

December 21, 2004

*Privileged & Confidential*

Brian Robinson  
The Society of Energy Professionals  
425 Bloor Street East, Suite 300  
Toronto, Ontario M4W 3R4

Dear Mr. Robinson:

**Re: The impact of Ontario's proposed Electricity Restructuring Act, 2004 ("Bill 100") on Canada's international law commitments under the NAFTA, the GATT and the GATS**

You have requested our legal opinion on certain questions respecting the impact of the North American Free Trade Agreement ("NAFTA") and the World Trade Organization ("WTO") Agreements upon Ontario's proposed *Electricity Restructuring Act* ("Bill 100"). In particular, you have sought our opinion on the following questions:

**Question One:** To what extent are the policies proposed under the *Electricity Restructuring Act, 2004* ("Bill 100") inconsistent with Canada's international trade law obligations under the NAFTA and the WTO?

**Question Two:** Does the proposed *Electricity Restructuring Act, 2004* diminish Ontario's existing trade law reservations currently in place under these international agreements?

Based on the facts summarized in this opinion and having regard to the legal considerations that we deem relevant, we are of the opinion that:

1. Some policies proposed under provisions of *Bill 100* are inconsistent with the international trade law obligations undertaken by the Government of Canada and applicable to the Government of Ontario under the NAFTA and the General Agreement on Trade in Services ("GATS"), as well as other international trade obligations set out in the WTO Agreements. These obligations may restrict the ability of the Government of Ontario to implement its proposals for comprehensive electricity reform as expressed by this proposed legislation.

The objectives and the intended use of the institutions created under *Bill 100* appear to conflict with Canada's obligations under the trade in goods, state enterprises, and national treatment obligations contained in agreements such as the GATT, the NAFTA

and the GATS. Inconsistency with these obligations could result in trade action being brought by the Government of the United States or in some circumstances by investors from the United States.

In particular, we point out the following examples of measures which, under the infrastructure created by *Bill 100*, appear to be inconsistent with Canada's international trade law obligations:

- a) Ontario practices, such as RFPs for new power made pursuant to *Bill 100*, which require local presence for electricity generation facilities as a condition for selling new power;
  - b) Ontario's stated objective of terminating reliance on foreign based coal and substituting that energy for locally produced and domestically produced alternative and renewable energy sources;
  - c) Ontario's tiered electricity pricing system, which sets domestic prices lower than prices set for power exports; and
  - d) Ontario's preferential energy pricing deals, which provide certain selected local companies with power at highly preferential rates that is not offered on the same terms to investments owned by foreign investors.
2. The proposed *Electricity Restructuring Act* would have the effect of reducing the Government of Ontario's existing flexibility to take actions inconsistent with the NAFTA and the GATS.
- a) The Government of Ontario's current ability to take actions which are otherwise inconsistent with key NAFTA investment and cross-border trade in service obligations is limited to specific exceptions and reservations. The most broad of these reservations is the "general reservation" made for non-conforming Ontario government laws, regulations, requirements and practices which were in force on January 1, 1994 and which have been continued in force since that date. Provincial government practices (that were in force on January 1, 1996 and have stayed in force since then), which have limited national treatment or imposed performance requirements on foreign investors, could be maintained but only to the extent that they are based on a continuous policy which reaches back before January 1, 1994. The reservations will be reduced to the extent that commercial considerations replace market driven considerations in these energy policies.
  - b) The Government of Ontario did not make any reservations with respect to its service obligations under the GATS other than for the matter of hydro-electric power plant construction. Thus, there are no reservations that apply to permit Ontario to take

otherwise inconsistent policy measures in violation of international service obligations contained in the GATS.

**Question One:** To what extent are the policies proposed under *Bill 100* inconsistent with Canada's international trade law obligations under the NAFTA and the WTO?

In order to provide an answer to this question it is necessary to examine the provisions of *Bill 100*, the nature of how electrical energy is covered by Canada's international trade obligations and then to assess whether the policies advanced under *Bill 100* are inconsistent with Canada's existing international trade law obligations.

### **I. Bill 100**

On June 15, 2004, the Government of Ontario introduced the *Electricity Restructuring Act, 2004* to the Ontario Legislature. The proposed legislation, known as *Bill 100*, would make a number of fundamental changes, particularly to the Ontario *Electricity Act, 1998*<sup>1</sup> and to the *Ontario Energy Board Act, 1998*<sup>2</sup> regarding the generation, management and the transmission of electrical power in Ontario. *Bill 100* would create an infrastructure through which new types of policy objectives could be imposed upon the Ontario energy market. *Bill 100* primarily deals with energy generation issues, however, it has set up an infrastructure that can be used to deal with transmission and generation matters as well.

The largest power generator in Ontario is Ontario Power Generation Inc. ("OPG"), which is a successor company of the former Ontario Hydro. The term "Electricity Transmission" refers to the movement of high voltage power. Ontario has existing highvoltage interconnections with the provinces of Manitoba and Quebec and with the states of New York, Michigan and Minnesota. Through these lines, up to 4000 MW of electricity can be wheeled into and out of Ontario every day.

Distribution refers to the manner in which high voltage power is distributed to customers as low voltage power. Hydro One Inc. ("Hydro One") is the successor company of Ontario Hydro that deals with transmission and distribution issues. Electricity distribution is a monopoly designated on a geographical basis undertaken by municipal electricity utilities ("MEUs") and Hydro One. There is also a retail market which is marked by significant price regulation and rate freezes.

The Independent Electricity Market Operator ("IMO") is responsible for operation of Ontario's bulk and wholesale electricity market. It establishes a series of market rules that govern the wholesale market. It is also responsible for electricity reliability issues in Ontario.

---

<sup>1</sup> S.O. 2002, Ch. 1, Schedule A.

<sup>2</sup> S.O. 2002, Ch. 23 and S.O. 2003, Ch. 3.

*Bill 100* marks a change in government policy in Ontario. The Ontario government has rejected a monopoly model in exchange for a hybrid private market system with governmental oversight.<sup>3</sup>

*Bill 100* contains an enumerated list of public policy objectives. These objectives include:

- (a) ensuring the adequacy and reliability of electricity;
- (b) encouraging electricity conservation;
- (c) facilitating load management in a manner consistent with Ontario government policies;
- (d) promoting the use of cleaner energy sources and technologies;
- (e) providing generators, retailers and consumers with non-discriminatory access to transmission;
- (f) protecting consumers' interest with respect to adequate electricity;
- (g) the promotion of economic efficiency in the generation and transmission of electricity;
- (h) ensuring that Ontario Hydro's debt is repaid;
- (i) the maintenance of a financially viable electricity industry; and
- (j) the protection of corridor land while recognizing the primacy of transmission uses.<sup>4</sup>

The new Ontario energy system will have both private sector and public elements. The wholesale electricity market will be run by an Independent Electricity System Operator ("IESO"), which replaced the previous wholesale electricity market operator, the Independent Electricity Market Operator. The IESO will continue to operate the wholesale electricity market in Ontario and will have primary responsibility for the operation and reliability of the power system. *Bill 100* gives the IESO authority to direct the operation of transmitters' transmission systems and to develop the reliability of transmission systems.<sup>5</sup> Section 4(1)(d) of *Bill 100* provides that the IESO's objectives include the participation by a Standards Authority in the development of reliability standards and criteria.

The Ontario Energy Board ("OEB") is responsible for market planning and operation in Ontario. It has powers over licensing and rate regulation in Ontario. *Bill 100* transfers to the OEB the Market Surveillance Panel to guard against market abuse. *Bill 100* amends the *Ontario Energy Board Act* to ensure that one of the Board's objectives is the promotion of economic efficiency and cost-effectiveness in the generation, transmission, distribution and demand management of electricity.

---

<sup>3</sup> *Hansard*, Standing Committee on Social Policy, August 9, 2004 at SP-4. Of course, there still are monopoly features maintained under *Bill 100*.

<sup>4</sup> Article 1.

<sup>5</sup> Article 3(1) amends the name of the IMSO. Section (1) repeals section 5(1) of the *Electricity Act* and establishes new objectives for the IESO.

The Ontario Power Authority (“OPA”) would be created by *Bill 100*. The OPA would assess the adequacy and reliability of electricity resources and forecast future demand. It would also prepare an integrated system plan for generation, transmission and conservation to be reviewed by the OEB. The OPA’s goal is to forecast electricity demand, to conduct independent planning for electricity generation, demand management, conservation and transmission and to promote the use of cleaner energy sources and technologies.<sup>6</sup> Section 32 of *Bill 100* requires that the OPA creates an Integrated Power Plan for Ontario.<sup>7</sup> The OPA also considers generation and transmission capacities and technologies and conservation measures.<sup>8</sup> The OPA has the power to take such steps as it considers advisable to ensure there is adequate transmission capacity as identified in the Integrated Power System Plan.<sup>9</sup>

*Bill 100* permits the Ontario Energy Minister to make a directive, which the OPA is obliged to follow, with goals relating to the following: the production of electricity from particular combinations of energy sources and generation technologies; increases in generation capacity from alternative energy sources, renewable energy sources or other energy sources; and the phasing-out of coal-fired generation facilities.<sup>10</sup>

The OPA will also have powers to direct the type of energy produced in Ontario. The Ontario Minister of Energy, Dwight Duncan, explained that:

Having a fully functioning electricity sector is not only about generating raw power; the province must also be concerned with conservation, the use of renewable energy and the security and diversity of our electricity supply. Therefore, through *Bill 100*, explicit directive power would be given to the Ministry of Energy with respect to targets for conservation, the use of renewables and the overall supply mix of electricity in the province. The Ontario Power Authority would be charged with achieving these and other targets set by the government and would include them in its system planning.<sup>11</sup>

The Minister set out this goal in his testimony with specific reference to coal powered electricity generation as follows:

---

<sup>6</sup> Proposed Article 25.2 of *Electricity Act*.

<sup>7</sup> Through the addition of Section 25.28 to the *Electricity Act*.

<sup>8</sup> Section 31 of *Bill 100* which proposes the addition of a new Article 25.27 to the *Electricity Act*.

<sup>9</sup> Article 25.2(5)(F)

<sup>10</sup> Section 32 of *Bill 100* adds section 25.28 to the *Electricity Act*. This directive is set out in proposed section 25.28(2).

<sup>11</sup> *Hansard*, Standing Committee on Social Policy, August 9, 2004 at SP-5.

We remain committed to replacing coal-fired electricity generation in this province. In so doing, we will never put Ontario consumers in jeopardy and will be totally satisfied that adequate alternatives are in place before we shut down the coal plants.<sup>12</sup>

Minister Duncan confirmed that the OPA would be an arm of the Government of Ontario and would be backed by the creditworthiness of the province.<sup>13</sup>

Through these fundamental changes, *Bill 100* has created institutions through which electricity generation, distribution, pricing and transmission can be regulated in Ontario.

## **II. OVERVIEW: International Trade Law and Electricity in Ontario**

There are a number of international trade law obligations that apply to issues considered in *Bill 100*. These obligations deal with diverse subject matters such as energy, cross-border trade in goods and services, the regulation of state enterprises and international obligations regarding investment.

Three main activities are generally recognized as comprising the electricity sector:

- (a) electric power generation, involving the conversion of primary energy (fossil fuels such as coal and oil) into electrical energy;
- (b) the transmission of electricity, which refers to the transportation of electricity from generators to distribution companies and large final consumers through high voltage mains (grids); and
- (c) the distribution of electricity, including the selling and delivery of electricity to end users through low voltage mains.<sup>14</sup>

### **A. The NAFTA**

Coming into force in January 1994, the North American Free Trade Agreement (“NAFTA”)<sup>15</sup> is a comprehensive agreement dealing with trade in goods, services, labour facilitation and investment. The NAFTA contains an important chapter which governs Canada’s energy trading

---

<sup>12</sup> *Hansard*, Standing Committee on Social Policy, August 9, 2004 at SP-5.

<sup>13</sup> *Hansard*, Standing Committee on Social Policy, August 9, 2004 at SP-7.

<sup>14</sup> Gary Horlick, Howard Mann and Christiane Schuchhardt, “NAFTA Provisions and the Electricity Sector” Background Paper No. 4 to the Secretariat of the North American Agreement on Environmental Cooperation, June 2002.

<sup>15</sup> Reprinted in 32 I.L.M. 289 (1993).

relationship with the United States (Chapter 6). This chapter deepens the existing continental energy trading relationship and has established an interdependent continental market.

While only the national governments of Canada, the United States and Mexico negotiated and signed the NAFTA, all levels of governments in a NAFTA country are bound by the obligations in the agreement.<sup>16</sup>

What differentiates the NAFTA from other agreements is its enforceability. At its very heart lies an investor-state dispute settlement process that allows investors to bring international commercial arbitration claims. While this investor-state dispute settlement system was available in earlier bilateral treaties, the NAFTA investor-state dispute settlement process marks the first time an individual citizen or business can use a multilateral treaty to proceed entirely on its own initiative against a foreign government.<sup>17</sup> This system quickly allows a NAFTA investor to settle a claim that a government has not met its NAFTA investment chapter obligations in a fast, effective and binding manner.

In addition, there are other chapters of the NAFTA which are relevant to an examination of energy issues, namely:

- Chapter 3 - which governs trade in goods;
- Chapter 15 - which sets out rules governing the behaviour of state enterprises and government monopolies.

## **B. NAFTA Dispute Settlement**

### *Investor-State Disputes*

Under the dispute settlement provisions of the NAFTA, investors from other NAFTA member countries are entitled to a special remedy if a government acted in a manner inconsistent with its obligations under Section A of the NAFTA investment chapter. The Investor-State dispute settlement process allows an investor of a NAFTA Party (either a natural person or a corporation) to directly bring a compensation claim against another NAFTA government for any breach of Section A of NAFTA Chapter 11 which results in harm to the investor or its investment.

---

<sup>16</sup> This includes state, provincial, territorial and local governments.

<sup>17</sup> Prior to the NAFTA, trade disputes between a national of one country and another government were espoused by the national's government. Typically, such trade disputes were allowed in the context of multilateral trade agreements such as the GATT or bilateral treaties such as treaties of Friendship, Commerce and Navigation between the national's government and the host government.

NAFTA investors are entitled to dispute government measures. Measures include, but are not limited to, legislation, regulations, governmental policies and practices. Not only are the national governments covered by this Agreement, but so are state, provincial, territorial and local governments.

The dispute settlement provisions in NAFTA Chapter 11 permits investor-state dispute resolution over a breach of the substantial investment obligations of Chapter 11 (set out in Section A). The NAFTA provides that monetary damages or restitution can be paid to the investor or to the investment.

NAFTA compensation claims are heard before a special international arbitration panel that can award financial compensation to investors. The panels cannot strike down NAFTA-infringing measures but the threat of paying enforceable damage awards can negatively affect government policy initiatives.

The Investor-State dispute settlement process established in the NAFTA has been described as “an untapped source of extensive private investor rights, including guaranteed access to a NAFTA panel for a private party.”<sup>18</sup> While the NAFTA process is new in that it gives rights to investors to bring investment disputes throughout North America, the actual use of Investor-State dispute settlement is not new in bilateral disputes. For example, under the World Bank’s ICSID<sup>19</sup> Process, there have been many disputes decided since 1977.<sup>20</sup> The NAFTA creates an entirely new multilateral dispute process, vastly different from the GATT/WTO process. What is clear is that the NAFTA creates a speedy and enforceable process to settle disputes with governments. This is likely to result in investors carefully scrutinizing government practices to determine if they are consistent with the NAFTA.

An example of an Investor-State claim under the NAFTA can better illustrate the process. In 1996, an American chemical manufacturer, Ethyl Corporation, brought a NAFTA Investor-State claim against the Government of Canada over Canada’s prohibition on the importation and interprovincial trade of Ethyl Corp.’s octane fuel enhancer, MMT.<sup>21</sup> Ethyl Corp. alleged that Canada had taken its trade ban in violation of its NAFTA expropriation, national treatment and performance requirement obligations and sought compensation in excess of \$250 million U.S. dollars. The *Ethyl* case proceeded to a tribunal hearing and preliminary awards were issued by the Tribunal. Before the Tribunal completed its deliberations of the entire process, a settlement

---

<sup>18</sup> Horlick, G.N., Marti, A.L., “NAFTA Chapter 11B, A Private Right of Action to Enforce Market Access Through Investments,” *Journal of International Arbitration*, Vol. 14 No.1, March 1997, at 54.

<sup>19</sup> International Centre for the Settlement of Investment Disputes (ICSID).

<sup>20</sup> There have been over 180 disputes filed under the ICSID rules. For more information, see Dolzer and Stevens *Bilateral Investment Treaties* (Martinus Nijhoff Publishers; The Hague, 1995) and also *Foreign Investment Law Review*.

<sup>21</sup> *Wall Street Journal*, “Ethyl Acts to Avert Losses If Canada Bans Fuel Additive”, September 11, 1996.

was reached. According to press reports, Canada agreed to remove its ban on the chemical and issue a statement indicating that there was no scientific evidence for its previous action. In addition, Canada compensated the investor with some \$13 million U.S. dollars.<sup>22</sup> The *Ethyl* case demonstrates an example where a government action can result in significant litigation and the payment of sizable damages under an international investment agreement.

### **State-State Disputes**

American (or Mexican ) investors can seek the intervention of the their respective governments to commence a dispute against the Canadian federal Government under NAFTA Chapter 20 for a breach of any NAFTA obligation or for a breach of an obligation under any of the WTO Agreements. Under these provisions, foreign governments could obtain a decision by a panel indicating that the Ontario practices violated the relevant international trade obligation and Ontario could become the target of trade retaliation if it did not modify its policies to comply with the panel ruling.

### **C. The WTO**

The WTO Agreements also govern international trade between Canada and the United States. There are a number of agreements which are relevant to trade in energy. These include:

- The GATT, which governs cross-border trade in goods;
- The GATS, which governs cross-border trade in services; and
- The Trade Related Investment Measures (“TRIMs”) Code, which governs certain cross-border investment measures.

### **III. Electricity as a Good, Service and Investment**

Electricity has many characteristics which make it appear to be more a service than a good. It is intangible and is not durable. Energy services are not well defined in international trade agreements. In general, the multilateral debate regarding the definition and coverage of energy leads to the tentative conclusion that within the existing WTO framework, the generation of electricity falls under the scope of the goods agreement, while the transmission, distribution and related services fall under the scope of the GATS.<sup>23</sup>

---

<sup>22</sup> “Threat of NAFTA case kills Canada’s MMT Ban” *Globe and Mail* July 20, 1998 at p.1.

<sup>23</sup> Gary Horlick, Howard Mann and Christiane Schuchhardt, “NAFTA Provisions and the Electricity Sector” Background Paper No. 4 to the Secretariat of the North American Agreement on Environmental Cooperation, June 2002 at 3.

A key issue is whether electric power generation constitutes a service or a manufacturing process.<sup>24</sup> In addition, it is easy to consider electricity generation facilities as an investment. Such definition is important since the treatment of electricity depends on whether, under the particular treaty, electricity is considered to be a good, a service, or an investment.

Originally, electrical energy was not generally considered covered by the trade in goods obligations in the GATT. This original status has changed over time for some countries. Electricity is covered under the World Customs Organization Harmonized Commodity Description and Coding System under classification 27.16, which is an optional classification. NAFTA Chapter 3 on trade in goods applies to all items covered by the Harmonized tariff schedule.<sup>25</sup> Thus for the NAFTA, electrical energy is considered a good.<sup>26</sup>

Electricity generation facilities in Canadian territory also qualify as an investment under NAFTA Chapter 11. Since these facilities qualify as an investment, they are excluded from coverage under NAFTA's cross-border services chapter (Chapter 12), which specifically excludes from its coverage any cross-border service provided by an investment covered by NAFTA Chapter 11.<sup>27</sup>

However, the GATS does not contain any similar restriction on services provided by investments. Thus under the WTO Agreements, electricity generation could be a good while electrical transportation and distribution would be a service.<sup>28</sup> Under the NAFTA, electricity can only be a good and its generation facilities are investments.

In addition to coverage as a good and investment under NAFTA, electrical energy is also covered by other NAFTA obligations in a chapter devoted to Energy (Chapter 6) and in rules governing state enterprises and monopolies (Chapter 15).

#### **A. The NAFTA Energy Chapter**

The NAFTA Energy Chapter applies to measures relating to crude oil, gas, refined products, basic petrochemicals, coal, electricity and nuclear energy and measures relating to investment

---

<sup>24</sup> Gary Horlick, Howard Mann and Christiane Schuchhardt, "NAFTA Provisions and the Electricity Sector" Background Paper No. 4 to the Secretariat of the North American Agreement on Environmental Cooperation, June 2002.

<sup>25</sup> NAFTA Article 201 - goods.

<sup>26</sup> For the avoidance of doubt, Chapter 6 which deals exclusively with energy refers to heading 27.16 as a good in Article 602(2)(h).

<sup>27</sup> NAFTA Article 1213.

<sup>28</sup> S/C/W152 (Council for Trade in Services), *Energy Services: Background Note by the Secretariat*, 9 September 1998 at 3.

and services associated with energy goods.<sup>29</sup> Chapter 6 of the NAFTA falls under Part Two of the NAFTA: Trade in Goods.<sup>30</sup> NAFTA Article 602 sets out the Energy Chapter's application. It specifically deals with electrical energy as a good, investment and service.<sup>31</sup> It states:

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

Electricity as a good under Chapter 6 is subject to the provisions of NAFTA Chapter 3 regarding national treatment and market access for goods.<sup>32</sup> Accordingly, the obligations of national treatment under Article 301 and tariff elimination under Article 302 apply to trade in electricity.

The NAFTA establishes a number of obligations upon its Parties regarding the treatment and supply of energy.

*i. Import and Export Restrictions*

The NAFTA incorporates the GATT provisions which deal with the prohibition or restriction on trade in energy and basic petrochemical goods<sup>33</sup> to the extent that they do not conflict with other provisions in the Energy Chapter.<sup>34</sup> The incorporation of these obligations requires NAFTA Parties to not impose minimum or maximum export price requirements or import price requirements except to the extent necessary to enforce countervail or antidumping duty orders<sup>35</sup>. Thus, torrid pricing policies which set exports at higher price than domestic sales are specifically prohibited under the NAFTA.

Governments can adopt or maintain restrictions on energy imports or exports from non-Parties. If a Party imposes a restriction on a non-Party, the other NAFTA Parties will avoid undue

---

<sup>29</sup> NAFTA article 602.

<sup>30</sup> Gary Horlick, Howard Mann and Christiane Schuchhardt, "NAFTA Provisions and the Electricity Sector" Background Paper No. 4 to the Secretariat of the North American Agreement on Environmental Cooperation, June 2002.

<sup>31</sup> NAFTA article 602(2)(h).

<sup>32</sup> Gary Horlick, Howard Mann and Christiane Schuchhardt, "NAFTA Provisions and the Electricity Sector" Background Paper No. 4 to the Secretariat of the North American Agreement on Environmental Cooperation, June 2002 at 5.

<sup>33</sup> Such as GATT Articles XI.

<sup>34</sup> NAFTA article 603(1).

<sup>35</sup> NAFTA article 603(2).

interference with it.<sup>36</sup> Each Party may administer export and import licensing systems for energy and basic petrochemical goods, provided that they are operated in a manner consistent with the agreement as described in the discussion of the GATT trade in goods provisions.<sup>37</sup>

The NAFTA prohibits the imposition of a tax, duty or charge on the export of energy or basic petrochemical goods unless the same measure is applied domestically and to all exports.<sup>38</sup> The NAFTA imposes significant limits on the ability of governments to impose import and export restrictions. Limits can only be imposed to address matters such as:

- Preventing or relieving critical shortages on a temporary basis;<sup>39</sup>
- Conserving exhaustible natural resources;<sup>40</sup>
- Ensuring essential supplies for domestic industries as part of a domestic government stabilization plan;<sup>41</sup> or
- Dealing with matters essential to the acquisition or distribution of products in short supply.<sup>42</sup>

The NAFTA establishes a more stringent set of obligations than the WTO for situations where a Canadian government wishes to reduce the supply of energy. In such cases, it must abide by the following:

- i) Proportional access of the good must be made available to the other Party on the basis of the average supply over the last thirty-six month period;
- ii) A Party may not impose a higher price for exports than the price charged domestically by way of taxes, royalties or minimum price regulation; and
- iii) The restriction does not require the disruption of normal channels of supply of that good.<sup>43</sup>

---

<sup>36</sup> NAFTA article 603(3).

<sup>37</sup> NAFTA article 603(5).

<sup>38</sup> NAFTA article 604.

<sup>39</sup> GATT Article XI:2(a).

<sup>40</sup> GATT Article XX(g).

<sup>41</sup> GATT Article XX(i).

<sup>42</sup> GATT Article XX(j).

<sup>43</sup> NAFTA article 605.

The NAFTA replicates the wording of Article 904 of the Canada-U.S. Free Trade Agreement and also incorporates it into the NAFTA.<sup>44</sup> NAFTA Article 608(2) incorporates Canada-U.S. Free Trade Agreement Annexes 902.5 and 905.2 which establish the primacy of the *International Energy Program* over the NAFTA in the case of any inconsistency between them regarding the obligation of proportionality.

Canada and the United States are members of the *International Energy Program*. Parties to the *International Energy Program* undertake similar energy sharing obligations as under the NAFTA. There are several key differences based on the nature of the two agreements. For example, the *International Energy Program* covers emergency shortages in oil only while the NAFTA deals with scarcity in all forms of energy. The *International Energy Program* establishes a general sharing obligation while the NAFTA imposes sharing based on the preceding thirty-six months production. NAFTA Article 604 prohibits policies which establish different energy prices that distinguish between domestic and export users in any class of energy consumers.

## **ii. Energy Regulatory Measures**

The NAFTA includes provisions on energy regulatory measures. It establishes an obligation on energy regulatory bodies to apply measures consistent with the NAFTA's obligation on national treatment, import and export restrictions and export taxes.<sup>45</sup> In addition, the Parties agreed that in the application of energy regulatory measures, governments should seek to avoid disruption of contractual relationships.<sup>46</sup>

The scope of this section applies to national governments and subnationals that regulate energy measures. Article 609 defines energy regulatory measures as "... any measure by federal or sub-federal entities that directly affects that transportation, transmission or distribution, purchase or sale of an energy or basic petrochemical good." This expands the coverage of the NAFTA disciplines affecting energy regulatory measures to all sub-federal entities.<sup>47</sup>

These restrictions on regulatory measures restrict the actions of the Ontario Energy Board, the Ontario Power Authority and the Ontario Minister of Energy under *Bill 100* with respect to energy regulatory measures.

---

<sup>44</sup> NAFTA annex 608.2

<sup>45</sup> NAFTA article 606(1).

<sup>46</sup> NAFTA article 606(2).

<sup>47</sup> Gary Horlick, Howard Mann and Christiane Schuchhardt, "NAFTA Provisions and the Electricity Sector" Background Paper No. 4 to the Secretariat of the North American Agreement on Environmental Cooperation, June 2002 at 6.

## B. The Nature of Concurrent Coverage

Treaty obligations between different treaties (or even other parts of the same treaty) can often create a situation of concurrent coverage of obligations. Given its hybrid nature, the electricity sector can easily be the subject of several different types of obligations under different chapters in the NAFTA. The WTO Appellate Body has determined that such overlap is to be expected and is permissible.<sup>48</sup> NAFTA Chapter 11 Tribunals have agreed. In *Pope & Talbot*, the Tribunal said, with respect to the overlap between NAFTA chapters (with respect to trade) and NAFTA Chapter 11:

... the fact that a measure may primarily be concerned with trade in goods does not necessarily mean that it does not relate to investment or investors. By way of example, an attempt by a Party to require all producers of a particular good located in its territory to purchase all of a specified necessary raw material from persons in its territory may well be said to be a measure relating to trade in goods. But it is clear from the terms of Article 1105 that it is also a measure relating to investment insofar as it might affect an enterprise owned by an investor of a Party.<sup>49</sup>

In the case of conflict between treaty obligations from the NAFTA and other treaties, the NAFTA text provides a specific answer. NAFTA Article 103 establishes that the NAFTA takes priority over the WTO. NAFTA Article 1112(1) provides specific guidance as to the resolution of conflict between provisions within the NAFTA in that the obligations of all Chapters prevail to the extent of an inconsistency over an obligation in Chapter 11.

In addition, the definition of a “cross-border provision of a service” in Article 1213 provides that the provision of a service in the territory of a Party by an investment as defined by Chapter 11 is not a service covered under Chapter 12. Thus, where a cross-border service is provided by an investment under NAFTA Chapter 11, the NAFTA makes it an investment matter while the GATS makes it a cross-border service at the same time.

Thus, there is the capability for energy to be covered under international agreements as follows:

Goods	NAFTA and GATT 1947
Service	GATS
Investment	NAFTA Chapter 11 (investment) and TRIMS
State Enterprise	NAFTA and GATS

---

<sup>48</sup>EC - Regime for the Importation, Sale and Distribution of Bananas WT/DS27/AB/R, September 9, 1997 at 97. Referring to *Canada - Periodicals*, Appellate Body Report, WT/DS31/AB/R July 30, 1997 at 19.

<sup>49</sup> *Pope & Talbot, Inc. and Canada*, NAFTA/UNCITRAL Tribunal, Decision on Motion to Dismiss Relating to NAFTA Article 1101 January 26, 2000 at para. 33. See also *S.D. Myers*, where the Tribunal concluded:

The view that different chapters of the NAFTA can overlap and that the rights it provides can be cumulative except in cases of conflict, was accepted by the decision of the Arbitral Tribunal in *Pope & Talbot*. The reasoning in the case is sound and compelling. There is no reason why a measure which concerns goods (Chapter 3) cannot be a measure relating to an investor or an investment (Chapter 11).

Energy Sector NAFTA Chapter 6 (energy)

### **C. Are Ontario Government Actions Covered?**

NAFTA and WTO rules apply not only the Canadian federal government, which is the signatory to these treaties, but also to measures taken by subnational government such as provincial and local governments as well as federal and provincial crown corporations. The NAFTA defines government measures broadly as:

any law, regulation, procedure, requirement or practice.<sup>50</sup>

The federal government is responsible under the NAFTA to ensure that subnational governments follow the terms of the NAFTA. The extent of this obligation is contained in NAFTA Article 105 which states that the federal government must:

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

Article 201 of the NAFTA provides that unless otherwise specified, a reference to a state or province includes local governments of that state or province.<sup>51</sup> The NAFTA obligations apply not only to the Canadian federal government, but also to provincial governments and their crown corporations. Such coverage also applies under WTO agreements.

### **IV. How Electricity is Covered by the International Trade Rules**

Electricity is covered under a variety of different types of international trade law obligations:

- A. Electricity as a Good
- B. Electricity as an Investment
- C. Electricity as a Service
- D. Electricity by State Enterprises
- E. Coverage of the entire Energy Sector

#### **A. Electricity as a Good**

##### ***i. National Treatment***

The principle of national treatment is commonly applied in international trade agreements. For trade in goods, it appears in NAFTA Chapter 3 and GATT Article III. Articles 301 and 606(1)

---

<sup>50</sup> NAFTA Article 201 - measure. Under the GATS, a "measure" means any measure by a Member, whether in the form of a law, regulation, rule, procedure, decision, administrative action, or any other form.

<sup>51</sup> The GATS and the GATT also applies to provincial and local government measures.

of the NAFTA require national treatment to the goods of another party in accordance with Article III of the GATT. It also appears in similar contexts as a services obligation in the GATS and the NAFTA Chapter 12 and as an investment obligation in NAFTA Chapter 11.

Both the NAFTA and GATT rules recognize that internal taxes and charges, measures affecting the treatment of goods and internal quantitative regulations, will not be applied in a way that gives protection to domestic production. Imported products must be given treatment no less favourable than that given to similar domestic products in respect of all laws, regulations and requirements affecting their internal sale.<sup>52</sup> The GATT Article III national treatment provision does not apply to government procurement nor to domestic subsidies.<sup>53</sup>

Trade panels have determined that the granting of formally equal treatment to domestic and foreign products may not satisfy the national treatment obligation. *De facto* discrimination may be present where the application of formally identical legal provisions results, in practice, in less favourable treatment of imports. What must be provided is "effective equality of opportunities for imported products."<sup>54</sup> National treatment is not provided when a government provides differential treatment to "like" products.<sup>55</sup> For example, in *United States - Measures Affecting Alcoholic and Malt Beverages*, a GATT Panel examined the state of Mississippi's application of a lower excise tax rate to wines in which a certain variety of grape was used.<sup>56</sup> Although the excise tax rate did not on its face discriminate against imports, the Panel found that because the favoured grape grew only in Mississippi and certain Mediterranean regions, this tax differential was discriminatory.

Foreigners are entitled to the best treatment provided to any like domestic product. For example, this GATT Panel interpreted the national treatment obligation as follows:

...The Panel did not consider relevant the fact that many of the state provisions at issue in this dispute provide the same treatment to products of other states of the United States as that provided to foreign products. The national treatment provisions require contracting parties to accord to imported products treatment no less favourable than that accorded to any like domestic product, whatever the domestic origin. Article III consequently requires national treatment of imported products no less favourable than that accorded to the **most-favoured domestic products**.<sup>57</sup>

---

<sup>52</sup> GATT Article III:1.

<sup>53</sup> GATT Article III:8(a) and 8(b).

<sup>54</sup> GATT Panel Decision on s. 337 of the US *Tariff Act of 1930* (adopted on November 7, 1989, GATT L/6439) at page 51.

<sup>55</sup> *United States - Section 337 of the Tariff Act of 1930*, 36 B.I.S.D. (1989) at 345.

<sup>56</sup> *United States - Measures Affecting Alcoholic and Malt Beverages*, Report by the Panel adopted on June 19, 1992 (DS23/R) ("U.S. - Alcohol").

<sup>57</sup> *United States - Measures Affecting Alcoholic and Malt Beverages*, Report by the Panel adopted on June 19, 1992 (DS23/R) at para. 5.17 [Emphasis added].

The national treatment obligation was given similar consideration in the context of trade in services. The WTO dispute settlement Panel report in *Canada-Certain Measures Affecting the Automotive Industry* indicated that the goal of “no less favourable treatment” obligations is to remove any impediments to substantive equality among foreign and domestic competitors:

The “no less favourable treatment obligation” in Article III:4 has been consistently interpreted as a requirement to ensure effective equality of opportunities between imported products and domestic products. In this respect, it has been held that, since a fundamental objective of Article III is the protection of expectations on the competitive relationship between imported and domestic products, a measure can be found to be inconsistent with Article III:4 because of its **potential** discriminatory impact on imported products. The requirement of Article III:4 is addressed to “relative competitive opportunities created by the government in the market, not to the actual choices made by enterprises in that market.”<sup>58</sup>

The Panel’s concern for preserving an equality of competitive opportunities is reflected in the dangers associated by economists with measures that have a discriminatory impact on competitors within the marketplace. The Panel accordingly determined that the “treatment no less favourable” obligation meant that a measure would be discriminatory if it brought about circumstances that provided a material advantage to certain domestic firms that was not made available to some of the foreign-based firms competing in the same sector.<sup>59</sup>

### **Like Products**

The like products test limits the scope of the national treatment situation only to similar products. Thus a government benefit for farm equipment need not be provided to all types of equipment, but must be provided to all farm equipment without differentiation between local or foreign made equipment. This interpretative approach has also been consistently adopted by the WTO Appellate Body.<sup>60</sup>

Any interpretation of the “like products” concept must start with an analysis of the meaning of the term “like.” As stated in *Japan-Taxes on Alcoholic Beverages*, when considering the term “like products”:

---

<sup>58</sup> *Canada - Certain Measures Affecting the Automotive Industry*, WT/D5139/R, WT/D5142/R, February 11, 2000, at para. 10.78; citing: *US - Section 337*, at para’s. 5.11 and 5.13 and *US - Malt Beverages*, at para. 5.31.

<sup>59</sup> At para. 10.262. Essentially, the Panel determined that Canada’s practice of only providing certain foreign-owned or controlled enterprises with exemptions from paying customs duties on their automobile imports (contingent upon their manufacturing a certain number of cars in Canada), constituted a violation of Canada’s obligation under the GATS to provide most favoured nation treatment to enterprises from all GATS Members. The “best treatment” available to enterprises from GATS members was to be able to qualify for the advantage of importing cars duty free if the domestic-manufacturing performance requirement could be met.

<sup>60</sup> *Japan - Taxes on Alcoholic Beverages*, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, October 4, 1996; Cited in *Korea - Taxes on Alcoholic Beverages*, WT/DS75/AB/R, WT/DS84/AB/R, Appellate Body Report, January 18, 1999 at para. 119.

... the interpretation of the term should be examined on a case-by-case basis. This would allow a fair assessment in each case of the different elements that constitute a “similar” product. Some criteria were suggested for determining, on a case-by-case basis, whether a product is “similar”: [1] the product’s end-uses in a given market; [2] consumers’ tastes and habits, which change from country to country; [3] the product’s properties, nature and quality.<sup>61</sup>

## **A National Standard of Treatment**

The national treatment obligation imposes a standard that must be applied throughout the territory of the government that has taken a measure.<sup>62</sup> For the purposes of national treatment of goods, a tribunal must look to whether similarly-situated domestic goods receive differential treatment.

Discrimination, or less favourable treatment, need not be “motivated by or related to nationality”. When comparing products it is not a sufficient defense to assert that a measure was implemented without a motivation to discriminate against goods from other NAFTA Parties. The WTO Appellate Body has consistently rejected the inclusion of such an “aims and effects” test.<sup>63</sup>

A similar interpretation was considered by the WTO Panel in *Canada – Certain Measures Affecting the Automotive Industry*. The Panel in that case rejected Canada’s proposition<sup>64</sup> with respect to the WTO most favoured nation obligation contained in the GATS Agreement. Canada had essentially argued before the Panel that since its measure provided certain service providers from Japan and the European Union with treatment equivalent to the best treatment available to service providers from the United States, there was no evidence of discrimination on the basis of nationality and therefore no violation of the GATS most favoured nation treatment obligation. The Panel determined that by not offering the best treatment available to **all** service providers from Japan or Europe, rather than a closed list of service providers, Canada breached its obligation to accord “treatment no less favourable” to like service providers from foreign countries.

---

<sup>61</sup> *Japan - Taxes on Alcoholic Beverages* at 20-21.

<sup>62</sup> This approach has been followed by a number of WTO panels including: *Japan -- Taxes on Alcoholic Beverages*; *Canada-Periodicals* and *Korea – Taxes on Alcoholic Beverages*.

<sup>63</sup> In particular, see the WTO Panel and Appellate Body decisions in *Japan – Taxes on Alcoholic Beverages*

<sup>64</sup> *Canada - Certain Measures Affecting the Automobile Industry*, WT/D5139/R, WT/D5142/R, January 31, 2000, at paras. 10.237 & 10.246, where the Panel states: “We note that both sets of measures allow some wholesale trade services suppliers to import and resell under more favourable conditions, while putting at competitive disadvantage other suppliers... [when compared to the quota allocation regime also found to provide less favourable treatment, in effect, to certain foreign nationals (by another panel), the *Canada - Auto Pact* Panel concluded that]... In both cases there is an economic disadvantage.” The Panel concluded finally, at paras. 10.262 to 10.264 that differential treatment was, in effect, less favourable under GATS Article II.

### **Treatment No Less Favorable**

The GATT Panel in the *United States - Section 337 of the Tariff Act of 1930* addressed the concept of treatment “no less favourable” in Article III:4 and rejected the notion that a differential treatment of foreign products justified a standard based on the product with the least favourable treatment. The Panel stated as follows:

The “no less favourable” treatment requirement of Article III:4 has to be understood as applicable to each individual case of imported products. The Panel rejected any notion of balancing more favourable treatment of some imported products against less favourable treatment of other imported products. If this notion were accepted, it would entitle a contracting party to derogate from the no less favourable treatment obligation in one case, or indeed in respect of one contracting party, on the ground that it accords more favourable treatment in some other case, or to another contracting party. Such an interpretation would lead to great uncertainty about the conditions of competition between imported and domestic products and thus defeat the purposes of Article III.

Clearly differential treatment is less favourable treatment and thus the national treatment obligation obliged the United States to provide better treatment to foreign patent holders than permitted under the Section 337 process.

### **General Exceptions**

Each NAFTA Party has set out a detailed list of exceptions to the national treatment obligation for goods in Annex 301.3. As well, NAFTA Parties are entitled to rely on whatever reservations to national treatment that they made in their Protocol of Provisional Application when they first became GATT Parties. Canada and the United States were both original members of the GATT. Their exemptions under the Protocol of Provision Application relate to measures which they have continually maintained since October 30, 1947.

### **The Procurement Exception**

GATT Article III:8 exempts “purchases by government agencies of products purchased for governmental purposes” from national treatment obligations. A review of the GATT negotiation history demonstrates that this government procurement exemption does not cover governmental purchases of items intended for commercial resale. The negotiation history reports:

During discussions in Sub-Committee A at Havana, it was noted that “the Sub-Committee had considered that the language of paragraph 8 would exempt from the scope of Article 18 [III] and hence from Article 16 [I], laws regulations and requirements governing purchases effected for governmental use where resale was only incidental”.<sup>65</sup>

---

<sup>65</sup> *The GATT Analytic Index* refers to E/CONF.2/C.3/A/W.39, p 1

It was stated that paragraph 8 “had been redrafted by the Sub-Committee specifically to cover purchases made originally for governmental purposes and not with a view to commercial resale, which might nevertheless later be sold”.<sup>66</sup>

Under the GATT, items purchased by a government for resale are not considered to be government procurement, which is generally only understood to apply to purchases for governmental purposes. The purchase of electricity by the Ontario Ministry of Energy would thus not likely constitute government procurement.

**ii. *Import and Export Restrictions***

The NAFTA prohibits the use of import and export restrictions except in accordance with GATT Article XI.<sup>67</sup> This GATT article, which is incorporated into the NAFTA,<sup>68</sup> prohibits export and import prohibitions except for certain public policy reasons such as dealing with critical shortages of foodstuffs or the grading of goods. The restrictions which are prohibited include not only bans, but also export price requirements,<sup>69</sup> such as tiered pricing.

The NAFTA restricts Parties from imposing export taxes on goods unless that Party also imposes a similar charge on goods sold in its domestic market.<sup>70</sup> This charge must also be assessed against the good irrespective of whether the good is foreign or domestic.

If a Party takes an export measure for the purposes of the conservation of exhaustible natural resources, to ensure essential quantities of a good for domestic price stabilization or to preserve foodstuffs during times of critical shortage,<sup>71</sup> then the NAFTA imposes a proportional sharing obligation.<sup>72</sup> For a NAFTA Party to rely on these reasons to reduce the supply of a good it must abide by the following:

- i) Proportional access of the good must be made available to the other Party on the basis of the average supply over the last thirty-six month period;

---

<sup>66</sup> E/CONF.2/C.3/SR.41.

<sup>67</sup> NAFTA article 309.

<sup>68</sup> NAFTA article 309(1) incorporates this article, its interpretive notes and any successor article into the NAFTA.

<sup>69</sup> NAFTA article 309(2).

<sup>70</sup> NAFTA article 314.

<sup>71</sup> That is measures which are justified under the GATT exceptions XX(g),(i) or (j).

<sup>72</sup> NAFTA article 315.

- ii) A Party may not impose a higher price for exports than the price charged domestically by way of taxes, royalties or minimum price regulation; and
- iii) The restriction does not require the disruption of normal channels of supply of that good.<sup>73</sup>

Energy reliability standards often require the imposition of energy export prohibitions, however, Article XI(1) of the GATT, 1947 bans prohibitions on import or export restrictions “other than duties, taxes or other charges”. The effect of the operation of *Bill 100* may be inconsistent with international trade rules in this respect. Article XI(2) sets out two important exceptions to this general rule. Both of these GATT exceptions are incorporated into NAFTA Article 309.<sup>74</sup>

## **B. Electricity as an Investment**

Electricity is a business worth over a billion dollars every year in Canada. In conducting its business, electricity generators and transmitters engage in a variety of functions: They are businesses, service providers, employers, builders of large community-based projects and annual consumers of millions of dollars of goods and services.

The NAFTA is the most comprehensive investment treaty ever accepted between developed states. The term “investment”, widely used in the NAFTA, applies to *most kinds of business activity owned or controlled by a NAFTA investor, directly or indirectly*, including, businesses (incorporated and non-incorporated), shareholdings, loans, real estate, intellectual property and goodwill.<sup>75</sup> The NAFTA definition of investment contains the following categories which would apply to American energy providers supplying energy to Ontario. Article 1139 includes in this definition:

- (e) an interest in an enterprise that entitles the owner to share in income or profits of the enterprise;
- (g) real estate or other property, tangible or intangible, acquired in the expectation or used for the purpose of economic benefit or other business purposes; and

---

<sup>73</sup> NAFTA annex 315. There are also other obligations that apply to energy restrictions in NAFTA Chapter 6 discussed below.

<sup>74</sup> Article XI(2)(a) permits export prohibitions or restrictions temporarily applied to prevent or relieve critical shortages of foodstuffs, or other products essential to the exporting contracting Party. Article XI(2)(b) permits import and export restrictions necessary for the application of standards ... for the application of commodities in international law.

<sup>75</sup> NAFTA Article 1139 - investment.

- (h) interests arising from the commitment of capital or other resources in the territory of a Party to economic activity in such territory, such as under
  - (i) contracts involving the presence of an investor's property in the territory of the Party, including turnkey or construction contracts, or concessions, or
  - (ii) contracts where remuneration depends substantially on the production, revenues or profits of an enterprise.

*i. Performance Requirements and TRIMs*

The NAFTA Investment Chapter limits the freedom of governments to impose a wide variety of restrictions on business practices. These restrictions, known as performance requirements, ban certain mandatory government conditions.<sup>76</sup> These performance requirement limitations are the broadest obligations contained within the NAFTA as they apply not only to investors from other NAFTA countries, but to **all investors, whether local or foreign, even from non-NAFTA member countries.**<sup>77</sup>

This NAFTA prohibition prevents NAFTA governments from imposing certain conditions on the “establishment, acquisition, expansion, management, conduct, operation or sale” of an investment of an investor of a Party or of a non-Party in its territory. NAFTA Article 1106(1) prohibits seven different types of practices, including requirements or undertakings regarding:

- (b) Achieving a given level or percentage of domestic content;
- (c) Purchasing, using or according a preference to goods produced or services provided in its territory, or to purchase goods or services from persons in its territory.

Article 1106(1) establishes a general prohibition on all requirements, commitments or undertakings upon an investor to use goods or services provided in its territory.<sup>78</sup> Under this general provision, government actions that commit an investor to use local goods or services constitutes a clear violation of the NAFTA. *A requirement or commitment to locate a electrical generation facility in Ontario or to use locally available fuels would violate this NAFTA obligation.*

---

<sup>76</sup> The NAFTA performance requirements obligations are broader than those contained in the WTO “Agreement on Trade-Related Investment Measures” (TRIMS).

<sup>77</sup> The actual wording states that this section applies to the “investment of an investor of a Party or of a non-Party” in the territory of a NAFTA Party.

<sup>78</sup> NAFTA Article 1106(1)(c).

In addition to the general prohibitions on performance requirements established in Article 1106(1), the NAFTA contains a reference to prohibitions on performance requirements made in connection with the conferral of benefits by a government. These benefits, called “advantages” would include subsidies, financing assistance and tax abatements. NAFTA Article 1106(3) provides that these benefits cannot be based on the use of local goods. The NAFTA also prohibits governments from conditioning the granting of an “advantage” upon certain requirements. NAFTA Articles 1106(3)(a) and (b), provide that:

3. No Party may condition the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with any of the following requirements:
  - (a) to achieve a given level or percentage of domestic content;
  - (b) to purchase, use or accord a preference to goods produced in its territory, or to purchase goods from producers in its territory;

This section is expanded by Article 1106(4) which states:

4. Nothing in paragraph 3 shall be construed to prevent a Party from conditioning the receipt or continued receipt of an advantage, in connection with an investment in its territory of an investor of a Party or of a non-Party, on compliance with a requirement to locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development, in its territory.

Although this paragraph modifies those practices that are prohibited by NAFTA Article 1106(3), it does not affect those conditions prohibited by NAFTA Article 1106(1). Thus, the general prohibition against requiring an investment to use local goods or services provided in its territory in Article 1106(1) remains in force.

### **The TRIMs Code**

The TRIMs Code is a WTO Agreement that governs investment measures. It is similar to the NAFTA’s prohibition of performance requirements, except that its list of prohibited measures is more limited.

The TRIMs Code lists a series of prohibited trade related investment measures. An illustrative list of these “TRIMs,” set out in an Annex to the TRIMs Code, prohibits local purchase and local content requirements. Article 2 of the TRIMs Code requires that Members not apply any TRIM that is inconsistent with GATT Articles III or XI.

Any measures taken under *Bill 100* which create a requirement for local content such as local production or hiring of local services would violate GATT Article III and thus constitute a violation of the TRIMs Code.

WTO/ GATT tribunals have concluded that general governmental actions that induce private sector behaviours constitute requirements. In *Canada – Foreign Investment Review Act*, the GATT Panel found that mere undertakings provided by investors or as a matter of course to satisfy local content requirements constituted “requirements” under GATT III:4.<sup>79</sup> The Panel in *Canada – Certain Measures Affecting the Automotive Industry*, went even further, stating:

... the word “requirement” has been defined to mean “1. The action of requiring something; a request. 2. A thing required or needed, a want, a need. Also the action or an instance of needing or wanting something. 3. Something called for or demanded; a condition which must be complied with.” The word “requirement” in its ordinary meaning and in light of its context in Article III:4 clearly implies government action involving a demand, request or the imposition of a condition but in our view this term does not carry a particular connotation with respect to the legal form in which such government action is taken. In this respect, we consider that, in applying the concept of “requirements” in Article III:4 to situations involving actions by private parties, it is necessary to take into account that there is a **broad variety of forms of government action that can be effective in influencing the conduct of private parties.**<sup>80</sup>

In *Canada – Certain Measures Affecting the Automotive Industry*, the Panel was concerned with a Canadian measure that constituted a domestic content requirement which, if performed, provided the investment with the advantage of receiving a given amount of duty-free imports. The given amount was determined by a formula related to the production of each investment. The Panel went to the heart of the matter in determining that the fundamental question in determining whether a requirement exists is to ask whether *the measure would be effective in influencing the conduct of private parties*.

The WTO case law has not yet been reflected in settled NAFTA practice. The debate arises over whether a prohibited NAFTA performance requirement must in fact be a “requirement” imposed by the state.

The *S.D. Myers* Tribunal concluded that a tribunal must look at the substance over the form of a government measure to see whether a *de facto* performance requirement existed.<sup>81</sup> The *Pope & Talbot* Tribunal required that a performance requirement be an actual “requirement”. It rejected the concept that an investment following prudent business decisions would be commensurate with a requirement. Thus, for the *Pope & Talbot* Tribunal, if a business was faced with the

---

<sup>79</sup> *Canada – Measures Affecting the Automotive Industry*, WT/DS 139, 142/R, 11 February 2000 (also known as *Canada -Auto Pact*) at para 5.4.

<sup>80</sup> *Canada - Auto Pact* at para 10.107 [Emphasis added].

<sup>81</sup> *S.D. Myers (Partial Award)* at para 273. The Tribunal stated “The export ban imposed by CANADA was not cast in the form of express conditions attached to a regulatory approval but, in applying Article 1106 the Tribunal must look at substance, not only form.”

choice of following a government-encouraged practice or of taking other measures which would have the effect of the company becoming bankrupt, the adherence to the government practice would not constitute a *de facto* nor a *de jure* requirement. In looking at Canada's softwood lumber export regime, the *Pope & Talbot* Tribunal stated that:

While the Regime undoubtedly deters increased exports to the US., that deterrence is not a "requirement" for establishing, acquiring expanding, managing, conducting or operating a foreign owned business in Canada.<sup>82</sup>

This very restrictive "requirement" test set out by the *Pope & Talbot* Tribunal not only is at odds with the WTO jurisprudence but it is at odds with the international law duty of mitigation of damages.

As discussed above, NAFTA Articles 1106(1) and 1106(3) clearly and exhaustively list those performance requirement practices prohibited by the treaty.

### **Local Purchase Requirements**

In his separate opinion, Arbitrator Bryan Schwartz reviewed the operation of paragraphs (b) and (c) of NAFTA Article 1106. In looking at the meaning of these provisions, he found that:

It can be argued that (b) refers to requirements with respect to how an investor carries out its own operations, and that (c) refers only to requirements with respect to purchases from third parties. It seems obvious that if S.D. Myers had actually carried out the physical destruction of PCBs in Canada, it would have had to purchase various goods or services from local suppliers and hire various local employees.<sup>83</sup>

Arbitrator Schwartz gives a detailed review of the issues raised by Canada's PCB waste export ban and whether its domestic destruction policy constituted a prohibited performance requirement. His analysis about the operation of the Canadian ban gives insight into the meaning of NAFTA Article 1106. He found:

The practical effect of the export ban was contrary to Article 1106(b); S.D. Myers and its affiliate Myers Canada were effectively required to carry out a major step in the remediation process, the physical disposal of the waste, in Canada. The "Canadian content" of the service provided had to include destruction operations.

---

<sup>82</sup> *Pope & Talbot* (Interim Award), June 26, 2000 at para. 75.

<sup>83</sup> *S.D. Myers (Partial Award), Separate Opinion of Prof. Bryan Schwartz* at para 197. On the finding of a breach of NAFTA Article 1106, Professor Schwartz dissented from the majority decision. Professor Schwartz found Canada's PCB waste export ban to be a performance requirement while his Tribunal colleagues found this policy to constitute breaches of NAFTA other than Article 1106.

... It seems clear that the requirement of disposing PCBs in Canada was “in connection with” the expansion of the operations of the specific investor in this case. It was in response to S.D. Myers’ plans to expand its business of remediating Canadian PCB wastes that the government imposed the export ban.<sup>84</sup>

Professor Schwartz also examined Canada’s attempt to justify its PCB ban as an environmental measure under Article 1106(6). He found that Canada’s justification, in spite of the evidence from Environment Canada that the ban was not environmentally beneficial, made the performance requirement a disguised trade barrier that was unnecessary, arbitrary and unjustifiable. According to the Separate Opinion, Canada’s performance requirement could not be justified under the saving terms of NAFTA Article 1106(6).<sup>85</sup>

### **Exceptions**

The NAFTA permits a variety of exceptions and reservations from the prohibition against performance requirements. Governments were able to make specific reservations to the performance requirement rules when the NAFTA entered into force, or within two years thereafter. In addition, Article 1108(7) contains specific exceptions to the performance requirement obligations for procurement by a Party or state enterprise.

NAFTA Chapter 11 does not define “procurement”. The only guidance provided on the meaning of procurement is provided under NAFTA Chapter 10 (Procurement). NAFTA Article 1001(5) defines procurement as follows:

Procurement includes procurement by such methods as purchase, lease or rental, with or without an option to buy. Procurement does not include:

- i) non-contractual agreements or any form of government assistance, including cooperative agreements, grants, loans, equity infusions, guarantees, fiscal initiatives, and government provision of goods and services to persons or state, provincial and regional governments; and
- ii) the acquisition of fiscal agency or depository services, liquidation and management services for regulated financial institutions and sale and distribution services for government debt.

In attempting to give meaning to Article I:1 of the Government Procurement Agreement, the Panel Report on *US Sonar Mapping* examined the key elements of government procurement. The Panel stated:

While not intending to offer a definition of government procurement within the meaning of Article I:1 (a particular case, the following characteristics, none of which alone could be decisive, provide guidance as

---

<sup>84</sup> *S.D. Myers (Partial Award), Separate Opinion of Prof. Bryan Schwartz* at paras 193 - 196. While the other members of the *S.D. Myers* Tribunal agreed with Professor Schwartz in that the form and substance of a government measure must be considered by an investor-state tribunal, it did not agree with him on the fact that this particular discriminatory action constituted a prohibited performance requirement.

<sup>85</sup> *S.D. Myers (Partial Award), Separate Opinion of Prof. Bryan Schwartz* at paras 199 - 200.

to whether a transaction should be regarded as government procurement within the meaning of Article I:1(a): payment by government, government use or benefit from the product, government possession and government control over the obtaining of the product.<sup>86</sup>

The NAFTA exempts government procurement from a number of obligations including national treatment and performance requirements. For example, NAFTA Article 1108(7)(a) exempts from national treatment “procurement by a Party or a state enterprise”. The NAFTA contains different wording than the GATT as it exempts procurement from the operation of certain investment obligations without any reference to their purpose.

There is no question that when procurement is for a governmental purpose it is exempted under Article 1108(7). Thus, in the *ADF* decision, the NAFTA Chapter 11 Tribunal applied Article 1108(7)(a) and exempted government procurement from the national treatment obligation. In defining the meaning of “procurement,” the Tribunal referred both to a dictionary definition and to provisions of NAFTA Chapter 10 (Government Procurement). In concluding that the measure did constitute ‘procurement’ and was exempted from the national treatment obligation, the *ADF* Tribunal also held that:

What is excluded from the scope of procurement is the governmental assistance to the public entity or agency engaged in procurement, especially assistance in the form of financing or funding of the procurement activity by providing “grants, loans, equity infusions, guarantees, fiscal incentives”. In other words, the government entity or agency providing or arranging for funds for the purchase of goods, supplies, materials, etc. used or **to be used in the construction of a government project**, is not itself thereby engaged in procurement.<sup>87</sup>

The *ADF* decision raises a question as to whether the procurement exception applies to non-governmental procurement, such as for commercial resale. The WTO case law and the objectives of the NAFTA would not support such a broad exception.

Thus, it appears uncertain whether NAFTA investment obligations with respect to national treatment and performance requirements might be excused as a result of the operation of the government procurement exception in NAFTA Article 1108. There is no question that similar obligations, which arise under the GATS, the TRIMs Code and the GATT, would apply.

## *ii. National Treatment*

National treatment requires a domestic government to treat foreigners like local citizens. This general concept is one of the key elements of the GATT and it forms one of the interpretative principles of the NAFTA. Because of its broad application, national treatment is one of the most powerful components of these multilateral agreements.

---

<sup>86</sup> *United States - Procurement of a Sonar Mapping System*, 26S/34

<sup>87</sup> *ADF and The United States of America*, at para. 161

Under the GATT, national treatment has been given a broad meaning. GATT dispute settlement panels have determined that the provision of formally equal treatment to both domestic and foreign products may not satisfy the national treatment obligation. For example, in the GATT Panel Decision on *Section 337 of the U.S. Tariff Act of 1930*<sup>88</sup> the Panel stated that national treatment:

calls for effective equality of opportunities for imported products in respect of the application of laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products. This clearly sets a minimum permissible standard.

Thus, it is not enough to accord formal equality of treatment to non-residents. Special circumstances may need to be taken into account in order to meet the national treatment obligation.

Hypothetical violations of national treatment have formed the basis upon which GATT panels have ruled that a government measure violates national treatment. In addition, the discrimination between national and foreign goods need not actually be demonstrated. GATT panels have determined that if a measure could allow for discrimination, it violates the GATT national treatment standard.<sup>89</sup>

The NAFTA builds upon the GATT national treatment obligation in important ways. The NAFTA extends the GATT principles from trade in goods to the treatment of investors and their investments.<sup>90</sup> The national treatment provisions of the NAFTA state:

Article 1102: National Treatment

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

NAFTA Article 1102(2) requires that the investments of investors of other NAFTA Parties be given the best in-jurisdiction treatment in like circumstances with respect to the establishment, acquisition, expansion, management, conduct, operation and sale or other disposition of investments.<sup>91</sup> When read substantively, the national treatment obligation ensures that all companies, whether domestic or foreign, are treated equally.

---

<sup>88</sup> Adopted on November 7, 1989, GATT L/6439. This quote is at 5.11.

<sup>89</sup> *E.C. Oilseeds* case, GATT (January 25, 1990) B.I.S.D. Supp. No. 37 at page 125.

<sup>90</sup> NAFTA Article 1102(1) and (2).

<sup>91</sup> These national treatment obligations are expressly made applicable to measures adopted by states or provinces with respect to investors and their investments.

NAFTA tribunals have made reasoned decisions about the NAFTA national treatment obligation. NAFTA panels have examined the two specific requirements of the national treatment test: (a) are the investments “in like circumstances”; and (b) is less favourable treatment granted to the foreign investor or its investment.<sup>92</sup> The decisions of NAFTA Chapter 11 tribunals establish that, for each allegation of a national treatment violation, an investor must prove the following:

- a) That it competes in the same business on economic sector as a local competitor;
- b) That the measure in question provides a better treatment to the domestic competitor than to the foreign investor or its investment; and
- c) That there is no legitimate or *bona fide* public policy reason for this difference in treatment.

Once an investor establishes a violation of national treatment, liability will ensue if the investor can demonstrate resulting harm and there is no NAFTA reservation or exception available to justify the policy.

With respect to Bill 100, the NAFTA national treatment obligation means that Canadian governments (at all levels) must provide the best treatment to foreign investments (American energy investors) that they provide to local investors (Ontario companies) with respect to the establishment, acquisition, expansion, management, conduct, operation and sale of the investment.

Ontario measures that provide a benefit to local over foreign entities can violate the national treatment obligation. For example, preferential pricing rules for Ontario based businesses or access to the Ontario market through RFPs could violate national treatment rules unless the same benefits are made available to all investors. Otherwise, the government benefits could be an incentive to advantage local investments over investments of investors from other NAFTA countries.

### **The Procurement Exception**

Article 1108 (7) contains an exception from national treatment for procurement. As described in relation to performance requirements above, it is doubtful that this exception applies to procurement by a government intended for resale to the public.

Governmental activity generally does not include acts undertaken with a commercial purpose. In the area of sovereign immunity, a distinction is made between the public acts of states (*jure*

---

<sup>92</sup> *S.D. Myers and Canada*, Partial Award, November 13, 2001, *Pope & Talbot and Canada*, Award on the Merits of Phase 2, April 10, 2001 *ADF Group, Inc. and The United States of America*, Award, January 9, 2003. *Marvin Feldman and Mexico*, Award, December 16, 2002.

*imperii*) and private acts of states (*jure gestionis*) such as trading and commercial activities.<sup>93</sup> In general, a state can only rely on its immunity in relation to its public acts.

This restrictive approach to state immunity has been widely adopted.<sup>94</sup> European states have confirmed the principle of restrictive immunity in legislation, such as the *European Convention on State Immunity 1972* and the *State Immunity Act 1978*, and in cases, such as *The Philippine Admiral*.<sup>95</sup> In the United States, the restrictive approach to state immunity was first confirmed in *Alfred Dunhill of London, Inc. v. Republic of Cuba*<sup>96</sup>, and later codified in the *Foreign Sovereign Immunities Act*.<sup>97</sup> In Canada, this doctrine was confirmed in *Government of D.R. of the Congo v. Venne*<sup>98</sup> and *Cargo Ex The Ship 'Atra' v. Lorac Transport Ltd.*<sup>99</sup>

This well-established distinction between acts taken by governments for government purposes and acts taken by government for essentially commercial purposes also seems to apply to the government procurement exception in *NAFTA* Chapter 11.

## C. Electricity as a Service

### i. The NAFTA

The NAFTA contains broad obligations respecting the treatment that governments must provide for the cross-border trade in services. Services are one of the fastest growing sectors of the international economy and the NAFTA takes great care to ensure it protects this area.

The NAFTA Services Chapter applies to almost all cross-border trade in services. NAFTA Article 1213 sets out what is covered by the term "cross-border trade in services". This definition clearly provides that the chapter does not apply to a service provided by "an

---

<sup>93</sup> Alina Kaczorowska, *Public International Law* (London, Old Bailey Press: 2003) at 142.

<sup>94</sup> Ian Brownlie, *Principles of Public International Law* (Oxford, Oxford University Press, 1998) at 330-331.

<sup>95</sup> [1977] AC 373.

<sup>96</sup> 425 US 682 (1976).

<sup>97</sup> 15 *ILM* (1976), 1388.

<sup>98</sup> ILR 64, 24 (SC, 1971).

<sup>99</sup> (1986) 28 D.L.R. (4<sup>th</sup>) 309.

investment" as defined under the definition of investment in the NAFTA Investment Chapter (Article 1139).<sup>100</sup> Article 1213(2) states:

Article 1213: Definitions

2. For purposes of this Chapter:

**cross-border provision of a service or cross-border trade in services** means the provision of a service:

- (a) from the territory of a Party into the territory of another Party,
- (b) in the territory of a Party by a person of that Party to a person of another Party, or
- (c) by a national of a Party in the territory of another Party,

**but does not include the provision of a service in the territory of a Party by an investment, as defined in Article 1139 (Investment - Definitions), in that territory.**

While it seems self-evident that energy transmission is a service, the NAFTA's careful wording modifies this situation. Since energy generation is an investment as defined in the Investment Chapter, the terms of the Investment Chapter will apply to it, rather than the Service Chapter rules.

## *ii. The GATS*

The GATS agreement applies to cross-border services undertaken by an investment. Thus, cross-border energy transmission of a U.S. provider into Ontario is clearly covered under the GATS framework<sup>101</sup> (it could also easily be covered as an investment under the NAFTA).

The GATS applies to all cross-border services except government services or those "delivered in the exercise of government authority".<sup>102</sup> The wording of the GATS exclusion for government procurement mirrors the effective restriction in the NAFTA Article 1108 government procurement exception. Under either the GATS or the NAFTA, the very fact of the Government of Ontario's involvement with respect to electricity services as a commercial activity means it cannot rely on the GATS or NAFTA exclusion for government services.

The GATS is structured with very limited general obligations and then with a series of optional Specific Commitments made by governments. The general obligations include most favoured nation treatment obligations. Specific Commitments include national treatment, market access

---

<sup>100</sup> Article 1202(2) makes this clear.

<sup>101</sup> Energy transmission would be covered as a Mode III service.

<sup>102</sup> GATS Article I:3(c)

and domestic regulation obligations. These are made on a sector by sector basis by signatory governments.

Canada has made no specific commitments on energy generation services in the GATS but it has made a number of commitments on related services, including “General construction work for civil engineering – power facilities and pipelines”. Ontario made commitments for market access and national treatment and made no reservation regarding electrical power other than relating to hydro-generated power.

The GATS does not contain any exception for the National Energy Board regulation of international transmission lines. Such an exception is set out in Annex V of the NAFTA for cross-border services but is absent from the GATS.

#### **D. Crown Corporations**

The international trade law obligations apply to all government bodies that exercise regulatory or other governmental authority over the energy sector. These obligations apply to the public entities established by the *Electricity Act* including OPG, the IESO and the Local Distribution Companies. While OPG no longer has a monopoly over electricity generation in Ontario, it is a state enterprise. The transmission and distribution successors of Ontario Hydro are Hydro One and the MEUs. Hydro One is a monopoly within its given geographic markets, as well as a state enterprise.

NAFTA Chapter 15 sets out rules regarding government designated monopolies and state enterprises. It requires that governments ensure monopolies act consistent with Canada’s NAFTA obligations during the exercise of any regulatory, administrative or other government authority that has been delegated to them. A particularly important obligation is in Article 1502(3)(b) which requires:

monopolies to act solely in accordance with commercial considerations in the purchase or sale of the monopoly good or service in the relevant market, including with regard to price, quality, availability, marketability, transportation and other terms and conditions of purchase or sale.

The term “commercial considerations” is defined by Article 1505 to mean actions “consistent with normal business practices of privately-held enterprises in the relevant business or industry”. Thus, governmental considerations are not permitted – only business considerations.

In addition, GATT Article XII applies to state enterprises. Article XII(b) requires that when state trading enterprises engage in purchases and sales “involving either imports or exports” that they make such purchases:

solely in accordance with commercial considerations, including price, quality, availability, marketability, transportation or other conditions of purchase or sale and shall afford the enterprises of the other contracting parties adequate opportunity, in according with customary business practices, to participate in such purchases and sales.

Thus, Article XII imposes a national treatment obligation on state enterprises in their business decisions. Such monopolies are also prohibited from using their monopoly position to engage in anti-competitive practices. A similar obligation is set out in GATS Article VIII, governing Monopolies and Exclusive Service Suppliers, which states:

1. Each Member shall ensure that any monopoly supplier of a service in its territory does not, in the supply of the monopoly service in the relevant market, act in a manner inconsistent with that Member's obligations under Article 11 and specific commitments.

2. Where a Member's monopoly supplier competes, either directly or through an affiliated company, in the supply of a service outside the scope of its monopoly rights and which is subject to that Member's specific commitments, the Member shall ensure that such a supplier does not abuse its monopoly position to act in its territory in a manner inconsistent with such commitments.

## **V. SPECIFIC INCONSISTENCIES**

The NAFTA applies to all actions taken by governments in Canada, whether at the federal, provincial or local level. NAFTA Article 105 obliges the federal government to ensure that the obligations of the NAFTA are carried out by all levels of Canadian governments. Similarly, the obligations of the WTO also apply.

There is an important public policy division here as there has been an evolution in Ontario from government planning and control of energy towards private markets and open competition. The evolution to a competitive model has also expanded the scope and reach of international trade obligations targeted at ensuring that domestic electricity regulation is done on a non-discriminatory and competitive basis.

The international trade rules govern such issues as:

- a) treatment given to generators of electricity attempting to sell or selling into the Ontario grid;
- b) treatment given to Ontario power producers seeking to export electricity to the United States;
- c) decisions made to encourage alternative or renewable energy sources if such decisions favour local inputs over foreign ones; and
- d) rules respecting the reliability of the electricity system.

### **1. Renewable and Alternative Fuels**

Actions taken to provide preferences for non-renewable and alternative energy sources can offend performance requirement obligations and national treatment obligations. In the United States, there are two groups of states that have legislation pertaining to renewable energy sources. Legislation in the first group of states establishes the mandatory requirement that certain

percentages of energy sold or consumed in a state must be derived from renewable resources.<sup>103</sup> Legislation in the second group of states does not establish a mandatory requirement, providing instead a definition of renewable resources and encouraging the use of such resources.<sup>104</sup>

In the context of international trade law, the decision to regulate imports of a good on the basis of a non-product related process, such as the requirement that electricity come from renewable resources, will likely be considered discriminatory.<sup>105</sup> The renewable resources definition could be considered to exclude foreign hydropower suppliers, thereby altering the conditions of competition between local and foreign electricity. A change in competitive conditions in which a foreign supplier may receive less favorable treatment than domestic or local products has consistently been interpreted to be a violation of the national treatment requirement.<sup>106</sup>

Bill 100 amends the *Electricity Act* to permit the OPA to require a given level of renewable or alternative fuel production power.<sup>107</sup> Such mandatory standards can be inconsistent with international trade law obligations if they favour domestic inputs (such as local content and labour) and exclude foreign ones.<sup>108</sup>

Ontario has five coal fired plants producing nearly 7500 MW of power. Three in Southern Ontario (Lakeview, Nanticoke and Lambton) and two in Northern Ontario (Thunder Bay and Atikokan). All these plants are owned by OPG. The Southern Ontario coal fired plants almost exclusively rely upon coal supplies from the United States, either eastern bituminous coal of Appalachia or Powder River Basin coal from Montana and Wyoming. The Northern Ontario plants rely upon some Western Canadian coal and American coal.

---

<sup>103</sup> Gary Horlick, Howard Mann and Christiane Schuchhardt, "NAFTA Provisions and the Electricity Sector" Background Paper No. 4 to the Secretariat of the North American Agreement on Environmental Cooperation, June 2002 at 7. These states include: Arizona; California; Connecticut; Maine; Massachusetts; Nevada; and New Jersey.

<sup>104</sup> Gary Horlick, Howard Mann and Christiane Schuchhardt, "NAFTA Provisions and the Electricity Sector" Background Paper No. 4 to the Secretariat of the North American Agreement on Environmental Cooperation, June 2002 at 7. These states include: Arkansas; Delaware; the District of Columbia; Illinois; Maryland; Michigan; Montana; New Hampshire; New Mexico; Ohio; Oklahoma; Rhode Island; Texas; and Michigan.

<sup>105</sup> Gary Horlick, Howard Mann and Christiane Schuchhardt, "NAFTA Provisions and the Electricity Sector" Background Paper No. 4 to the Secretariat of the North American Agreement on Environmental Cooperation, June 2002 at 9.

<sup>106</sup> *Italian Discrimination Against Imported Agricultural Machinery*, BISD 7S/60, 64 at para. 12; *Japan—Customs Duties, Taxes and Labelling Practices on Imported Wines and Alcoholic Beverages*, BISD 34S/83, para. 5.5(b); Appellate Body report in *Japan—Taxes on Alcoholic Beverages*, WT/DS8/AB/R, adopted November 1, 1996, at p. 16.

<sup>107</sup> *Bill 100*, section 32.

<sup>108</sup> Peter Evans, "Strengthening WTO Member Commitments in Energy Services: Problems and Prospects: in A. Mattoo and P. Sauvé (eds) *Domestic Regulations and Service Trade Liberalization*, Oxford University Press, 2003 at 170.

The Ontario Power Generation Annual Information Form indicates that these coal sales are pursuant to short and mid-term coal purchase agreements. OPG has purchased coal from the United States as follows:

Central Appalachia	4 mm tons
Northern Appalachia	2 mm tons
Uinta Basin	1 mm tons
Powder River Basin	6 mm tons <sup>109</sup>

In testimony before the Standing Committee on Social Policy, the Director of Energy Supply and Competition for the Ontario Ministry of Energy, Rick Jennings, discussed the process of how *Bill 100* will be used to phase out coal-fired generation. He stated:

One of the features of this legislation is that we are adding responsibility for reliability to the Ontario Power Authority. This sets out, in terms of the directives that the minister will be able to issue, directives to the Ontario Power Authority that they're required to implement related to fuel mix. Those could be in the areas of alternative, renewable targets—the government has put some of those in place already; that could be on an ongoing basis—fuel mix, in terms of which sources they should be pursuing. Directives related to the phasing out of coal-fired generation facilities would be an example.<sup>110</sup>

The Minister of Energy has announced that, through *Bill 100*, Ontario seeks to replace its dependence on coal for other sources of energy. The substitution of foreign coal with Ontario produced energy inputs, such as locally produced wind, solar or biomass, is inconsistent with Canada's international trade obligations. In fact, this policy appears to be inconsistent with a variety of Canada's international trade obligations:

1. The substitution of local inputs in favour of foreign coal would constitute a prohibited performance requirement under NAFTA Article 1106 and the TRIMs Code by giving a preference to local content over foreign content in the generation of electricity.
2. The substitution away from coal also would constitute a national treatment violation under NAFTA Chapter 3 (goods) NAFTA Article 603(1)<sup>111</sup>(energy), GATT Article III:4 and NAFTA Chapter 11 (investment)
3. If Ontario were to justify its policy change under GATT Article XX(g), it would not be able to sustain such an exception as Article 605 (c) does not permit Ontario to disrupt the normal channels of supply between the United States and Canada, which would presumably occur by such a switch in energy inputs.

---

<sup>109</sup> ECNG Inc, Ontario Electricity Market overview, October 15, 2004 at page 5.

<sup>110</sup> *Hansard*, Standing Committee on Social Policy, August 9, 2004 at SP-16.

<sup>111</sup> This obligation incorporates the GATT obligations, including GATT Article III, in the treatment of energy trade.

Thus, if Ontario were to substitute electricity produced from Ontario inputs for its coal fired electricity generation capacity, there would be the possibility of international trade law challenges from the government of the United States (under the WTO and NAFTA Chapters 3 and 6) and from investors directly affected under NAFTA Chapter 11.

## **2. Access to Transmission and Distribution**

*Bill 100* does not set out guidelines for transmission and distribution access, although Section 31 permits the Minister of Energy to direct the OPA to consider such questions and include it in the Ontario Integrated Power System Plan. The OEB has powers to issue licenses which are necessary for transmission or distribution in Ontario. Section 66 of the *Ontario Energy Board Act* provides that the OEB should “have regard to whether that jurisdiction allows for equivalent access to its electricity markets for electricity generated from facilities located in Ontario”. This section is not repealed by *Bill 100*. We note that this criteria is a violation of the national treatment obligation as a transmitter or distributor from a jurisdiction that does not provide equivalent access to Ontario energy exports as to those that do. Such a reciprocity provision is simply not consistent with Canada’s international law obligations and could form the basis of trade challenge in future to decisions rendered by the OEB.

For the Integrated Power System Plan to be consistent with the international trade law obligations governing Ontario, it must guarantee non-discriminatory access for foreigners to transmission and distribution systems. To give effective meaning to these obligations, there must also be a guaranteed market access to all eligible customers in Ontario for these U.S. investments.

## **3. Reliability Issues**

The August 2003 blackout demonstrated that electricity reliability is a matter of public policy importance. Ensuring electricity reliability requires that there be regulatory supervision of Ontario’s electrical energy supply from the Ontario Energy Board and the IESO. In fact, *Bill 100* has made reliability one of its key objectives.

Canada’s international trade law obligations complicate reliability regulation because all regulation is required to meet obligations, such as national treatment, and to avoid imposing performance requirements, such as two-tiered pricing.

NAFTA prohibits export and import controls with respect to trade in goods (which covers electricity under the NAFTA) except in very narrow circumstances.

Actions taken to establish or to ensure reliability standards which can limit electricity available for export to the United States can be inconsistent with Article XI of the GATT, NAFTA Article 309 and NAFTA Article 604.

The North American Energy Reliability Council (“NERC”) has established guidelines for the types of reliability standards that can be adopted by regulators. These standards are set out to

ensure fair and transparent conduct to all market participants. The NERC Reliability Standards Manual discusses the meaning of a reliability standard. It states that:

A Reliability Standard shall have the following characteristics:

1. **Material to Reliability** . A Reliability Standard shall be material to the reliability of bulk electric systems of North America. If the reliability of the bulk electric systems could be compromised without a particular standard or by a failure to comply with that standard, then the standard is material to reliability.
2. **Measurable** . A Reliability Standard shall establish technical or performance requirements that can be practically measured.<sup>112</sup>

Government surplus energy export restrictions are one example of a type of practice that could be inconsistent with GATT Article XI(1). Ontario's criteria for approval of surplus transactions to the U.S. could be inconsistent with the international trade law rules if Ontario requires that priority be given to Ontarian and other Canadian customers over foreign customers. The NERC guidelines would not permit such actions and they are simply inconsistent with the energy and trade in goods obligations of the NAFTA and the GATT

Another approach that could be taken is to rely upon the general exceptions to NAFTA contained in NAFTA Chapter 21 which incorporated GATT Chapter XX. Some Ontario electrical power is generated from oil or natural gas. GATT Chapter XX (g) excuses otherwise inconsistent measures relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption. Such an exception would not apply to energy generated from renewable or non-exhaustible natural resources such as hydro-generation, winds or solar power sources.

This exception was examined during an interpretive dispute between Canada and the United States under the Canada-U.S. Free Trade Agreement. A Chapter 18 Panel was convened, at the request of the United States, to review the consistency of Canadian landing requirements for salmon and herring.<sup>113</sup> Canadian law required that all salmon and herring caught in Canadian waters had to be landed in Canada, so that statistical records could be maintained, before being exported. Canada argued that the measure was justified on the grounds that it related to Canada's ability to conserve an exhaustible natural resource and, as such, was excepted by Article XX(g).

The Panel did not agree entirely with the Canadian position. It found that the requirement that 100% of the catch be landed in Canada was not necessary to achieve the goal of conservation. The measure was not "primarily aimed" at Canadian management of the resource. The Panel did uphold the right of Canada to take measures to protect its fisheries through data collection but

---

<sup>112</sup> NERC Reliability Standards Process Manual, Version 2.1, Approved by Board of Trustees March 11, 2003 at page 6 .

<sup>113</sup> *In the matter of Canada's Landing Requirement for Pacific Salmon and Herring*, CDA 89-1807-01, (US-Canada Binational Panel, October 16, 1989).

this landing requirement went too far.<sup>114</sup> The dispute was ended after the Panel decision with a negotiated settlement between the Parties.

Exception clauses have been interpreted narrowly. The Panel established that a government can take measures aimed at protecting their resources if the measure is primarily aimed at protection. At the same time, the Panel suggests that there is a sense of proportionality that must be taken in the measure to relate the trade-distortion to the objective of the measure.

The NAFTA clarifies that measures to "protect human, animal or plant life or health" include environmental measures and measures relating to "the conservation of exhaustible natural resources" include the conservation of living and non-living natural resources.<sup>115</sup> This wording is broader than the WTO exception.

While governments could rely on the exhaustive natural resource exception contained in GATT Article XX(g), such an exception could not apply in relation to energy produced by hydro-electric power, renewable or alternative energy sources.

Relying on this exemption for other types of energy would trigger other requirements. Under the NAFTA, whenever a government relies upon the natural resource exception, NAFTA Article 315 incorporates the proportional sharing obligation of the Canada-U.S. Free Trade Agreement which has the effect of banning preferential domestic pricing schemes. It also requires that proportional access of the resource be made available to the other Party on the basis of the average supply over the last 36-month period.

Decisions of Canada-U.S. Free Trade panels which examined the use of the GATT Article XX(g) exception have held that this exception must only be used to the extent necessary and in proportion to the objective being served.<sup>116</sup> Thus, if a Party decided to justify an export ban of electrical energy for conservation reasons, that Party would be obligated to continue to supply other Parties on a proportional basis.

The imposition of standards-based regulations could have the effect of depriving an investor of some or all of its existing market. Also, depending on how it is imposed, it could also raise claims of national treatment if the regulation was intended to advantage domestic substitutes.

Many energy licensing regimes depend on the ability of governments to impose standards-based regulations and could possibly rely upon this exemption. Such a standards-based regulation exception would permit governments to engage in objective standards-based regulation that would not be inconsistent with the obligations contained in the NAFTA.

#### **4. Tiered Pricing**

---

<sup>114</sup> *Salmon and Herring case*, pages 51-52.

<sup>115</sup> NAFTA article 2101(2).

<sup>116</sup> *Salmon and Herring case*

It is clear that *Bill 100* will continue recent Ontario government policies which establish and maintain differential pricing for electricity. In his testimony to the Standing Committee on Social Policy, Energy Minister Duncan discussed the role of the OEB in rate setting as follows:

One of the biggest challenges we face as a province is balancing the needs of small- and large-volume electricity consumers. Residential and small business consumers make up the vast majority of ratepayers in the province, but consume only 50% of Ontario's electricity. Their priority is stability. My constituents in Windsor neither know nor likely care about the subtleties of electricity markets, but they do know that they want a price for electricity that they can depend on, and they deserve no less. There are far fewer large volume consumers, but they consume the other 50% of electricity in the province. Their priority is flexibility, so they can organize themselves to be as competitive as possible. The *Electricity Restructuring Act* meets the needs of both groups of consumers in Ontario.

With regard to rates, the Ontario Energy Board would approve an annual rate plan for low-volume and other smaller consumers, who would pay a blended price based on regulated, contract and forecasted competitive prices. Fixed prices for a large part of the energy consumed in the province would keep the overall blended price for electricity fair, stable and predictable. Consumers who do not wish to participate in the regular rate plan would have other options, such as purchasing their electricity from energy retailers. Our aim is not to limit options, but to in fact improve them. No one will be forced to put up with the gross instability of the market, but at the same time the annual rate plan option would not be forced on people interested in taking advantage of other opportunities.

Medium and large businesses would continue to have the flexibility to pay the market price for electricity, or could use retailers or financial hedging instruments to manage electricity costs. This flexibility includes having the opportunity and information to pursue cogeneration or distributed generation opportunities. Distributed generation, which is also attractive from a security perspective, holds significant promise for the environment, as it suggests an electricity system that minimizes massive transmission networks and focuses resources only where they are absolutely necessary. Our desire is to help Ontarians unlock the potential for efficient electricity generation that is around them. We will remove barriers, free up resources, and bring new thinking and new ideas to the challenges that lie before us.<sup>117</sup>

*Bill 100* clearly contemplates an Ontario policy of tiered prices, where some local consumers obtain lower electricity prices than others. Tiered pricing violates GATT Article XI as it establishes a minimum export price above that charged domestically. It also appears to be a violation of GATT Article III:4's national treatment requirement.<sup>118</sup>

Charging tiered prices violates NAFTA's national treatment for goods obligations (Article 309), Article 602's prohibition on export measures and likely violates NAFTA's investment chapter national treatment obligation (Article 1102).

Ontario's tiered pricing regime was not in effect on January 1, 1994 and thus cannot be covered by the provinces grandparented general reservation for existing non conforming measures under the NAFTA.

---

<sup>117</sup> *Hansard*, Standing Committee on Social Policy, August 9, 2004 at SP-6.

<sup>118</sup> Such a policy could also constitute an expropriation contrary to NAFTA Article 1110.

The NAFTA national treatment obligation requires Canadian governments (at all levels) to provide the best treatment to foreign investments that they provide to local ones with respect to the establishment, acquisition, expansion, management, conduct, operation and sale of the investment. Provincial government measures that provide a benefit to local entities over foreign ones can violate the national treatment obligation. For example, preferential energy pricing provided to local businesses that is not extended to foreign power purchasers could violate national treatment rules. Otherwise, the government benefits could be an incentive to advantage local investors over investors from other NAFTA countries.

## **5. Performance Requirements**

The NAFTA and the TRIMs prohibit governments from requiring investors to move production in order to have access to markets. Ontario has made local presence and thus local content a requirement for access to new power supply markets in Ontario. Pursuant to the provisions of *Bill 100*, the Ontario Ministry of Energy has issued two Request For Proposals (“RFP”) for Energy Supply. An example of one of these RFPs is the RFP for 300 MW of renewable energy required that any prospective bidder must locate its facility in Ontario to be eligible to supply this power.<sup>119</sup> Such requirements are violations of NAFTA Article 1106, 1102, and the TRIMs Agreement.

## **6. Market Access for investments**

The NAFTA obligation for national treatment in Article 1102 requires the Government of Ontario to provide national treatment to the establishment, management, conduct and operation of investments. Ontario has now made market access for energy available through IESO’s rather than through government action, and thus, national treatment must be provided to market suppliers from the United States.

Similarly, the OEB cannot impose restrictions upon the export of energy from Ontario companies to the United States as to do so could constitute either a breach of national treatment or an export control or other measure that would violate GATT Article XI, NAFTA Article 604 and NAFTA Article 1102.

Access to transmission lines or distribution services must be provided to foreign companies on the same basis as to local ones. This is covered as an investment under the NAFTA and a service under the GATS agreement.

The OEB must provide American electricity purchasers the same access to Ontario’s energy. The international trade rules require foreigners to be given the same opportunity to purchase electricity in the same manner as locals as a result of the national treatment rules.

---

<sup>119</sup> RFP No. SSB-065230 issued on June 4, 2004, Part III (D)(1)(b).

Differential charges are outlawed by Chapter 6 of the NAFTA as well as by the national treatment obligations of the NAFTA and the GATS.

### **Effects of violation**

By becoming a member of the NAFTA, Canada gained a number of advantages in participating in a continental market. However, there are a number of costs in joining this economic relationship. The investment provisions of the NAFTA provide a high level of investor protection afforded by any international agreement in the world today. Its provisions do not force governments to change their laws, but the NAFTA penalizes governments financially for their failure to observe their international obligations. While the NAFTA governments have been obliged to conform to these new NAFTA obligations since 1994, it is clear that many governments do not fully understand the effect that the NAFTA will have on their policy choices. The NAFTA fundamentally changes the nature of international economic law. This change occurs through potentially allowing compensation for Canadian and Mexican citizens and businesses if American government measures violate their NAFTA investor rights.

Through *Bill 100*, the Government of Ontario has taken measures which could be inconsistent with the NAFTA obligations of the Canadian federal Government. As a result of these actions, U.S. or Mexican-owned energy investments may be able to use the NAFTA's investor dispute resolution process in order to seek compensation from the Canadian government which in turn would seek compensation from the Government of Ontario.

In addition, violations of the provisions of the WTO Agreements and the NAFTA also makes Canada and Ontario the target for trade actions by the United States Government.

**Question Two:** Does the proposed *Electricity Restructuring Act* diminish Ontario's existing trade law reservations currently in place under these international agreements?

Reservations are unilateral statements made by a treaty Party indicating that it will not be bound to a specific treaty obligation. Reservations are not the same as general exceptions to a treaty. Exceptions apply to all obligations in a treaty while reservations apply only to those obligations specified by the terms of the treaty. Also, exceptions must be agreed upon by all Parties and form a part of the treaty itself, while reservations are usually unilateral in nature and only affect the listing country.

There are no general public policy exceptions set out in the NAFTA investment chapter.<sup>120</sup> What is permitted are specific actions that governments preserved through "NAFTA reservations". At the

---

<sup>120</sup> NAFTA Article 2101(2).

federal level, the Governments of Canada, Mexico and the United States have not made any reservations in the NAFTA that would justify the taking of a measure in contravention of Article 1106 or Article 1102.

A general exception to certain NAFTA investment chapter obligations has been taken by provincial governments. Provincial measures taken before January 1, 1994 and maintained in force through January 1, 1996 were reserved through a blanket reservation to the NAFTA taken by Canada, the United States and Mexico in March 1996. While prompt renewals of existing measures are also permitted no new inconsistent measures were allowed. **All new measures taken by state or local governments since 1994 are not subject to the NAFTA reservation, unless they are a renewal of a reserved measure.**

The proposed *Electricity Restructuring Act* would have the effect of reducing the Government of Ontario's existing flexibility to take actions inconsistent with the NAFTA and the GATS.

- a. The Government of Ontario's current ability to take actions which are otherwise inconsistent with key NAFTA investment and cross-border trade in service obligations is limited to specific exceptions and reservations. The broadest of these reservations is the "general reservation" made for non-conforming Ontario government laws, regulations, requirements and practices which were in force on January 1, 1994 and which have been continued in force since that date. Provincial government practices (that were in force on January 1, 1996 and have stayed in force since then), which have limited national treatment or imposed performance requirements on foreign investors, could be maintained but only to the extent that they are based on the continuous policy which reaches back before January 1, 1994. The reservations will be reduced to the extent that non-market driven considerations replace market driven considerations in these energy policies.
- b. The Government of Ontario did not make any reservations with respect to its service obligations under the GATS other than for the matter of hydro-electric power plant construction. Thus, there are no reservations that apply to permit Ontario to take otherwise inconsistent policy measures in violation of international service obligations contained in the GATS.

## V. Assumptions and Exclusions

In coming to our opinion, we have consulted the provisions of the NAFTA, the WTO Agreements and other relevant international and municipal legal materials. This opinion relates only to the laws of Canada and to international law applicable in Canada as such laws existed at the time of the writing of this opinion. While we have tried to be as accurate and comprehensive as possible, this opinion is subject to the following qualifications:

- a. Opinions on the appropriate interpretation and application of international treaty obligations can never be entirely free from doubt. Such treaties are not the subject of binding judicial interpretation in domestic and international courts. They are drafted in the broad and general language of diplomacy, which is appropriate to

treaties between sovereign states, and lack the precision normally found in domestic statutes.

- b) The NAFTA creates the Free Trade Commission, which can interpret the NAFTA on a consensus basis. This opinion is made subject to the possible interpretation by this NAFTA Body as it could provide binding interpretations on the NAFTA which need not be based on principles of international law or the NAFTA itself.

Please note that this legal opinion has been prepared at your request and it is not reasonable for any person, other than you, to rely upon this report without first obtaining authorization in writing from Appleton & Associates.

Respectfully submitted,

Appleton & Associates International Lawyers