition from the pipeline carrier would seem unfounded as long as it is assured of its transportation costs, as well as a fair return for its services. Therefore, the direct sale controversy really seems to involve an identification of the parties who will actually bear the burden of displacement. One commentator says that:

> "The interests principally injured by such displacement must surely be the system producers who either lose sales or must cut prices to foreclose displacement. This form of competitive injury, however, is consistent with the efficient functioning of market forces."[271]

In other words, the producers who are under long-term contract to the TCPL "system" would stand to lose money by such competition. Additionally, TCPL would lose money to the extent of its interest as a commodity broker. While this form of economic injury would be healthy for the economy as a

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[271] Trebilcock, supra note 265 at 6.

whole, various lobby groups effectively represent the vested interests against disruption of the status quo by the direct sale arrangement.

In the absence of significant new exports to the United States, the government of Alberta, the producer associations as well as TCPL, are keen to receive the greatest amount of revenue possible from the commodity's interprovincial sale. It is submitted that their interests do not necessarily reflect those of the consuming public who should be better protected. While the difference in interests is not surprising, the question that needs to be addressed is the type of relationship that should exist between consumers and producers. Although deregulation unbundled the transportation component of natural gas from the merchandizing component, the former appears to be indirectly influencing or "regulating" the latter.

Accordingly, the distribution of natural gas in Canada is administratively beleagured. One reason for this is the downstream dissatisfaction of the protection afforded to TransCanada's gas marketing interests. Partly as a result of this dissatisfaction, the National Energy Board has decided to conduct a public hearing on TCPL's tolls, as well as a myriad of other related issues. Designated as Hearing Order RH-1-88, the new inquiry will proceed in two phases and is not expected to conclude until after October 1988.[272] Included among the issues to be addressed are displacement and operating demand

[272] National Energy Board, Hearing Order RH-1-88, February 17, 1988.

(ODV) methodology. For instance, the hearing will ask whether self-displacement should now be allowed, and if so, whether it should be phased-in. Also slated for examination is the necessity of maintaining the ODV relief concept and the circumstances when it should be granted for self-displacement volumes.[273]

Thus the new hearing will affect the position of the Manitoba Oil and Gas Corporation (MOGC) and its efforts to bring lower, more cost-based natural gas prices to the residential and other core customers of that Province. Particularly, MOGC has requested[274] that the self-displacement and ODV issues be framed against the fact inter alia, that TCPL will not, barring re-negotiation, have enforceable price provisions with the local distributors after October 31, 1988. Therefore, in light of the new hearing's scope, one interested party has described the proceedings as the "first meaningful opportunity for the self-displacement prohibition to be re-examined."[275] However, while the NEB has curiously stated that it is not "questioning the correctness of its earlier decisions,"[276] it nevertheless seems otherwise, since these decisions will be re-evaluated in effect, if not nominally.

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273 Id. at Appendix IV, p.1.

274 A.R. Thompson, Counsel for MOGC and the Minister of Energy and Mines, Gov't of Manitoba; RH-1-88 Notice of Intervention at 3.

275 J.D. Brett, Counsel (of Thompson, Dorfman, Sweatman; Barristers and Solicitors, Winnipeg) for GWG and ICG Utilities (Manitoba) Ltd.; letter to NEB dated March 3, 1988, at 5.

276 J.S. Klenavic, NEB Secretary; letter dated March 8, 1988 to J.W.S McQuat, Q.C., Vice-President, TCPL.

Although the decisions of the National Energy Board are interprovincial in jurisdiction, they invariably have an impact upon those provincial regulatory tribunals whose decisions affect natural gas customers. In particular, the Manitoba decision has effectively fettered that province's consumers in such an obtuse manner that one commentator has described the Board as "a mere handmaiden to the political process."[277] What is needed now is for the National Energy Board to cystallise its own concept of public interest so that it may be understood in light of the competitive natural gas environment.

It is therefore hoped that the NEB arrives at a satisfactory decision regarding the displacement issue in order to galvanize the objectives of deregulation. Rather than protecting TCPL from its over-contracted supply liabilities, the NEB should grant either MOGC or ICG/GWG a direct sale transmission order once that commodity seller and monopoly pipeline's CD service contracts expire. Such actions might induce TCPL and natural gas producers to re-negotiate their supply contracts thereby fostering the upstream competition that is needed to distribute the downstream benefits of deregulation.

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277 Keeping, supra note 263 at 7.

6. THE "CYANAMID" PIPELINE BYPASS ISSUE IN ONTARIO

One noteworthy aspect of natural gas deregulation is the provision for individual end-users to literally bypass a local distribution company with their own connection to the main interprovincial trunk line. While the former enterprise is widely accepted to fall under federal jurisdiction, a Canadian constitutional law argument is raging over the control of local bypass pipelines. In a unique set of judicial appeals which addressed the division of powers, these undertakings have recently been held to fall under provincial competence. Although the matter is in a state of flux until it is adjudicated by the Canadian Supreme Court, provincial control of bypass pipelines, if affirmed, will have significant commercial implications.

6.1 BACKGROUND

Changes in the policy pertaining to natural gas pricing allows consumers to purchase gas directly from Alberta producers at negotiated prices or indirectly via buy-sell arrangements, given the availability of contract carriage from distributors.[278] Most local distribution companies (LDC's) in eastern Canada are parties to long-term supply contracts with

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[278] Natural Gas prices and Markets Agreement, supra note 139 at Clause 5.

TransCanada Pipelines Ltd. (TCPL), and their residential and commercial customers do not appear to have yet benefitted from this policy. However, some large industrial customers have either taken advantage of TCPL's competitive marketing programmes or negotiated direct purchases after the expiration of their contracts with the LDC's.[279] The former transactions are programmes provided for in the Hallowe'en Agreement[280] that accords price discounts to industrial customers so that the gas sold remains competitive with alternative fuel costs.

In Ontario, one industrial end-user is leading a battle in the increasingly popular desire to take natural gas deliveries directly from pipeline suppliers rather than through the LDC's. This deregulation phenomenon is better known as "pipeline bypass". The protagonist in the matter is Cyanamid Canada Inc., a large fertilizer plant that seeks to construct its own pipeline to the TCPL system, entirely bypassing the local distribution company, Consumers Gas Co. Ltd. Cyanamid considered the venture attractive because of the significant gas supply cost savings. Conversely, bypass is a matter of concern to remaining LDC customers. Their rates could proportionally increase given the lower volumes that would be available to meet the Local Distribution Companies' fixed costs.[281]

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279 J. Keeping, "Bypass Pipelines" (1987), 20 Resources 1 (The Newsletter of the Canadian Institute of Resources Law).

280 Natural Gas Prices and Markets Agreement, supra note 139 at Clause 8.

281 Keeping, supra note 279.

In order to proceed, Cyanamid incorporated a subsidiary, Cyanamid Canada Pipeline Inc. (CCPI) as a federally incorporated company. It applied to the National Energy Board for authorization[282] to construct and operate the 6.2 km. bypass pipeline. The NEB granted the order[283] in December 1986. Shortly after Cyanamid's N.E.B. application, the Ontario Energy Board (O.E.B.) commenced a hearing on its own motion in the matter and determined that it had jurisdiction over bypass pipelines in the province.[284] Prior to the N.E.B. decision, the O.E.B. then stated a case[285] for the opinion of the Ontario Divisional Court so that its opinion could be verified. On March 26, 1987 the court affirmed provincial jurisdiction over the typical bypass facility declaring it to be a local work or undertaking pursuant to section 92(10) of the Constitution Act, 1867, subject to certain criteria.[286]

Provided that they are entirely located within the province, bypass facilities must inter alia, be owned, operated, controlled, and maintained separate from the interprovincial work to which they are connected. Their purpose must not be essential to the interprovincial work, nor may they have any direct effect upon it but rather their

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282 NEB Act, supra note 41 at s.49.

283 Canada Energy Law Service supra note 43, N.E.B. decision 42, "Cyanamid Canada Pipeline Inc.", Dec. 1986. See also NEB Orders XG-13-86 and MO-63-86.

284 Id. O.E.B. decision 41, "Bypass of Local Gas Distribution Systems" (OEB file #EBRO 410-1,411-1,412-1) Dec. 12, 1986.

285 Ontario Energy Board Act, R.S.O. 1980, c.332, s.31.

286 Re Ontario Energy Board and Consumers' Gas Co. et al. (1987) 59 O.R. (2d) 766.

purpose must be to serve an Ontario user.[287] After this result, Cyanamid withdrew from the proceedings and the local utility abandoned its NEB decision appeal. This left Cyanamid with prima facie valid NEB orders albeit orders which are subject to the threat of sanctions by Ontario if indeed acted upon. Therefore, this peculiar ability of one jurisdiction's tribunal to effectively render another's decision nugatory may, according to one commentator, be a "natural consequence"[288] of Canadian federalism.

The issue of provincial legislative competence over typical bypass pipelines was referred to the Ontario Court of Appeal.[289] Shortly afterward, Cyanamid's application to the National Energy Board was granted directing a reference review of that Board's original decision to the Federal Court of Appeal.[290] On November 27, 1987, that court overruled the decision at first instance, holding that the NEB did not have jurisdiction over the proposed facilities which were ultra vires the legislative competence of Parliament. The Federal Court of Appeal did not consider it to be an interprovincial work or undertaking of the kind expressly reserved to the federal government under section 92(10)(a) of the Constitution Act 1867. Furthermore, the endeavour was not viewed as an

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287 Id.

288 Kay, supra note 30 at 284.

289 Order in Council O.C. 1079/87, dated April 30, 1987; pursuant to: Courts of Justice Act, S.O., 1984 c.11, s.19.

290 National Energy Board Order decision dated May 29, 1987; pursuant to: National Energy Board Act R.S.C. 1970, c.N-6, s. 17(1); Federal Court Act, S.C. 1970-71-72, c.1, s.28(4).

express exception from provincial power pursuant to the Peace, Order and Good Government (POGG) declaratory provisions found in section 91(29).[291]

The Ontario Court of Appeal released its decision on February 15, 1988, holding that the CCPI pipeline is subject to provincial legislative authority. In essence, the court concurred with the reasons of the Federal Court of Appeal decision as enunciated by Mr. Justice MacGuigan.[292] Any appeal from that decision lies as of right to the Supreme Court of Canada, and on April 12, 1988, a Notice of Appeal was filed by Cyanamid Canada Pipeline Inc. and Cyanamid Canada Inc.[293]

Another application was made for leave to appeal to the Supreme Court of Canada in the Federal Court matter. Leave was granted on April 25, 1988 apparently because the similar Ontario Court of Appeal matter would in any event, be before the Court. Currently, it is intended that both cases will be argued together in the Supreme Court as one constitutional question. However the Court's schedule may preclude a decision for at least a year if not longer.[294] Thus, despite these two compelling authorities in favour of provincial competence, the matter remains in a state of flux until a

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291 Ref. re Bypass Pipelines, [1987] F.C.A., unreported. Reasons for judgement by MacGuigan,J., concurred in by: Mahoney and Stone,JJ.

292 Ref. re Bypass Pipelines [1988] Ont.C.A., unreported.

293 Personal Communication, C. Kemm Yates, Counsel for Cyanamid, 27 April 1988. The Appeal is available pursuant to s.37 of the Supreme Court Act and s.19(7) of the Ontario Courts Of Justice Act.

294 Id.

final adjudication is rendered. Nevertheless, pipeline bypass remains a compelling matter due to its commercial implications.

6.2 COMMERCIAL IMPLICATIONS

Support for bypass pipelines was stated by the Pipeline Review panel who discussed its optional use in the provision of non-discriminatory natural gas transportation services. The panel believed that large industrial users should be able to construct and operate their own bypass pipelines, providing that a regulatory application for the service met the standard construction specifications. Importantly, the bypass would have to be economically justifiable and could not be warranted in the presence of another reasonably competitive distribution system.[295]

In a market oriented regime, the Panel reported that gas customers should be able to negotiate direct sales from a producer and choose the type of transportation services that they desired, including bypass services. Although bypass operations could result in significantly higher costs to remaining system customers, the initiative would rest with the distributor to offer "unbundled transportation rates which will be competitive with the bypass option." Thus the Panel thought that provincial regulators should have the power of approval over the bypass option provided that it is in the "best interests of core customers". Provincial regulators

[295] Pipeline Review Panel Report, supra note 146 at s.3.2.5.

could then approve those special transportation rates of a distributor in order to prevent a large user seeking the bypass option.[296] Yet despite these provisions, opposition to the bypass option has crystalised.

Some opponents to bypass criticise its potential to place increasingly higher costs upon core customers such as residential and commercial users who cannot afford to switch to alternative fuels as easily as could large industries. One particularly colourful turn of phrase has described the economic impact of a bypass as a death spiral:

> "Death spiral refers to the impact on rates of a customer bypassing the system causing the remaining customers to cover the fixed costs that are not absorbed by the customer who left the system to bypass. Rates are increased causing others to leave the system."[297]

Since the relevant local distribution company was a party to a long term gas supply contract from TCPL, its fixed demand charges under that arrangement would continue once the bypass buyer left the inter-provincial pipeline's so-called "system." These charges would be unabsorbed by the bypass end-user and would have to be apportioned by the remaining utility customers.[298]

Given the unrelieved demand charges, Ontario's regulatory tribunal decided against a policy opposing the option, while recognising a public interest need to meritoriously evaluate each bypass application, inter alia considering economic and

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296 Id. at s.5.3.5.

297 Canada Energy Law Service, supra note 43, O.E.B. decision 41 at s.5.36; p.60-1843.

298 Id. at s.5.37; p.60-1844.

cost factors.[299] Similarly, the province of British Columbia has endorsed bypass as a result of its commitment to deregulation and a desire that its gas utilities remain competitive. An important desiratum there is that the bypass contracts of industries and utilities "reflect the true cost of service to all categories of customers" in order to glean the best from this new form of gas service as well as the conventional type.[300] However, negative speculation persists concerning bypass' ability to "allow market signals to flow"[301] via the provincial regulatory Boards to the distributor utilities as was hoped for by the National Energy Board.

Manitoba has unequivocally opposed the bypass option as being inefficient and against the public interest, which in that province's view can be better served by a single distribution system for each franchise area.[302] Their position is alive to the economic ramifications of the death spiral problem. This problem has been noted in the United States where commentators on their deregulation process have said that a death spiral:

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299 Id. at s.6.9; p.60-1845.

300 British Columbia, Ministry of Energy, Mines & Petroleum Resources, News Release, 1987:10, March 19, 1987.

301 Canada Energy Law Service, supra note 43, NEB decision 42 at s.7.5, p.10-4474.

302 Manitoba Public Utilities Board, Order No. 158/86, at 21.

> "consists of response to a highly elastic market whereby higher prices mean loss of business with fewer sales units over which to spread fixed cost. The result is a further increase in price to cover the increase in unit cost until the business is no longer viable."[303]

In order to prevent the duplication of facilities and economic inefficiency, others have suggested that a distribution utility reduce its rates to large industrial users who are contemplating a bypass option. This cost-based approach would lessen the increase in the rates to the utility's other customers and contemporaneously would make the option less attractive to the proposed bypasser.[304]

Significantly, the federal government has not contemplated using the section 92(10)(c) declaratory powers of the Constitution Act 1867, which when read with section 91(29) would enable Parliament to assume jurisdiction over the Bypass pipelines.[305] By deeming them to be "for the general advantage of Canada," the dispute over jurisdiction could be resolved in favour of central government. For instance, this

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303 Foster Associates, Inc., Deregulation Of Natural Gas Sales To Large Volume Industrial Users, report prepared for The American Gas Association (Washington, D.C., August 1987) at 44.

304 Canada Energy Law Service supra note 43, NEB decision 42 at s.7.2; p.10-4472.

305 For a more thorough discussion on the federal declaratory power, see: I.H. Fraser, "Some Comments on Subsection 92(10) of the Constitution Act, 1867" 29 McGill L.J. (1984) 558; V.C. MacDonald, Parliamentary Jurisdiction By Declaration [1934] 1 D.L.R. 1; P. Shwartz, "Fiat by Declaration - S.92(10)(c) of the British North America Act" (1960), 2 Osgoode Hall L.J. 1; K. Hansen, "The Federal Declaratory Power Under The British North America Act" (1968) 3 Man. L.J. 87; A. Lajoie, Le Pouvoir déclaratoire du Parlement (Université de Montréal: Montréal,1969).

power has been used over 469 times in Canada, often in respect of railways, canals, telegraphs, telephones, harbours, oil refineries and other enterprises. Thus in an incident when federal regulatory competence was denied to Parliament,[306] jurisdiction was assumed over the grain trade following a declaration that grain elevators and related mills were works for the general advantage of the country.[307]

It is however doubtful that the present federal, Progressive Conservative government would consider such an action because of their ideology. Recently, this philosophy has resulted in the so-called Meech Lake Accord.[308] Nevertheless, while the federal government is not disposed to declaring bypass pipelines to be a work for the general advantage of Canada, this particular type of intervention does not, by itself seem to be in the public interest.

According to one commentator, bypass is not consistent with the efficient functioning of the Canadian natural gas market. Capacity costs are allocated in such a way as to motivate large end-users to commit social and economic waste

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306 R. v. Eastern Terminal Elevator Co. [1925] S.C.R 434, [1925] 3 D.L.R. 1.

307 Hogg, supra note 26 at 491-492.

308 Meech Lake Accord, An intergovernmental Agreement signed June 3, 1987 by the Prime Minister and all 10 Provincial Premiers (in office at that time) that inter alia recognizes the distinct nature of Québec, and gives the provinces the right to 1) select judges for the Supreme Court of Canada, 2) select Senators for appointment to Canada's upper House of Parliament, 3) veto future constitutional amendments. If implemented as an amendment to the Canadian Constitution, certain powers of the federal government will be lessened in favour of the Provinces with arguably adverse effects for national unity.

by duplicating transportation facilities that already exist. Furthermore, the remaining users will constitute a smaller customer base who would have to absorb the fixed costs of the local distribution company with an increase in rates.[309] Rather than promote the inefficient competition of downstream bypass, it therefore seems more efficacious to promote upstream competition among producers, preferably through the instrumentality of direct sales.[310]

Finally, while the pricing of natural gas has been deregulated, it has been seen that the transportation component remains regulated given the monopolistic nature of TCPL and the local distribution companies. Unfortunately, the regulatory regime transition has not been effected without friction. One exacerbating factor is the dual role of the Interprovincial TransCanada (TCPL) pipeline as a carrier and a merchant which seems to have locked residential and commercial gas users into uncompetitively higher purchase prices. Consequently, it appears likely that the Canadian process of deregulation will continue over the next few years. Hopefully, the legal incidents of the participants will be pragmatically adapted either through responsible public regulation and/or private negotiation, so as to reflect the current commercial reality.

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309 Trebilcock, supra note 265 at 5-6.
310 See the text accompanying note 271 supra.

7. CONCLUSION

Transitional difficulties are being encountered as the deregulation process evolves. Although these problems were not totally unexpected it seems that the promises of a new market oriented environment have not lived up to the expectations that they have created. This can be seen in the administrative thwarting of Manitoba's attempt to obtain cheaper gas service for residential and commercial users. Several criticisms therefore result from the decision of the National Energy Board in this matter.

Earlier the NEB had effectively prohibited self-displacement by a local distributor and then expanded this prohibition to apply to the third party Manitoba Oil and Gas Corporation (MOGC). However, it is difficult to see how MOGC's application for a direct sale transmission order could result in self-displacement since it hitherto had no system contracts or gas volumes to displace. While the Board held that the application did not constitute self-displacement in form, it nevertheless opined that it would achieve that result in substance if granted. Furthermore, the public interest considerations that influenced the decisions are both undeveloped and unconvincing.

Political considerations appear to have influenced the NEB in the execution of its legislative mandate to promote the

public interest and prevent undue discrimination. The NEB accurately noted that the so-called Hallowe'en Agreement was not a legal document but was rather a political one. Unfortunately, the National Energy Board seems to have digressed from its legislative mandate and basic public utilities theory by placing too much attention on the political considerations.

It is well known that the producing industry partly agreed to the deregulation process as a quid pro quo for expected enhanced exports to the United States. It seems that the failure of these exports to materialise has left the producing industry reluctant to absorb the domestic losses that true competition might provide. It should be remembered that producers asked for deregulation when prices were being kept artificially low in order to benefit eastern Canadian consumers. With the decline of gas prices in the free market the attraction of deregulation for producers has paled.

Having been encouraged by the Hallowe'en Agreement, the National Energy Board enabled breach of contracts by its direct sales policy. Paradoxically, it then pontificated on the sanctity of contracts to uphold TCPL's contracts with distributors through its self-displacement rule even when those contracts were becoming unenforceable. Although the TransCanada system producers would stand to lose money by the competition from direct gas sales, the economic injury would be healthy for the economy as a whole. Unfortunately, the reasons of the NEB in the Manitoba Hearing do not explain why

the sanctity of these contracts must be respected when the contractual arrangements between TCPL and ordinary direct purchasers can be altered. The effect however is that the NEB failed to facilitate new direct sale arrangements where that form of competition could efficaciously occur.

The pricing of the commodity continues to be regulated to the extent that regulation of the commodity's transportation charges indirectly affects pricing. Therefore, the stewardship of Canada's monopolistic gas distribution system by the National Energy Board continues to be important. This importance becomes more pronounced when gas consumers allege rates or services that exceed the limits of discrimination that are permissible by regulatory legislation and theory.

Clearly there is a need for some discrimination in Canadian gas rates, especially in the preferential prices afforded to industry. If such discrimination discourages this class of customer from switching to competitive fuels, the result may be that remaining gas utility users will incur lower rates because volume throughput is maintained. Conversely, since their demand is less elastic, the higher rates are usually levied to residential and commercial customers. This is acceptable utility theory. Although some users will understandably switch to competing fuels if it is more economic, it is submitted that regulators are justified in endeavouring to prevent this change if other classes of customers would suffer significant detriment. Regulation should balance the concerns of all customer classes since the

benefits of a non-discriminating free market can not be achieved while the natural gas industry continues to display monopolistic characteristics.

Eventually there arrives a point when discrimination becomes undue. Given the broad legal meaning of "undue discrimination", it seems difficult to define this point in the abstract rather than as a judgement on the conditions existing in a particular case. Nevertheless, in my view "undue discrimination" has happened and is being condoned to the extent that NEB policies inhibit lower priced direct sales and conversely protect the marketing position of TCPL. Like the gas that flows downstream, this protection is indirectly afforded to the local distribution companies and their gas supply arrangements. Hence, the pivotal National Energy Board actions can affect the ability of the relevant regulatory tribunals to protect the provincial public interest. Accordingly, there are grave doubts as to whether the NEB is properly applying principles of utility regulation. Hopefully, the Board will redress the problem of undue discrimination and the availability of direct gas sales at the RH-1-88 Hearing.

However, not all of the provincial regulatory powers have been emasculated as shown by the recent bypass appellate decisions. In the Federal Court of Appeal decision, the provincial legislative competence over local works and undertakings is classically reaffirmed vis à vis a typical bypass pipeline. From a natural gas regulatory standpoint,

this decision is significant because it confirms the province's power to control the undue discrimination in rates that might accompany a bypass pipeline.

In other words, industrial bypass orders could leave a local distribution company with unabsorbed costs which would have to be met by the remaining customers. Rather than risk a death spiral with this type of unhealthy downstream competition, it is suggested that the producers upstream should be encouraged by responsible regulation to engage in healthy competition through direct sales. The death spiral would be stopped since the competitively priced direct sales would discourage end-users from leaving the local distribution system.

Natural gas regulators have a compelling concern over equitable natural gas rates and services. In view of the present controversies, the future for natural gas public utilities regulation will certainly not be uneventful. Hopefully the National Energy Board will be able to respond responsibly to the challenge of changing commercial conditions in the deregulation epoch.

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