Canadian Oil and Gas Policy: from the N.E.P to the Canada-U.S. Free Trade Agreement

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Carney also developed and implemented some policies without industry input. One of the most important initiatives was a settlement of the ongoing dispute between the federal government and Newfoundland over ownership of offshore resources. The dispute had ended up in the Supreme Court, which ruled in favour of the federal government. While still in Opposition, the Tories announced that if elected, they would ratify the agreement and grant control of the resources to Newfoundland, contravening the Supreme Court decision.[i] The provincial jurisdiction recommendation became a significant part of Conservative energy policy once the Tories assumed power and in February 1985, Carney kept her word to Newfoundland and ratified the Atlantic Accord, with its basic principles the same as those outlined in the early June 1984 agreement-in-principle.[ii] After reaching agreement with Newfoundland, Carney turned her attention westward.

The next significant oil and gas policy development was the Western Accord, signed on 28 March 1985 between the Conservative government in Ottawa and the governments of the producing provinces. As far as Canadian oil markets were concerned, the Western Accord accomplished two main objectives: the deregulation of domestic oil prices and the lifting of controls on short-term oil exports.[iii] The Western Accord reflected in one form or another the directives presented in the study groups' recommendations. Moreover, the agreement's basic premise derived from the early discussions that took place while the Conservatives were in Opposition. Significantly, the Western Accord purported to resolve controversies over issues of pricing and revenue sharing that had existed since the mid-1970s and which had crystallized in 1980.

The Western Accord phased out the Petroleum Gas Revenue Tax (PGRT),[iv] removed all other oil and gas taxes, and eliminated the PIP Grant program and replaced it with tax-based exploration incentives. Furthermore, like most other industries, instead of taxing gross revenue, taxes now came from profits. The Western Accord's deregulation of pricing aimed to stimulate investment and job creation in the energy sector, marking the first time in more than two decades that the price of domestic crude oil was determined in direct relation to international markets.[v] Although Ottawa maintained certain tax incentives and export licensing through the National Energy Board (NEB), the remarkable federal withdrawal from virtually all areas of the oil and gas industry bears out the assertion by some observers that the Western Accord marked the end of an era in Canadian energy policy. Re-vamped frontier energy policy was also a function of the points outlined in Prince Albert. The key takeaway was the removal of discrimination against foreign investment and the abolition of the 25 percent back-in provision.[vi]

A brief discussion of natural gas policy during this period is important. On 31 October 1985, the federal government and the western provinces signed the Agreement on Natural Gas Markets and Prices. Although negotiations were difficult, this aspect of energy policy marked a shift in federal-provincial relations. For several years, discord characterized the federal Liberal government's relationship with the western provinces regarding natural gas markets and pricing.

The new Conservative designed agreement accomplished several goals. Most importantly, and paralleling the tenor of Conservative policy, the agreement created a more flexible and market-oriented pricing regime for the domestic pricing of natural gas. Additionally, buyers and sellers freely negotiated the interprovincial trade of natural gas.[vii] Ontario leaders were not pleased, because of large consumer and industrial natural gas users, who preferred a mechanism to provide for lower prices. However, Ottawa and Alberta kept Ontario well apprised of developments. According to Nemeth, "it was Alberta's understanding that Ontario would accept crude oil deregulation if it could be assured that natural gas would not be sold to Americans at a cheaper rate than that paid by Canadians."[viii] The Agreement clearly provided for market forces to prevail while meeting Ontario's concerns.

Carney accomplished what she had set out to do. She had faith in market forces and her own business background provided an understanding of what was required, from both a political and a policy perspective in order to satisfy industry and the provinces. As she noted, "They were carefully designed policies. I did my homework. I knew what I was going to do, I went out and talked to everybody. I had task forces. I figured it out in my own mind and I'd got through caucus what we were going to do."[ix] Was the end of the NEP a result of Conservative ideology or industry influence? Carney's basic premise was the belief that natural resources belonged to the provinces. Coupled with the Conservative ideology of the prevalence of market forces and less government, a recipe for efficiency and profitability emerged. Conservative ideology mirrored the industry view.

Historian Denis Stairs argues that the demise of the National Energy Program preceded the Mulroney government and that the dismantling of the NEP had actually begun before the Conservatives came into office with, "the process having been manifested in a series of small steps that, for political and economic reasons alike, had been forced on their Liberal predecessors almost from the beginning. The Conservatives simply administered a merciful, but enthusiastic coup de grace."[x] Nemeth disagrees: "the dismantling of the NEP was in fact not well advanced by the time the Conservatives took office…[S]uggesting that the Conservatives merely administered changes that were already in motion overlooks the actual sequence of events, particularly in light of the extensive work done by the Conservatives while in opposition to develop a coherent vision and comprehensive policy that was implemented almost in total when they assumed office."[xi] The latter argument is more persuasive. The NEP was the epitome of the bureaucratic creation and implementation of policy. Moreover, the complexity and confusion associated with the overt and multiple levels of taxation made efficiency in the industry-government interface impossible. The Mulroney Conservatives set out to decentralize government, encourage positive federal-provincial relations, and develop an energy policy outside the federal bureaucracy. As Opposition critic of the Department of Energy, Mines and Natural Resources and later as minister of the portfolio, Carney's influence cannot be underestimated.

The Canada-U.S. Free Trade Agreement

For the Mulroney government, all global relations were important, but Canada's relationship with the United States towered above all the others. Mulroney focused single-mindedly on the deterioration of Canadian-American relations in the early 1980s and insisted from the very beginning that, "one of his leading principles in foreign affairs was to repair the damage to the Canada-U.S. relationship that had been wrought by his Liberal predecessor."[xii] A number of serious policy disputes between the Liberal government and the Reagan administration had resulted in this deterioration and had progressively soured Canadian-American relations.[xiii] In fact, by 1982, as the pressures of the recession continued to rise, the traditionally cautious and suspicious business community was convinced of the need for a change in direction in Canada's commercial relations with the United States.[xiv] Escalating apprehension about a nationalistic lurch in Canadian energy and investment policies had further eroded confidence within the business community.

One of the reasons for alignment of interests between Canada's Conservatives and the U.S. Republicans was a parallel subscription to neo-conservative ideas about the economy that dominated the 1980s. Accordingly, "market forces, not governments, should direct the economy; less government control would allow business to operate more efficiently and profitably; and trade liberalization and deregulation were the most appropriate responses to a rising tide of protectionism."[xv] Mulroney's game plan was relatively simple. He introduced a new era of civility in both the substance and the tenor of the Canadian-American relationship.[xvi] However, as can be shown, Mulroney did not at once embrace free trade.

The free trade issue was so broad, far-reaching, and complicated that introspection and hesitancy were inevitable and understandable. Moreover, Mulroney began to see the possibilities only after the MacDonald Commission[xvii] called for Canadians to 'take a leap of faith.' The MacDonald Commission's recommendations affected trade policy directly by giving greater legitimacy and momentum to the debate surrounding free trade with the United States. In 1985, David Pollock and Grant Manuge published an article entitled "The Mulroney Doctrine."[xviii] They contended that the seeds of the Mulroney Doctrine were two economic policies: closer Canada-U.S. economic ties, and greater reliance on foreign investment and the private sector in general.[xix] By this time, several agencies advocated the benefits of free trade, including the Economic Council of Canada, the Senate Committee on Foreign affairs, in addition to the Macdonald Commission. However, according to former cabinet minister John Crosbie, the Mulroney cabinet was not sure:

> when Mulroney came to embrace free trade; but his support for the concept was revealed at his so called Shamrock Summit…We'd been in office for six months by then, and there had been no discussion in cabinet or in the Conservative caucus about pursuing a free-trade deal with the Americans. As far as any of us knew, Mulroney was still opposed to free trade, as he was during the 1983 Tory leadership campaign. But the [Macdonald commission] embraced the notion of free trade, and I think helped to change Mulroney's thinking.[xx]

As noted, the free trade issue was very broad and consequently the negotiation of the agreement was protracted. "And just as Mulroney's conversion was by no means assured, neither was the actual negotiation of the agreement: as the accounts of the negotiation all make clear, it was a close run thing."[xxi] Nevertheless, in May 1986 Canada and the U.S. began negotiating a bilateral free trade arrangement and the two governments committed to allowing the marketplace to allocate resources with a minimum of government intervention. There was no doubting the importance of U.S. trade for Canada. In 1960, the percentage of Canadian exports to the U.S. was 55.8 percent. By 1984, it had increased to 75.6 percent.[xxii] Late in 1987, the two sides reached a consensus and the agreement was signed on 1 January 1988. From that point forward, the Canada-U.S. Free Trade Agreement was at the forefront of Canadian economic discussion and became the major issue in the autumn 1988 federal election. When the Mulroney Conservatives won the election and preserved their mandate for at least four more years, they ratified the FTA into law on 2 January 1989.

The Canada-U.S. energy relationship is one of mutual interdependence due in large part to the geographic distribution of oil and gas reserves and challenges of efficient supply and demand distribution. However, a bilateral agreement that deregulated energy policy had never gained widespread acceptance politically. In the past, periods of recession had triggered protectionist actions in the United States.[xxiii] In this instance, however, the Mulroney government "sought to guarantee the access of oil and gas to the American market through the binding mechanism of the FTA, which would prevent future discriminatory import/export regulations being imposed on Canadian energy products."[xxiv] To underpin the FTA, both countries were committed to deregulation, liberalization of trade, and market forces. Therefore, the FTA's energy provisions were an attempt to guarantee the long-term economic stability of oil and natural gas exports to the large American market.

Continental energy policy (as it pertained to the FTA), was the joint planning of energy production and shipment without regard to borders. There was also the underlying implication that free trade in energy made the creation of a policy instrument like the NEP next to impossible without renegotiating or terminating the free trade agreement. The FTA was a profound alteration of traditional Canadian trade policy which ensured that discriminatory taxes and regulations could not be implemented by future governments.[xxv] One of the FTA's major energy provisions is pricing and "Neither country can export its energy products for a greater price than what it sells for domestically."[xxvi] Additionally, Article 908 reaffirms both nations' obligations and commitments to the International Energy Agency (IEA) whereby members are obligated to share their resources in times of crisis.[xxvii]

The oil crises of the 1970s led to the founding of the IEA in 1974. Both Canada and the U.S. are founding members of the IEA and are obligated "to impose upon themselves several symbolic and some important material constraints on their behavior and at least rhetorically to commit themselves to coordinated and multilateral energy management strategy."[xxviii] The IEA's mandate is to inspire its member countries to plan for emergencies and it has two main provisions. First, in an emergency, one IEA member cannot cut off supplies to another member country. Second, an IEA member can only reduce exports by the level of demand restraints it has placed on itself. This IEA provision reflects the "proportionality clause"[xxix] of the FTA. Nemeth surmises that the proportionality clause was a reaffirmation of IEA principles as well as providing limitations on regulatory actions of either country. Most importantly, secure, guaranteed access to the large American market, even if it entailed the remote possibility that Canada's independence would be constrained in a time of crisis, was a necessary condition of the FTA and reaffirmed Canada's commitment to the IEA.

Much like the unwinding of the NEP, the oil and gas industry and the producing provinces participated in the policy-making process that led to the FTA.[xxx] Moreover, the western provinces were motivated by the advent of ensured markets for crude oil and natural gas and the FTA "essentially guaranteed that market pricing and access would prevail for both countries."[xxxi] During the run-up to the Agreement in 1987, an energy fact-finding group had considered the special problems in energy trade. The group concluded that Canada was prepared to enter into a broad agreement guaranteeing access to supply in return for secure access to the U.S. market.[xxxii] Well known Canadian academic and former member of the Department of External Affairs, Michael Hart, observed about the FTA's energy provisions:

> Canada had long sought secure access for its energy products (oil, gas, uranium, and electricity) to the United States. The United States had long sought assurances that Canada would be a reliable supplier and not cut supplies arbitrarily. The agreement

> enshrined commitments that met both of those objectives. That was a victory for free trade and a defeat for nationalism and xenophobia. There is however, no obligation on either party to buy or sell any energy commodity. The agreement requires no more than the commitment that when an energy commodity is traded, neither government can arbitrarily cut off either country's access to its market or the supply of available energy; in times of short supply, the producing country agrees to make a proportion of its supply available for export at prevailing prices on the basis of the historical level of exports."[xxxiii]

Former Alberta premier Peter Lougheed echoed Hart's view: "Basically, the situation is that we now export one-third of our natural gas and one-third of our crude oil to the United States. Sustaining and expanding that market are essential to new investment."[xxxiv] Apparent was that Canadians had learned that a country that derives an increasing share of its wealth from international commerce had much to gain from such an agreement. They had bought into the Mulroney government's overarching theme, present since 1984, that the energy industry could provide an engine of growth for the rejuvenation of the economy with increased activity creating employment, the removal of regulation increasing efficiency, and exports free from American protectionism. Constructive dialogue between the federal and provincial governments and the oil and gas industry changed the way oil and gas policy implementation occurred during the latter half of the 1980s.

Not all commentators on the FTA agreed that this was the best policy for Canadian trade. Noted political economist James Laxer contended at the time that, "It is my submission that the free traders are essentially asking Canadians to adopt the American model as the best way to run their national economy, while the anti-free traders reject significant features of the American model."[xxxv] Laxer contended that the American model was failing as the millennium approached and that other alternatives for Canada were potentially better. Laxer cited the enormous U.S. trade deficit, the asymmetrical Canada-U.S. relationship (in which the U.S. is a much a larger entity and can therefore dictate the rules of engagement), and the large Canadian trade surplus. Clear also was the relative importance to the two governments. For Canada, the FTA was extremely important and any failure was potentially catastrophic. For the U.S., if the Agreement failed it would form no more than a footnote in the annals of American trade history. According to Laxer, two goals made sense for Canada---stifling the effects of U.S. protectionism and the surety of the large American market for Canadian exports. However, Laxer hangs his argument on the merits of the so-called mixed economy and states that "The clear winner as the most successful economic model in the post-war decades is the mixed economy, combining private enterprise and competition with long term planning, government intervention and business, labour, state coordination."[xxxvi] Many of the leftist critics of the FTA share this view. Their value systems include a preference for more governmental planning and less private enterprise, more national self-sufficiency and less international economic interdependence.[xxxvii] Arguably, the U.S. economic model today appears in decline, along with many other global economic models. However, the growth of the western economies from the implementation of the FTA in 1989 up to 2006-2007 was massive. Globalization predominates as other countries and trading zones continue to look to freer trading relationships and lowered barriers to international commerce.

Conclusion

Canadians enjoy one of the highest standards of living in the world, living in the second largest country in the world, and being less than half of one percent of the world's population. Moreover, since Confederation in 1867, the country has relied heavily on the export of natural resources. In fact, by the end of the second millennium, the value of Canadian exports and imports of goods and services reached nearly 90 percent of the value of Canada's gross domestic product.[xxxviii] Therefore, the importance of trading arrangements cannot be over-emphasized. Unfortunately, the framework of trade and economic policies are forged by bureaucratic practitioners who take their lead from the priorities and values set by cabinet ministers.[xxxix] Although this route to policy development reflects the practical from a political perspective, it is not necessarily policy development that works. As Hart points out, when trying to plot the best course for the future, the past cannot be overlooked: "Trade policy, trade relations and trade negotiations, are thus less about grand ideas and ideologies and more about the pragmatic working out of very specific problems, within the contours of existing political and economic realities, informed by the decisions and experiences of the past."[xl] Balance is therefore the key, as the myriad of important items that lie between foreign and domestic priorities can potentially overwhelm the process. In sum, it is individuals who create trading relationships based on opportunity, desire, consultation and market conditions, rather than politicians' rhetoric that suggests that countries---not individuals---trade with one another.

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[i] The achievement of an agreement with Newfoundland can be attributed to Carney and her own fundamental belief that the resources belong to the provinces. Nemeth was able to conduct personal interviews with Carney where she was able to ascertain the interpersonal relationship Carney established with William Marshall, the energy minister of Newfoundland who was dumbfounded that the Conservatives were prepared to treat the offshore the same as land-based oil and gas resources. See Nemeth, "Pat Carney and the Dismantling of the National Energy Program," 99.

[ii] EMR, *The Atlantic Accord: Memorandum of Agreement between the Government of Canada and the government of Newfoundland and Labrador on offshore oil and gas resource management and resource sharing* (Ottawa: Supply and Services Canada, 1985), 2-11.

[iii] Ramzi Issa, Robert LaFrance, and John Murray, "The Turning Black Tide: Energy Prices and the Canadian Dollar," *Bank of Canada* (Ottawa: Working Paper 2006-29), 3.

[iv]The PGRT was a petroleum and gas revenue tax of 8 per cent applied to net operating revenues before royalty and other expense deductions on all production of oil and natural gas in Canada.

[v] Patrick James, "Energy Politics in Canada, 1980-1981: Threat Power in a Sequential Game," *Canadian Journal of Political Science* 26, No. 1 (March 1993): 56.

[vi] The provision known as the 'back-in' required firms to give the federal government a 25 percent interest in every discovery made on the Canada Lands. This provision really riled the MNCs as they were the most active companies in the north and offshore.

[vii] EMR, *Agreement on Natural Gas Markets and Prices* (Ottawa: Supply and Services Canada, 1985), 1-5.

[viii] Public Archives of Alberta (PAA), ENR, ACC. 93.337, Memorandum from Luigi Di Marzo to N.E. MacMurchy, 9 October 1984, "Position of Consuming Provinces Re a New Energy Policy"

[ix] Vancouver Sun, 16 November 1985.

[x] Denis Stairs, "The Conservative Era in Canadian Foreign Policy, 1984-1993," *Diplomatic Departures: The Conservative Era in Canadian Foreign Policy1984-1993,* ed. Nelson Michaud and Kim Richard Nossal (Vancouver: UBC Press, 2001), 31.

[xi] Nemeth, "Continental Drift,"62.

[xii] Stairs, 29-30.

[xiii] Nelson Michaud and Kim Richard Nossal, "The Conservative Era in Canadian Foreign Policy, 1984-1993," *Diplomatic Departures: The Conservative Era in Canadian Foreign Policy1984-1993,* ed. Nelson Michaud and Kim Richard Nossal (Vancouver: UBC Press, 2001), 6.

[xiv] Michael Hart, *Decision at Midnight,"* 15.

[xv] Nemeth, "Continental Drift," 64.

[xvi] Michaud and Nossal, 8.

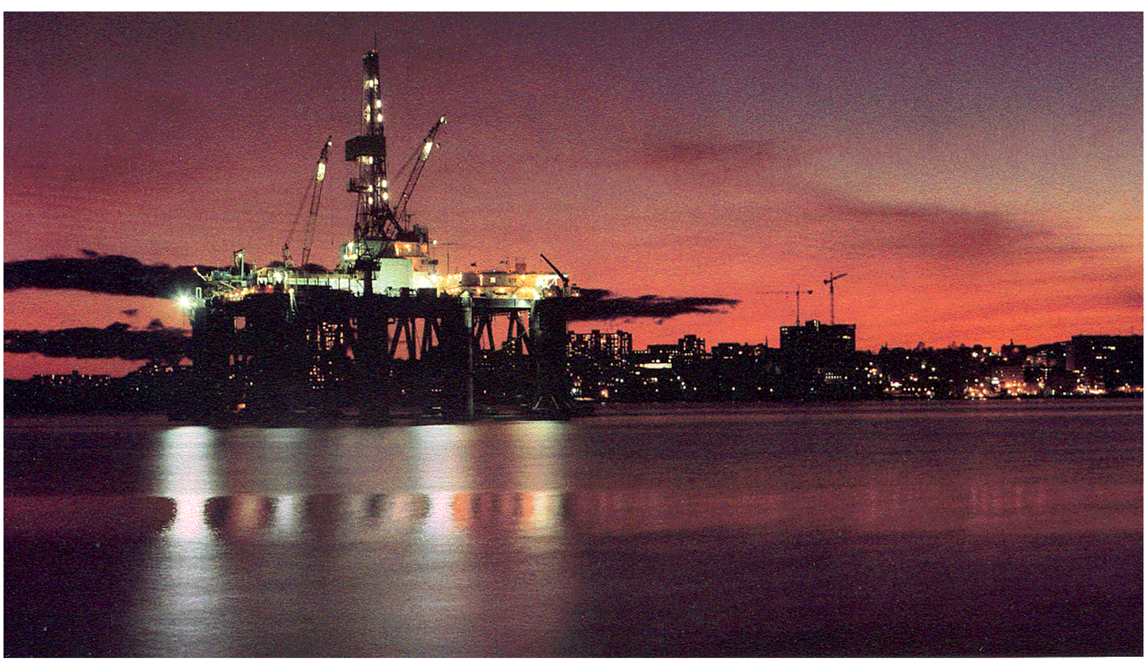
[xvii] Established at the end of the Trudeau period, the *Royal Commission on the Economic Union and Development Prospects for Canada* was chaired by Donald S. Macdonald and known as the Macdonald Commission. It was an historic landmark in Canadian economic policy. Prime Minister Trudeau appointed the commission in 1982 and it presented its recommendations to Prime Minister Mulroney in 1985. The commission's recommendations reflect three broad themes. First, the report suggested that Canada should foster a more flexible economy, capable of adjusting to international and technological changes. Toward this end, the commission recommended greater reliance on market mechanisms and pursue a free trade agreement with the United States. Second, the commission recommended various reforms to the welfare state model, emphasizing social equity and economic efficiency. Third, the commission recommended the adoption of an elected Senate in order to better represent Canada's diverse regions.

[xviii] David Pollock and Grant Manuge, "The Mulroney Doctrine," *International Perspectives* (January/February, 1985).
[xix] Stairs, 29. See also Pollock and Manuge, 5.
[xx] John C. Crosbie with Geoffrey Stevens, *No Holds Barred: My Life in Politics* (Toronto: McClelland and Stewart, 1997), 307-8.
[xxi] Michaud and Nossal, 12.
[xxii] Richard D. Lipsey and Murray G. Smith, *Taking the initiative: Canada's Trade Options in a Turbulent World* (Toronto: C.D. Howe Institute, 1985), 47.
[xxiii] The Nixon administration, not yet faced with oil supply problems, decided to cut the flow of Canadian crude to the U.S. market to bring the Canadian government speedily to terms. In March 1970, the U.S. imposed a quota on Canadian crude imports, cutting them back to 395,000 barrels a day.
[xxiv] Nemeth, "Continental Drift,"64.
[xxv] Nemeth, "Continental Drift,"63.
[xxvi] Nemeth, "Continental Drift,"62. One exception to this is a crisis of national security. According to Article 907, national security must refer to armed military conflict rather than the desire for domestic producers to reduce the access of competitively priced imports.
[xxvii] In 2005, the ravages of Hurricane Katrina forced much of the oil production coming from the Gulf of Mexico to be curtailed. The provincial government of Alberta allowed oil producers to increase production from prolific wells (which have limitations on their allowable daily rates) in order to increase exports in this time of need.
[xxviii] Glen Toner and Greg Legare, "Canadian energy Security: The State of Canada's Emergency Preparedness System," *Canadian Public Administration* 33 (Spring 1989):69.
[xxix] If either government imposes supply restrictions, proportionality provisions (provisions for maintaining the share of exports in total supply) come into play. Their intent is to ensure a degree of access on commercial terms by consumers in one country if the other imposes restrictions. If one party restricts supplies for reasons of conservation, supply shortages, or price stabilization, it must ensure that consumers in the other countries as a group are not denied access, on commercial terms, to a proportion of the total available supply. The proportion is a historical share based on the average of the 36-month period immediately prior to the imposition of the export restriction. This proportionality provision does not constitute a supply *obligation*. The government imposing a restriction is not required to export a specific quantity. It is obliged only not to deny commercial access by importers to levels less than the past 36-month average share. The importer is not guaranteed a set volume. Restrictions are neither to disrupt normal channels of supply nor to impose higher prices on exports via licence fees, taxation, or minimum prices. Until a request is made to invoke the proportionality clause, its significance remains hazy.   But it binds Canada and the United States to allocations dictated by market-clearing

prices, even when supply is restricted. The proportionality provision refers to *government* actions to restrict exports. There is nothing to stop *markets* constraining exports. Canadians could outbid Americans even for the proportional share of supply. National security is a possible justification for import or export restrictions, but the grounds for action to be taken are tightly specified. They relate to emergencies in international relations, a party's essential security interests, or actions required under the U.N. charter. The U.S.-Canada arrangements on supply restrictions can be viewed as reciprocal tradeoffs. Canada granted proportionality to assuage U.S. concerns arising from Canada's export restrictions in the regulated era of 1970-to-1985. The United States granted a narrow interpretation of national security to meet Canadian concerns about any revival of U.S. import constraints imposed under the guise of national security in the 1950s and 1960s. See: Paul G. Bradley and G. Campbell Watkins, *Canada and the U.S.: A Seamless Energy Border?* http://www.cdhowe.org/pdf/commentary_178.pdf. Accessed November 13, 2011.

[xxx] Nemeth, Continental Drift," 66.
[xxxi] Nemeth, "Continental Drift," 65.
[xxxii] Hart, *Decision at Midnight*, 307.
[xxxiii] Hart, *Decision at Midnight*, 378.
[xxxiv] Peter Lougheed, 152.
[xxxv] James Laxer, "Free Trade and Canada's Choice of an Economic Model," *The Future on the Table: Canada and the Free Trade Issue,* ed. Michael A. Henderson (North York: Masterpress, 1987), 55.
[xxxvi] Laxer, 75.
[xxxvii] Michael Hart, *Decision at Midnight,"* 413-14.
[xxxviii] Michael Hart, *A Trading Nation: Canadian Trade Policy from Colonialism to Globalization* (Vancouver: UBC Press, 2002), 4
[xxxix] Michael Hart, A *Trading Nation,* ix.
[xl] Michael Hart, *A Trading Nation,* 5-6.

Contender: Production testing Terra Nova, a find by Petro-Canada, which has vowed to make it the next production development on the Grand Banks. (Petro-Canada)



Semisubmersible drilling rig in the harbour of Halifax, Nova Scotia in the 1980's