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Breaking the free trade concensus

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ISBN: 0-88627-312-9

August 2002

CAW 567 OTTAWA

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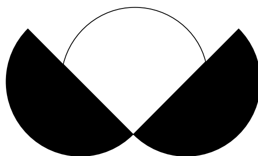

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"New Brunswick is asking that… consistent with the National Energy Board Act, any incremental Scotian offshore gas is shown to be surplus to reasonably foreseeable requirements in Canada before the Board grants as short term export order."

—Ian Blue, New Brunswick counsel, in the opening statement to the National Energy Board (NEB) hearings in Fredericton, July 15, 2002

Introduction

The National Energy Board hearings on Scotian offshore natural gas in Fredericton, NB, this July have revived a debate about Canadian energy policy that has largely been dormant since the days leading to the negotiation of the Canada US Free Trade Agreement. At issue is a seemingly modest request by the Province of New Brunswick that the process of issuing gas export orders for gas extracted from Nova Scotia's offshore be subject to public review.

New Brunswick wants Canadian purchasers to have a fair opportunity to purchase Canadian natural gas before it is exported into the United States. After all, under the NEB Act, gas exports are supposed to occur only if there is a surplus beyond reasonably foreseeable Canadian needs.

Now that doesn't sound so radical or threatening. Why, then, has Encana, the largest natural gas producer in Canada, threatened a capital strike to withhold investment on the next major Scotian offshore gas well (the Deep Panuke)? Why has the Canadian Association of Petroleum Producers (the proxy for Exxon and Shell's interests in Scotian offshore resources) condemned New Brunswick's proposal as "bizarre" and "crazy"? Why has Nova Scotia Premier John Hamm likened the New Brunswick request to the Trudeau National Energy Program? Why did former free trade negotiator Simon Reisman emerge from retirement to castigate the New Brunswick application as "dumb" and a violation of NAFTA?

New Brunswick's application certainly has the attention of North America's oil and gas oligopoly. They are understandably concerned that New Brunswick's application may tear away a veil of secrecy that has obscured the virtual abandonment of any public interest safeguards when it comes to the export of Canadian natural gas. In the wake of the Enron and other corporate debacles, New Brunswick's application has exposed the close relationship between North America's largest energy companies and the National Energy Board. Gas export "orders" are routinely issued by the NEB without any public review and only perfunctory regulatory oversight.

The huge increase in natural gas exports to the US has taken place through ex parte (granted without public notice or hearing) "short term orders," distinct from exports authorized by an export license as the National Energy Board Act envisages. The orders are a byproduct of the "market-based procedures" of the National Energy Board, but they effectively circumvent the safeguards for determining Canadian needs for our natural gas resources.

Natural gas deregulation and market-based procedures were put in place a few years before Canada signed on to free trade with the United States. However NAFTA now overlays a number of new constraints on Canada, most notably the proportionality regime that requires Canada not to disrupt or reduce the proportion of our energy exports to the US.

While what New Brunswick wants from the National Energy Board at this time does not violate NAFTA, there can be no doubt that Canadian needs and the continentalist assumptions and disciplines of NAFTA will ultimately collide. Given the proportionality regime that NAFTA imposes, it is crucial that new exports

of our scarce natural gas resources are genuinely surplus to our present and future needs. It may not be so simple for Canadians to "turn off the tap" later, even if the tap has been flowing through so-called "short term" orders.

In this paper we discuss how regulatory procedures have been exploited by oil and gas companies to undermine the public interest safeguards in our national energy legislation. We also consider the implications of the free trade context for natural gas exports. These are crucial issues for Canadian public policy, but what New Brunswick's challenge has brought into focus is perhaps even more important: the consensus in the Canadian establishment that unbridled energy continentalism serves this country's needs has met its first challenge.

The New Brunswick story

For over fifteen years the assumption has been that Canadian energy resources must be sold into "world" (US) markets at the highest price, and that this policy would bring prosperity to this country. This assumption was enshrined in NAFTA, guaranteeing American access to our energy resources in perpetuity and rendering illegal any Canadian measure that would favour Canadian needs. Once these measures were forced on the country by the Mulroney government and affirmed by the Chretien Liberals, the Canadian establishment closed ranks. Until now.

The development of natural gas reserves off Nova Scotia's coast in the late 1990s provided a critical opportunity to end Maritime Canada's isolation from the country's natural gas markets. Efforts to extend the pipeline infrastructure beyond Quebec City had stalled years earlier.

However, the developers of Scotian offshore resources, Exxon and Shell, managed to persuade Canadian regulators that access to US markets was the necessary precondition for further exploration and development of the offshore. Accordingly in 1996 the NEB approved the construction of a gas pipeline to the United States, and did not require a connection to the pipeline that still dead ends at Quebec City.

As Scotian offshore gas wells came into production over the past decade, the continentalist assumptions were, for the most part, unchallenged. A gas pipeline was built through Nova Scotia, southwest through New Brunswick and into the state of Maine. Large areas of New Brunswick remained without access to Canadian natural gas reserves, and Maritime Canada was still isolated from western Canadian gas markets. Some natural gas would be made available to Canadian Maritime consumers – but today 75 per cent of Scotian natural gas is exported to the US.

As further discoveries were made in the Scotian offshore, New Brunswick and Quebec agreed to renew their efforts to have Maritime gas reserves connected to the rest of Canada's gas system. This would mean building a pipeline through northern New Brunswick to Edmundston, and from there across the St. Lawrence River to Quebec City where it would link up to the eastern extension of the TransCanada pipeline that takes Western gas to Ontario and Quebec. New Brunswick also wanted another pipeline built to northeastern region of the province to service a power plant and its resource industries.

The next major Scotian offshore natural gas well, Encana's Deep Panuke, is scheduled go into production in 2005. New Brunswick and its various corporate partners have been unable to make a deal with the producer, Encana, or the pipeline company, Maritime North East (owned by US giant Duke Energy). The producer and the pipeline company have another plan—to increase the capacity of the existing pipeline to the US to increase exports. New

Brunswick hit the panic button as it appeared that no gas would be made available for domestic projects, even though Canadians are willing to pay the market price.

This is the background against which New Brunswick's Conservative Premier Bernard Lord stepped forward as the somewhat unlikely champion of Canadian nationalism. These days that means no more than asking that Canadians have the same opportunity to purchase Canada's public natural resources at the international market price.

Mr. Lord's determination to assert New Brunwick's interests has also brought into question the National Energy Board's practice of allowing most gas exports to flow from Canada without any regard to whether these resources might be needed in Canada.

The 80 percent loophole

The National Energy Board Act has clear procedures on how a producer should go about exporting natural gas. In Section 116 of the Act it is stated, "except as otherwise authorized by or under the regulations, no person shall export or import any oil or gas except under and in accordance with a license issued under this Part." Before issuing such a license, the NEB is required to ensure that a proposed export "not exceed the surplus remaining after due allowance has been made for the reasonably foreseeable requirements for use in Canada having regard to the trends in the discovery of oil or gas in Canada." The regulation stipulating that gas exports occur only when there is a surplus to Canadian needs is essentially the only public interest safeguard that has survived, at least in theory, the implementation of free trade and free market policies by federal governments, both Tory and Liberal.

However, NEB Act regulations allow a key exception to this licensing requirement by empowering the Board to issue gas export *orders* for unlimited quantities of natural gas and for periods of up to two years. Unlike export *licenses,* gas export *orders* engender no obligation to protect Canadian reserves. Moreover, orders are issued "ex parte," (granted without public notice or hearing) thereby circumventing the public hearing requirements of the Act as well. The procedures adopted by the Board to issue such orders were last examined in 1992, and until now have never been seriously challenged. However, since that time export orders have become the rule, not the exception. Today, 80 percent of Canada's natural gas exports are taking place pursuant to short-term, ex parte orders.[1] For the Maritime region this figure is 90 percent.

Not surprisingly, New Brunswick has called upon the NEB to cease the practice of granting ex parte short-term orders for Scotian offshore gas, so that its residents and industries can have a reasonable opportunity to bid on Canadian gas resources before they disappear south.

Regardless of the Board's decision, this may be a matter that is eventually decided by Canada's Supreme Court. Regulations are generally meant to carry into effect the purposes and provisions of the Act they support. However when 80 percent of Canada's natural gas is being exported through a regulatory loophole, it seems that the requirements of the Act (Sections 116 and 118) are being effectively circumvented, thereby allowing producers and exporters to avoid compliance with the surplus and public interest safeguards of the Act.

The fiction of market based procedures

The practice of exporting gas through short-term orders has its origins in the 1987 decisions of the National Energy Board. At this time they to changed the criteria and procedures for natu-

ral gas exports through the introduction of "market-based procedures."

Today, these procedures have become ideological fence posts for the oil and gas industries. Indeed, most of the players in government and the energy industries begin their pleadings by emphasizing their devotion to market-based procedures. While the petroleum companies condemn New Brunswick's application because it offends the notion of unfettered markets, New Brunswick retorts that the problem with Scotian gas is that the Maritime market is dominated by less than a handful of transnational corporations and is far from a competitive and free market.

But when the NEB speaks of market-based procedures, it is more than an ideological nod to free markets; it refers to a specific set of guidelines for the exporting of natural gas. In 1985, the federal government, Saskatchewan, Alberta and British Columbia agreed to deregulate the natural gas industry. Until then, the National Energy Board had evaluated applications for energy export licenses based on the requirement to determine that the exports were surplus to Canadian needs by setting aside and protecting reserves of natural gas.

In 1987, the NEB changed its procedure by this decision[2]:

> The new procedure, which will be referred to as the Market-Based Procedure, is founded on the premise that the marketplace will generally operate in such a way that Canadian requirements for natural gas will be met at fair market prices.
>
> The Board will act in two ways to ensure that natural gas to be licensed for export is surplus to reasonably foreseeable Canadian requirements: one will be in the context of public hearings to consider applications to export natural gas; the other will be by monitoring Canadian energy markets on an ongoing basis.
>
> A. Public Hearings
>
> During public hearings to consider applications for licences to export natural gas, the Board's assessment as to whether the market is functioning in a satisfactory way will consist of three main components:
>
> 1) Complaints Procedure
> 2) Export Impact Assessment
> 3) Public Interest Determination.
>
> B. Ongoing Monitoring
>
> The Board's ongoing monitoring will consist of two main components:
>
> 1) Assessment of Canadian Energy Supply and Demand
> 2) Natural Gas Market Assessment.

This remarkable premise, in conjunction with the new procedures permitting exparte short term orders, is now, in light of New Brunswick's current complaints, reduced to a highly questionable article of faith. But it must be remembered that this new practice is a *policy* of the NEB, by which it chose to carry out its *obligations* under the NEB Act. This policy was adopted almost two years before free trade rules overlaid a new set of obligations.

Nevertheless, the 1987 NEB's procedures did envisage some safeguards. The complaints procedure was "based on the principle that gas should not be authorized for export if Canadian users have not had an opportunity to buy gas for their needs on terms and conditions similar to those of the proposed export." The export impact assessment placed the onus on the applicant to demonstrate that the export in question was in fact surplus to Canadian needs. And the public interest determination involved the questioning of export licenses by a wide range of criteria, including examination of the

contracts that had been entered into, whether the export revenues recover all of Canada's costs, and Canada's future pipeline needs and the timing of those needs.[3]

Fifteen years later, the 1987 safeguards have been rendered almost irrelevant to a deregulated gas export highway on which 80 percent of gas exports speed south with few questions asked, and no opportunity for public comment or review.

Canadians have been told that the public interest safeguard now is the market, and specifically the "market-based procedures" of the NEB. Any other consideration or policy that would interfere in this free market is to be discouraged.

However the surplus test that must be applied by the NEB before export licenses can be issued is fundamentally a regulatory standard, not a market-based standard. It explicitly acknowledges that the market is not sufficient to ensure the protection of Canadian interests. The market-based procedure adopted by the NEB in 1987 must not be confused with the continuing mandate of the Board as set out in Section 118 of its governing Act. The surplus to Canadian needs test is fundamentally a public interest safeguard to prevent the machinations of the market from overwhelming the right of Canadian consumers to access their own natural resources on reasonable terms.

The NAFTA backdrop

The spectre looming over these remarkable 1987 NEB proceedings is the North American Free Trade Agreement, although this is scarcely mentioned by New Brunswick. The Canadian Association of Petroleum Producers refer to free trade often, and argue that NAFTA is the backdrop by which the Scotian offshore energy project must be understood. The petroleum producers vigorously oppose any suggestion of protecting natural gas for Canadian needs, and argue "the starting point is respect for the market-based policy and Canada's treaty obligations."[4]

Their references to NAFTA are pointedly reinforced by free trade negotiator Simon Reisman, who recently emerged to make media statements about the New Brunswick application. According to Reisman:

> If New Brunswick acted in that way, Canada would be vulnerable to a trade complaint and that under the rules that complaint would very likely be upheld. Personally I think it is a dumb policy…such shenanigans are more befitting of less experienced…and poorer trading nations.
> Usually this type of thing sounds sort of reasonable, that you should look after your own. But as a rule you can almost always find that it is contrary to international trading rules. [5]

These arguments seem timed to pressure the National Energy Board to reject New Brunswick's application for fear of provoking an international trade complaint. In fact, New Brunswick's proposed remedy for the refusal of gas producers and pipeline companies to supply gas to Canadian markets is procedural in character and does not go so far as to offend NAFTA rules. New Brunswick asks that ex parte orders be ended, and that all export orders be made public with a "complaint procedure" to allow Canadians to come forward and claim that Canadian needs are being denied by the export order.

However the NEB hardly needs Mr. Reisman to remind it of Canada's obligations under NAFTA because these have been explicitly written into the NEB Act which obliges the Board to "give effect to NAFTA…"

NAFTA's rules could not be more explicit when it comes to energy exports and preclude the imposition of export taxes in any situation, and the imposition of quantitative export controls except in extraordinary circumstances, and then only when established in conjunction with domestic rationing. Even then, export markets are entitled to a perpetual share of Canadian energy resources—no matter how severe the impact of supply shortfalls in Canada.

This has been described as NAFTA's proportional access regime codified by Article 605 of the trade deal which provides that regulators may not:

> ... reduce the proportion of the total export shipments of the specific energy or basic petrochemical good made available to that other Party relative to the total supply of that good of the Party maintaining the restriction as compared to the proportion prevailing in the most recent 36 month period for which data are available prior to the imposition of the measure, or in such other representative period on which the Parties may agree; [or]
>
> … require the disruption of normal channels of supply to that other Party or normal proportions among specific energy or basic petrochemical goods supplied to that other Party, such as, for example, between crude oil and refined products and among different categories of crude oil and of refined products.

In other words, Canada's NAFTA obligations regarding the export of energy and petrochemicals involve maintaining proportional export flows until resources are finally and completed exhausted and doing so in a manner that does not disrupt normal channels of supply. These extraordinary rules have yet to be interpreted by an international dispute body convened under NAFTA, and it is uncertain how these obligations will be viewed. For example, for the purposes of maintaining export flows in relative proportion to domestic supply, would the frame of reference be provincial, regional or national? How will disruption of supply be interpreted? Perhaps the most important point is that, under NAFTA, it will be an international trade or investment tribunal that will ultimately make these determinations, not the NEB, Canadian courts or parliament.

The kernel of the matter before the NEB is New Brunswick's contention that no short-term orders should be granted unless they are found to be surplus to reasonable, foreseeable Canadian needs. Until now, the Board's approval procedures have simply ignored the issue of how such exports may impact Canadians needs.

Underlying New Brunswick's argument is the point that there are not enough proven reserves in the Scotian offshore to support both the export plans of the companies and Canadian needs. The Province of Nova Scotia and oil companies have argued that over time additional discoveries will be made and there will eventually be enough gas for Canadian and American purchasers. However, New Brunswick's geologists and experts hold firm to the view that even if this does occur, it is unreasonable to expect any new supply of gas to be available until at least the end of the present decade.[6] The crunch is here, and it appears that when the choice is left to US-based production and pipeline companies, the higher liquidity US markets are favoured over the needs of Canadians.

Canadian needs

What are "reasonable foreseeable Canadian needs?" It has been a long time since our National Energy Board or, for that matter, our fed-

eral government has given any serious consideration to this question.

Nova Scotia Premier John Hamm wrote an opinion editorial in the Globe and Mail (July 19, 2002) evoking memories of the National Energy Program which allegedly deprived Alberta of a decade of wealth that might have been gained from exploiting world energy markets. After several years of Scotian gas flowing to US markets, Nova Scotia has not used natural gas to enhance their industrial base, nor is there a natural gas distribution system in Nova Scotia.

New Brunswick, on the other hand, makes a strong case for needing natural gas for economic development. And, although the province has not argued the environmental case, the Conservation Council of New Brunswick makes a persuasive case for substituting natural gas for petroleum in New Brunswick's electrical generation utilities, if the province's obligations to reduce greenhouse gas emissions are to be met.

The evidence of Max Michaud, Atlantic Vice President of the Communications, Energy and Paperworkers Union of Canada, which intervened in the NEB hearings, succinctly puts these issues in focus by using the forest industry as an example:

> Many of the industrial facilities our members work in consume large amounts of energy. For example in a typical pulp and paper mill such as those at Fraser-Nexfor in the Edmundston region, energy costs represent as much as 12% to 15% of the cost of production and may equal or exceed labour costs. Obviously the cost of energy can represent the difference between a profitable operation and one that loses money. When energy costs increase, the pressure on wages and employment are often immediate in today's competitive environment. Capital spending also suffers, with consequent impacts on the competitiveness of the plant. In commodity-based industries where prices are set in world markets, employment stability relies heavily on the cost of fixed inputs such as energy.
>
> Natural gas can be a competitive advantage for an industrial producer such as a pulp and paper mill. However, this advantage depends on a competitive price. Canadian industry has historically benefited from this country's natural advantages for energy costs. An enhanced supply of natural gas for Canadian use can lower and / or stabilize energy costs for Canadian producers, provided that Canada's natural advantages are not negated by continental market forces.
>
> Natural gas availability is important to the future viability of the pulp and paper industry in the context of Canada's Kyoto commitments. A recent study by T.C. Browne, D.W. Frances and M.T. Towers in *Pulp and Paper Canada*, February 2001, estimates that Canadian pulp and paper producers will be required to reduce greenhouse gas emissions by 11.9% by 2010. To accomplish this goal will require a 40% increase in natural gas consumption by the industry and a 47% reduction in the use of refined petroleum. The introduction of emissions trading may well impose significant economic penalties on industries or companies that fail to meet these Kyoto goals.[7]

A strategic moment for Canada

The National Energy Board's re-visitation of the deregulated, continentalist natural gas export business in Canada is a strategic moment for

Canada. The New Brunswick application has shown that there are regions of our country that are not and will not be served by a continental energy market. These regions are simply excluded, to their economic and environmental detriment. New Brunswick is arguably the first natural gas 'have-not' market to speak up, but as the supply crunch emerges in Western Canada, there will be others.

It remains to be seen whether a NEB decision to limit exports would be challenged under NAFTA. This is probably an outcome that neither Canada nor the US would welcome because of the clear message that it will send to Canadians about our sovereignty under free trade.

If anything, the proportional sharing rules of NAFTA present the best argument for the NEB to be especially prudent in forecasting Canadian needs. Increased exports of our natural gas to the US, whether by license or short-term order, only increases our proportionality commitments. If the next tranche of Scotian offshore gas is approved for export, the relative proportion of exports to domestic consumption will grow from 75 to 90 percent. The sooner we stem the tide, the greater the degree of energy security Canadian consumers will still enjoy.

The other lever the NEB enjoys arises from its power to approve new pipelines. It might therefore decline approval for new pipeline capacity south, and encourage the completion of the east-west pipeline grid from BC to Nova Scotia. Perhaps before the NEB renders a decision on the present proceedings, another pipeline issue will emerge that will profoundly affect the practical result. Maritime & Northeastern Pipelines has applied to the NEB to put compressor stations on the existing pipeline to the US that would significantly increase the export capacity of the pipeline. If approval is given for new investment to increase exports to the US, it is difficult to imagine how gas would be available for a lateral expansion to Edmundston and Quebec City. This issue will be the next chapter of the New Brunswick story with NEB hearings to commence in mid September.

Most of all, the New Brunswick application puts in sharp relief the failure of market ideology to serve Canadians. In spite of almost two decades of relentless attacks on the very concept of a public interest, the public interest and the idea of a reasonable Canadian need remains at the core of our legislative framework.

For these reasons, an NEB decision in favour of New Brunswick may take Canada a decisive step back from the continental, free trade abyss. Perhaps, this will provide another chance to rethink our national interest.

Endnotes

1. Hugh Warren Johnson, written evidence, Appendix 5, NEB Application MH2-2002
2. National Energy Board. Review of Natural Gas Surplus Determination Procedures, GHR-1-87. July 1987.
3. IBID.
4. Canadian Association of Petroleum Producers, written evidence, paragraph 59, NEB Application MH2-2002.
5. Richard Roik, July 15, 2002. "NB plan contrary to trade rules." *New Brunswick Telegraph Journal*.
6. J.A. Wright and I.M. Atkinson. July 16, 2002. NEB Hearing Transcripts MH2-2002. Wright:: "The difficulty, I think, is that to our knowledge there are no other even discoveries of the Deep Panuke style currently known today…So the fact – the answer to your question, I think, the short answer is that there are no discoveries that we are aware of today…That means, with our timeline, that we are getting very close to the end of the decade before they could provide incremental gas."
7. Max Michaud, Communications, Energy and Paperworkers Union of Canada, Written Evidence to NEB Hearing MH2-2002.