REGULATORY AND POLICY DEVELOPMENTS

NEB AFFIRMS FAITH IN FREE MARKET IN FACE OF STORM OF CONTROVERSY

By: N.J. Schultz
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The storm created by the NEB's November, 1989, decision to deny four of seven applications for the export of natural gas to the U.S. Northeast was not quelled by the pre-Christmas release of the Reasons for the Decision. The Reasons confirm that the NEB's approach to the economic assessment of natural gas exports was a major factor in denying the exports. The controversy has led the NEB to abandon its approach – a conversion which has been coupled with a reaffirmation of free market principles.

Those denied export licences sought leave to appeal to the Federal Court of Appeal on the grounds, among other things, that the economic test imposed by the NEB through social benefit-cost analysis (BCA) constitutes a minimum export price contrary to the *Free Trade Agreement* (*FTA*).

The NEB's Reasons for denying the exports of Direct Energy to a co-generation project in Vermont, Western Gas Marketing Limited as agent for TransCanada PipeLines Limited to Niagara Mohawk Power Corporation, Indeck Gas Supply Corporation to two co-generation plants, and Shell Canada to a co-generation project indicate that the approach to BCA was closely related to an assessment of the price flexibility in the gas export contracts. The NEB carefully scrutinized each of the gas export contracts to see how the price of gas was determined and whether, over the life of the project, the export price would be able to adjust to changing conditions in the market price of gas. A finding by the NEB that an export would not likely yield a net benefit to Canada, as measured in accordance with BCA, typically went hand-in-hand with an expression of concern that the export contract would not respond to changing market conditions. The exception was the Western Gas Marketing Ltd. (WGML) sale to Niagara Mohawk where the contract did contain provision for price renegotiation. However, the NEB's perception was that WGML would be able to secure that market at prices less than those of competitors. The NEB was not prepared, in that circumstance, to give weight to the contract flexibility.

The NEB, for the purposes of BCA, calculated incremental production costs on the basis of an industry-wide projection of production costs and by-product revenues in both a high-world oil price scenario and a low-world oil price scenario. A number of sensitivities were run to show the effect of changes in key variables. The NEB did not consider an individual export licence applicant's specific production costs to be relevant unless the production of that applicant's gas were to change the NEB's view of either the industry's progression up the industry supply cost curve or of the industry supply cost curve itself. It is this use of an industry supply cost curve which has been pointed to as creating an effective minimum export price contrary to the *FTA*.

The purpose of BCA is to assess the social costs imposed by an export as distinct from the private costs incurred by the private parties to the export. Given the use by the NEB of its own macro-economic analysis of supply and demand, the issue on BCA was whether a project yielded export revenues which, on a net present value basis, equaled or exceeded the average costs attributed to the project. Where a project failed to yield net benefits measured in this way, the only real option for the proponents was to come back with a higher export price. This gave rise to objections that the NEB was imposing a minimum export price contrary to the *FTA*.

The NEB created some breathing room by initiating a review of its approach to BCA. The

review has been directed to policy rather than legal and jurisdictional issues. Nevertheless, it held out some hope of change to the producing sector. The numerous submissions made to the NEB on the review have demonstrated a clear demarcation between the interests of producers and the interests of Canadian consumers. It has been left to the NEB to fashion a span between the free market inclinations of producers and the fear of consumers that unbridled exports will prejudice Canada's energy security. The challenge for the NEB was to develop an approach which builds on the market-oriented policy established by the October 31, 1985, *Agreement on Natural Gas Markets and Prices*, respects the *FTA* and gives effect to the NEB's statutory mandate to protect the reasonably foreseeable requirements of Canadians. To date, while the *FTA* has undoubtedly loomed large in the NEB's meditations, the Board has yet to expressly commit itself to an interpretation of the *FTA*. Moreover, no such express discussion has come from the present examination given the exclusion of jurisdictional questions from the scope of the review.

On March 15, 1990, the NEB confirmed its faith in the workings of a competitive free market for natural gas by abandoning its use of BCA in the review of natural gas export licence applications. The decision does not, however, signal a withdrawal from effective export licensing. The NEB will continue to examine the supply arrangements underpinning an export proposal and whether the contractual arrangments in their entirety have commercial substance and are likely to be durable over the life of the project. The NEB must also determine that the gas is surplus to reasonably foreseeable Canadian requirements.

The NEB took the view that, in the current market-oriented framework, it must be clearly established that markets are not working efficiently and that the public interest is not sufficiently protected before regulatory intervention is warranted. The NEB agreed that there is considerable legitimate debate about the size of any difference which exists between the private and public evaluation of gas production costs. There is a wide range of uncertainty about the appropriate values of the social and private discount rates, the level and shape of aggregate gas supply cost curves, and the basis upon which individual producers develop their respective views of relevant natural gas supply costs. The NEB agreed that, to the extent differences do exist between public and private evaluations of gas supply costs, royalty and land bonus mechanisms established by the governments of the producing provinces may be regarded as a means to account for at least part of the divergence, although such arrangements are not necessarily structured with this specific objective in mind. The NEB concluded that there is not sufficient evidence of a difference between public and private determinations of gas production costs to warrant regulatory intervention.

Incremental transportation costs also form a significant element of cost in a BCA. The NEB recognized that there may be real differences between the charges to a project under a particular pipeline toll methodology and the costs actually incurred in providing the incremental transportation. This is especially the case where tolls are established on a rolled-in basis where all costs are put into a common pot and allocated to all customers. The NEB determined that it would address this issue by way of an economic evaluation of pipeline facilities in the context of applications to construct and operate new pipeline facilities or as an issue of toll methodology in pipeline toll proceedings.

The NEB rejected arguments that BCA was an essential part of a determination that an export is in the public interest. The NEB noted that there were many aspects to the NEB's determination that an export was in the public interest and that BCA was only one such factor. The NEB was of the view that the other tools at its disposal were adequate to protect the Canadian public interest. Those tools include a mechanism for Canadian consumers to complain to the NEB if they are having difficulty in meeting their gas requirements. In addition, the NEB assesses the impact on Canadians before authorizing the export.

The NEB raised the issue of contract flexibility. The issue is the extent to which contracts are able to adjust to changing market conditions over the life of the contract. The NEB indicated that it

would continue to examine contracts to assure itself that the contracts have commercial substance and are likely to be durable over their term. However, the NEB recognized that there may be cases where contracts are attractive notwithstanding a lack of flexibility. The NEB has stated that it will operate on the presumption that, where contracts are freely negotiated at arm's length, they will be in the public as well as the private interest and that the NEB will intervene only in exceptional circumstances. Gas supply contracts to electric generation facilities typically have less flexibility than contracts for sales to gas distribution companies.

The exports which have been denied by the NEB will now be reviewed and a number of these projects can be expected to be approved. The appeals will likely be abandoned.

RAFFERTY ALAMEDA FALLOUT: ENERGY MINISTER DIRECTS NEB TO COMPLY WITH EARP GUIDELINES ORDER

By: N.J. Schultz
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Federal Energy Minister, Jake Epp, in a February 8, 1990, letter to the Chairman of the NEB has requested that the NEB ensure compliance with the Environmental Assessment and Review Process (EARP) Guidelines Order. The letter arises from the NEB's conditional approval of natural gas exports from the Mackenzie Delta. The Canadian Environmental Law Association had petitioned the Cabinet to refuse approval of the licences pending compliance with the EARP Guidelines Order. The Minister's letter applies to all natural gas exports which are now awaiting Cabinet approval or which may come before Cabinet in the future.

The NEB has issued information requests to the Applicants in the Mackenzie Delta case and in two other cases completed last year, the GH-8-88 and GH-1-89 proceedings, to provide information on environmental issues from the well-head to the burner tip. The information to be provided is similar to that required during the initial screening stage under the EARP Guidelines Order and includes impacts outside Canada. The NEB will conduct an environmental screening of pending gas export applications in the GH-5-89 and GH-6-89 proceedings. The Minister's letter follows decisions in the Federal Court of Appeal and Federal Court Trial Division arising from the Rafferty Alameda Dam project putting teeth in the EARP Guidelines Order.

FEDERAL COURT EXPANDS SCOPE OF ENVIRONMENTAL REVIEW

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In a March 13, 1990, judgment, the Federal Court of Appeal expanded the rationale it expounded last year in the *Rafferty-Alameda Dam* case and, in the process, put more teeth in the federal Environmental Assessment and Review Process (EARP).

The Court granted the appeal of the Friends of the Old Man River Society from a trial judgment denying the Society's application to quash an approval granted by the federal Minister of Transport to the Department of the Environment of the Province of Alberta in respect of the construction of a dam on the Oldman River pursuant to the provisions of the *Navigable Waters Protection Act* (*NWPA*). The Society had also sought an Order requiring both the federal Minister of Transport and the Minister of Fisheries and Oceans to comply with the EARP Guidelines Order. The Federal Court of Appeal held that both federal Ministers were required to comply with the EARP Guidelines Order with the result that the approval issued under the *NWPA* was quashed and orders requiring compliance with the EARP Guidelines Order were issued.

The federal Justice Department and the Province of Alberta had argued that the Guidelines Order was not applicable to the *NWPA* since the *NWPA* was a specialized statute which required

the Minister of Transport to consider issues related to navigation only and did not contemplate consideration of environmental concerns. The Federal Court, in rejecting this view, held that the Guidelines Order is a law of general application and created a duty which was additional to the exercise of the statutory power conferred on the Minister by the *NWPA*. The source of the Minister's responsibility and jurisdiction to address environmental issues in this area of federal responsibility, namely, navigable waters, springs not from the *NWPA* but from the Guidelines Order. The Minister, therefore, had a positive obligation to comply. Once it is determined that a proposal may have an environmental effect on an area of federal responsibility, the Guidelines Order is engaged in all of its detail.

The Federal Court also rejected the argument that the Guidelines Order did not apply to the Minister of Fisheries and Oceans. The argument was that there was no "initiative, undertaking or activity" before the Minister in respect of which he was the "decision-making authority". The *Fisheries Act* gave the Minister authority to act in connection with the disruption or damage to fish habitat caused by the dam but the authority was not expressed in mandatory language. Nor was any approval required under the *Fisheries Act*. In the *Old Man River* case, however, the Society had written to the Minister asking that the Minister take action under the *Fisheries Act*. The Minister responded by referring to long-standing administrative arrangements that are in place for the management of fisheries in Alberta and noted that the potential problems associated with the dam were being addressed. The Minister did not propose to intervene in the matter. The Federal Court determined that the alteration, disruption or destruction of fish habitat by the project fell within an area of federal responsibility and was thus an initiative, undertaking or activity within the meaning of the Guidelines Order. The Minister had the authority to decide either not to intervene or to exercise the authority conferred by the *Fisheries Act* and he did make a decision not to intervene. That decision was made in response to the request of the Society. As a result, the Minister was required to apply the Guidelines Order. He had failed to do so.

This aspect of the decision is interesting in that it indicates clearly that the Guidelines Order must be applied in circumstances where no licence, permit or other approval is required for a project to proceed. It is enough that an area of federal responsibility be affected by the project in circumstances where the federal government has the statutory authority to intervene if it wishes. Moreover, it is sufficient to trigger this "decision-making" authority that concerned citizens write to the responsible minister seeking the invocation of federal power. Lawyers engaged in due diligence reviews of projects must add to their list not only those statutes and regulations which contemplate permits, licences or other authorizations but must also examine statutes and regulations under which federal authority could be exercised in the discretion of federal officials.

Of equal significance is the Order of the Court that each of the Minister of Transport and the Minister of Fisheries and Oceans apply the Guidelines Order to their respective areas of authority. That is, each of the Ministers was treated as a separate "initiating department" for the purposes of the Guidelines Order and each had a separate responsibility to ensure that the Guidelines Order was applied to each proposal for which it is the decision-making authority.

The Court went further and indicated that, even if the Department of Fisheries and Oceans did not constitute a separate "initiating department" for the purposes of the Guidelines Order, the jurisdiction and responsibilities of the Minister of Fisheries and Oceans would have been engaged by reason of the application made to the Minister of Transport. Once the Guidelines Order was brought into play by virtue of that application, the Guidelines Order required that every department with responsibility in an area which may be environmentally affected by a proposal play a full part in the environmental review.

The Orders sought at the trial level were discretionary in nature and the trial judge also indicated that this was an appropriate case to exercise the discretion not to grant the Orders sought. The trial judge considered that too much time had elapsed between the time the approval under the *NWPA* had been granted and the bringing

of the application. The trial judge was also of the view that triggering the federal environmental review process would involve undesirable duplication of the extensive review which had already taken place at the provincial level. The Court of Appeal was not persuaded that the trial judge's view on the question of delay was well-founded in principle. More importantly, the Court of Appeal did not accept the trial judge's view on duplication. The Court determined that the Guidelines Order, unlike the provincial regime, "... was plainly drafted to allow for the expressing of public concern and the availability of a full opportunity for the public to participate in the environmental assessment and review process." The Court of Appeal also noted that there was nothing in the provincial laws to guarantee the independence of the environmental review panel in any discernable measure and certainly not in a measure like that provided for in the Guidelines Order.

The Court also rejected the argument of the Province of Alberta that it was immune from the exercise of the authority under the *NWPA* and was not a proper party to the Federal Court proceedings. Although the Province of Alberta is not a "federal board, commission or other tribunal" as defined in the *Federal Court Act*, the Province of Alberta was nevertheless a proper party in that it could be adversely affected by the Order of the Court and, by virtue of being a party, would be able to pursue whatever remedy may be open to it by way of appeal.

On the issue of Crown immunity, the Court was persuaded that when the provisions of the *NWPA* are read in context, it is clear that the *Act* applies to the provincial Crown. Quite apart from that, the Court also agreed that to hold that the Crown, both federal and provincial, were exempt from the approval requirements of the *Act* could result in navigable waters being rendered unsafe contrary to the true intent and spirit of the *NWPA*.

The result of the *Old Man River* decision is that multiple environmental reviews may be required, not only as between the federal and provincial governments, but also as between various departments and agencies at the federal level. In addition, the obligation to comply with the Guidelines Order may be triggered even though a department has no role as an approving agency. It is sufficient that the department could take action in connection with the matter in pursuit of its legitimate statutory authority. Finally, there must be an element of publicity and public participation in the review process to comply with the Guidelines Order.

FEDERAL COURT ADDRESSES ROLE OF POLICY DIRECTIVES AND GUIDELINES

By: N.J. Schultz
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In a March 8, 1990, judgment, the Trial Division of the Federal Court determined that policy directives and guidelines issued by the Minister of Employment and Immigration with a view to clearing up the refugee backlog improperly fettered the Minister's discretion under the *Immigration Act*. Included in the guidelines were criteria for assessing applications on humanitarian and compassionate grounds.

The applicant in the case, Ken Yung Yhap, took the position that officials of the Department refused to consider any evidence which would support compassionate and humanitarian grounds other than those related to the criteria set out in the guidelines. This perception was confirmed by the evidence of twenty-five similar cases which were before the Court.

The *Immigration Act* provides for admission of an individual where there exist "compassionate or humanitarian considerations". This exceptional power may be exercised by regulation pursuant to s.114(2). The considerations are not further specified in the *Act*. Counsel for the Minister argued that there was nothing in the policy guidelines which prevented officials from examining each case on its individual merits but the Court found on the evidence before it that officials had not been questioning applicants on humanitarian issues which fell outside the specified criteria. The Court found that the guidelines were being applied as hard and fast

rules and, as a result, the wide discretion conferred by s.114(2) of the *Immigration Act* had been improperly fettered.

The Court confirmed that, although the discretion conferred by s.114(2) is exercised by regulations made by the Governor in Council, an application for admission on compassionate or humanitarian grounds must be dealt with in an administrative way in accordance with the requirements of administrative fairness. The applicant is entitled to "a full and fair review" to determine the existence of humanitarian or compassionate considerations. This finding followed the Judgment of the Supreme Court of Canada in *Minister of Employment and Immigration* v. *Jiminez-Perez*, [1984] 2 S.C.R. 565 which varied a Federal Court of Appeal judgment in form but not in substance as it related to what is now s.114(2). Where the Federal Court of Appeal had framed its Order to refer to the Governor in Council, the Supreme Court of Canada directed its Order to the Department. Both levels of Court were in agreement that an application by an individual for admission on compassionate or humanitarian grounds triggered a duty of fair consideration. In its judgment in the *Jiminez-Perez* case, the Federal Court of Appeal, 45 N.R. 149 at 155, distinguished between those provisions of the *Immigration Act* which contemplated regulations of a general legislative nature which would themselves be applied to individual cases and a provision such as the present s.114(2) which contemplates the making of regulations to grant exceptions in individual cases. The latter must be processed in an administrative manner and in accordance with administrative fairness. By implication, the former would fall under the traditional classification of legislative function and would give rise to no duty of fairness.

This case should be of interest to all practitioners who seek relief on behalf of clients under statutes which confer wide discretion and where the form of granting relief in individual cases takes the form of a regulation. The case is also interesting in that a pattern of unfairness may be demonstrated by evidence of many similar cases where no individual case on its own might be capable of demonstrating unfairness.

CRTC PERMITS RESALE AND SHARING OF PRIVATE LINE SERVICES

By: John F. Blakney
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In a decision released on March 1, 1990, the Canadian Radio-television and Telecommunicaitons Commission (CRTC) approved, subject to a number of terms and conditions, the resale of private line services for the provision of interconnected voice services. These services will compete with long distance voice services such as message toll and WATS provided by Bell Canada and other established tele-communications carriers.

In denying CNCP Telecommunications' first application to provide long distance service in August, 1985, the CRTC also concluded that resale and sharing of network services to provide message toll service or WATS was not at that time in the public interest. Subsequently, the Commission has permitted resale and sharing of data and non-interconnected voice services, the sharing of interconnected interexchange private line voice channels, and the resale of private line channels when the individual circuits are dedicated to a particular user. In 1988, the Commission permitted resale for the provision of enhanced services.

In the 1989 Public Notice announcing the reconsideration of its original 1985 prohibition against private line resale and sharing for voice services, the Commission noted that over the last four years substantial reductions of message toll service rates and introduction of new message toll volume discount schemes had reduced the arbitrage margins available to voice service resellers and reduced incentives for uneconomic entry through the resale of private line services.

In examining whether it was now appropriate to modify its resale restrictions to permit private line resale for voice communications alone, the Commission mentioned several factors that suggest that resale would result in greater innovation and in particular more vigorous competition in service features. First, the Commission observed that there were few voice resellers and sharing groups in the domestic

market. Private line resale would likely increase the number of suppliers and would, as a result, stimulate the development of integrated voice/data and value-added services. Although private line resale would result in the provision of message toll substitutes, the Commission indicated that such lower price substitutes could stimulate overall demand. Moreover, they would be materially different from message toll service since they would provide lower value to users because of the geographical limitations of the service and the dialing of extra digits in order to access the resale service. The limited margins now available to MTS private line resellers for arbitrage purposes also suggested to the Commission that sellers would not be able to compete solely on price in the Canadian market.

Having found that it was appropriate to modify the rules, the Commission then examined the likely market impact of such modification and what conditions, if any, were appropriate to prevent uneconomic entry and unnecessary erosion of MTS contribution margins to local telephone service costs. The Commission examined in detail the impact studies filed by Bell and BC Tel and concluded for several reasons that these had over estimated the ability of resellers to compete. The carriers had assumed that resellers would serve more locations than the Commission considered to be realistic. Specifically, the Commission found that resellers in Canada will have very little incentive to serve smaller centres. The Commission rejected the price discounts assumed by the carriers and found that the average discount would be unlikely to exceed 20%. The Commission also rejected the possibility that very low long distance rates would be offered in overseas services, observing that there is very little incentive to do so as Teleglobe's current overseas rates were comparable and, in some cases, lower than those of AT&T.

With respect to the transborder market, the Commission noted some of the Canada/U.S. traffic has already been lost to resellers. This traffic loss could not, therefore, be considered in assessing the incremental impact of a change in its rules. Finally, the Commission concluded that the carriers had overestimated the probability of the customers' subscription to resellers largely because of the discount assumption used and the market coverage of resellers.

A critical aspect of the carriers' overestimate of the market impact of resale in the CRTC's opinion was that they had assumed that sale through an affiliate would be possible. The Commission's decision prohibits a carrier from reselling WATS line services through an affiliate company. An affiliate may, however, resell services of another carrier. The Commission's reasons are that the pricing of an affiliate reseller would be based on the underlying costs of facilities to its carrier affiliate rather than the price that the affiliate charges for its services. Accordingly, the affiliate could offer larger discounts than an arm's length reseller. This would result in the resale market's competitive focus being directed at price as opposed to value added competition. The Commission was also concerned that this type of pricing through affiliate reseller could foreclose dependent reseller activity. It would appear that the Commission is pinning its hopes on independent resellers offering new service innovations where features rather than price is the prime justification for permitting private line resale at this time.

The Commission did accept the proposition that resellers should provide a contribution to the costs of local service over and above that paid in the private line rate of the carrier. The Commission rationalized this contribution payment as a measure to avoid uneconomic entry. While the Commission considered that revenue per minute charges may have theoretical attractions for the moment, the contribution charge should be based upon individual channels purchased. While the Commission considered that resellers provided a lower quality of service than direct carrier substitutes such as WATS, it was not necessary to design a contribution chart which fully compensated the carriers. The Commission set a contribution surcharge of $200.00 per interexchange voice channel per month.

CRTC HEARINGS EXAMINE CABLE RATES

By: John F. Blakney
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The Canadian Radio-television and Telecommunications Commission (CRTC) recently concluded public hearings to the formula by which cable television companies establish the price for basic cable television services.

In 1986, the CRTC established, in its Cable TV Regulations, a form of price formula regulation for basic cable rates. Each year cable companies can increase the basic rate up to 80% of the average annual percentage increase in the CPI during the previous 12 months. Increases are generally implemented on September 1st. As well, basic rates may be increased to recover any new or increased costs associated with payments to a third party relating to the transmission of programming services separately approved by the CRTC or a provincial regulatory authority (for example, specialty service fees and fees paid to telephone companies for access to their facilities). Third, subject to a review mechanism, cable companies can increase their monthly rates by an amount no greater than 10% of eligible capital investments distributed over the subscriber rates for a period of 5 years (the so-called CAPEX adjustment allowing 50% pass-through capital expenditures). Finally, cable companies may apply for additional increases through a formal rate increase application subject to full CRTC scrutiny.

At the time these provisions were adopted, the CRTC noted that the CAPEX pass-through was designed to encourage cable companies to make capital expenditures to enhance cable services other than discretionary or non-programming services. In part, this incentive was designed to put the bulk of Canadian cable companies in a position to offer the so-called mid-tier range of channels to their subscribers at a time the CRTC mandated the carriage over these channels of the new specialty services licensed in 1987 and introduced in September, 1988.

Several issues are currently being reviewed by the Commission as a result of this hearing process. The CRTC is proposing to remove telecommunication carriers facilities fees and rates from the second element of the pass-through (pass-through of cost increases outside the control of the cable television carrier). Specifically, the CRTC has proposed to eliminate the CAPEX pass-through for cable systems having more than six thousand subscribers. The Commission's rationale is that this pass-through was always intended to be a temporary measure to act as an incentive to cable companies to improve their capital plant and that the necessary improvements have largely been made with respect to larger systems. To ensure only 50% cost recovery under the CAPEX pass-through, CAPEX increases would, therefore, be sunsetted or deleted from monthly rates after five years of being in effect.

Not surprisingly, the CRTC hearings brought forward substantially differing views as to the current and appropriate future profitability of cable television firms. Several interests, including the Director of Investigation and Research, contended that the current formula permitted excessive profits and that tighter profit controls (but not necessarily involving more hands-on regulatory oversight) were necessary. The cable television industry contended that its overall level of profitability was not spectacular compared to telephone companies and other regulated enterprises.

The Director of Investigation and Research also contended that increased competition would help provide incentives to eliminate unreasonable profits. In the United States, the Federal Communications Commission has encouraged introduction of local microwave systems that permit consumers in less densely populated areas to access through small roof-top dishes a superior range of channels to those available "off air" (but not necessarily the whole range of channels offered by landline cable). Charges for these radio systems are comparable to those of cable, particularly if cable recovers the full cost of serving less dense areas from the subscribers in those areas. The Director's submission noted that competitive intervention such as this could be relied on to a greater extent by the CRTC to control the price level and structure of the established cable monopolies.

Finally, several cable companies noted that the rapid rise in basic cable rates over the last two years was caused to a large degree by the pass-through of specialty service charges. Cable television companies can be expected to focus on the level of these charges and the CRTC's policy requiring cable carriage of all specialty services at the 1992 licence renewal hearings of these services.

COMMUNICATIONS COMPETITION FINDS NEWFOUNDLAND

By: John F. Blakney
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With the extension of the CRTC's jurisdiction to Newfoundland Telephone, the company is facing increasing pressure to permit customer and competitor interconnection with its system (see discussion of AGT decision *CCPR*, Sept. 1989).

On January 29, 1990, the Commission concluded that the attachment of subscriber provided multi-line terminal equipment to the network of Newfoundland Telephone in its urban region would be in the public interest. This decision was prompted by a joint application of the Alliance of Competitive Communication Suppliers (ACTS) and the Canadian Business Telecommunications Alliance (CBTA). The Commission has elected to examine Newfoundland Tel's proposed decreases for terminal rates and increases for multi-line business service rates in the context of a general rate increase hearing to be held in mid-May 1990.

The Commission has also received an application from Cantel for cellular service interconnection with Newfoundland Tel, and an application from a supplier of radio communications services, Novacom Inc., to require Newfoundland Telephone to provide radio common carrier interconnection so that competing mobile telephone services can have access to the Newfoundland public switched telephone network. Both system interconnection applications have been opposed by Newfoundland Telephone. The Commission has yet to render its decision with respect to these applications.

FEDERAL COURT CHANGES TRANSCANADA PIPELINES AGENDA FOR NORTHEAST EXPANSION

By: N.J. Schultz
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TransCanada PipeLines' (TCPL) $2.6 billion pipeline expansion to serve primarily U.S. Northeast markets may be delayed as a result of a Federal Court Trial Division ruling that the National Energy Board (NEB) must consider the toll methodology applicable to the expanded pipeline.

The NEB has traditionally used a rolled-in methodology whereby all costs are put into a common pot and then allocated to all users. The effect of a $2.6 billion expansion would be to increase the cost for existing shippers to Eastern Canada by approximately $0.10 per gigajoules or 11%. The Industrial Gas Users Association (IGUA) and Consumers' Gas supported by Gulf Canada Resources and Shell Canada take the position that the costs of the expansion should be borne by the new volumes to be shipped. A purely incremental approach would have the effect of increasing the cost of transporting that gas by at least $0.50 per gigajoules over existing tolls. The increase could be even greater if the new volumes were required to pay a toll established not on a purely incremental basis but on a modified incremental basis. A modified incremental toll would recover the incremental costs plus a share of the existing costs of the system. A modified incremental toll would also reduce the cost of service for existing shippers. A different proposal would split the pot of costs into two: one pot for secure markets and one for risky markets. This approach would tend to put exports into the risky category.

The NEB fully examined the toll methodology question in a hearing in 1988 also in connection with an expansion to the U.S. Northeast. The NEB stated that, while the toll methodology question was relevant, it would not deal with the question again. IGUA and Consumers' Gas took the matter to the Federal Court which has ruled that the NEB cannot refuse to hear parties on a

relevant question. Reed, J. of the Federal Court noted that the NEB and TCPL were under great pressure to conduct an expeditious proceeding if the November 1, 1991, in-service date for this expansion was to be met. However, the Court, noting the recent Supreme Court of Canada Judgment in *American Airlines* v. *Competition Tribunal*, stated that administrative expedience and a desire to avoid protracted proceedings could not override the right of parties to be heard in the public hearing required by the *NEB Act*.

The NEB has now stated that it will conduct a full and exhaustive examination of the toll methodology question. It has also stated that it will not, as previously indicated, issue a decision without reasons in June, 1990. The NEB had issued decisions without reasons last year denying some gas exports. The denial of the exports was very upsetting to the producing sector and the absence of reasons only added to the confusion. No doubt the NEB has balanced the need of TCPL for an expeditious decision against the desirability of issuing decisions with the supporting reasons and this, together with the Federal Court Decision, has swung the pendulum away from what TCPL would have wished.

The NEB has delayed commencement of the hearing to the end of March to permit parties additional time to prepare for the new toll methodology issues. It is now expected that a decision will not be issued until the late Summer or early Fall.

PATENTED MEDICINE PRICES REVIEW BOARD UPDATE

By: John F. Blakney
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In December, 1989, the Patented Medicine Prices Review Board (PMPRB) published its first *Annual Report*. That month, the Board also published its Bulletin No. 5 which contains the Board's response to comments from interested parties on its July, 1989, *Supplementary Guidelines on Excessive Price*, the Board's 1990 Consultative Agenda, and requests for comment on the Board's draft Rules of Procedure.

The Board's *Annual Report* is notable for its analysis of general price trends of all medicines and its analysis of patentee compliance with respect to the Board's price guidelines on existing medicines.

The *Annual Report* observes that, from 1982 up to the time of the issuance of the Board's Price Guidelines in 1988, the year-to-year increases for the pharmaceutical component of the Industrial Products Price Index, (IPPI: factory gate drug prices of domestic manufacturers) were approximately 2% to 3% greater than the corresponding change in the Consumer Price Index. Since January, 1989, the date the Board's price guidelines for existing patented medicines became effective, the year-to-year change in the drug price index has continued to decline. By August, 1989, the rate of change in the Drug Price Index had dropped to 1.7% below the change in the Consumer Price Index. The Board's report concludes:

> These Statistics Canada data indicate a significant and stable reduction in the rate of change of drug prices at the factory gate both in absolute terms and in relation to the rate of change in the CPI...
> The findings of the Board's own review of price trends by sales of patentees of patented medicines are consistent with those of Statistics Canada for all medicines, patented and non-patented....The Board's preliminary analysis of a significant sample of existing patented medicines shows that, on average, the cumulative increase in their prices have been about 1% lower than would have been permitted under the Board's guidelines.

There are 423 patented drug products (203 medicines) which form the PMPRB's current analysis of price compliance. The Board had conducted preliminary reviews on 60% of these drug products by September 30, 1989. The basic presumption of the Board's guidelines is that the price of an existing patented medicine is excessive if the cumulative change in its price is greater than the cumulative change in the Consumer Price Index over the same period. The Board has noted that among the drugs subject to a preliminary review, average price increased by nearly 1% less than what would have been permitted under the Board's Guidelines on prices. Over 70% of the drug prices reviewed complied

with the Board's 1988 Guidelines. The prices of those patented medicines that appear to have risen by more than the guidelines are now subject to further examination by the Board. However, to date, the Board has not issued a formal Notice of Hearing with respect to any medicine.

The Board published supplementary guidelines on excessive price in its Bulletin No. 3 (July 1989, see *CCPR* September, 1989). In Bulletin No. 5 the Board responded to a number of issues raised in comments from interested parties on these supplementary guidelines.

The Board has emphasized that it intends to continue to apply guidelines in reviewing data on patented medicine prices and to apply bright line tests in the presumptions created by these guidelines. The Board expressed concern as to the uncertainty and expense that would be entailed if the Board elected to deal with each price on a case-by-case basis.

Certain Patented Medicine suppliers had objected to the weight the Board intended to attach to the international median price in determining excessive price under its supplementary guidelines. It was noted that such data is vulnerable to currency fluctuations and to variations in recommended dosage regimens. The Board concluded that these issues are not serious enough to compel it to abandon the use of international price comparison in its guidelines. The Board had proposed methodology for computing exchange rates based on 6 month averages to eliminate short term exchange rate fluctuations. The Board noted that the internationalization of the drug development and approval process appeared likely to lead to greater international standards of approved indications and recommended dosage regimens.

The Board also rejected the industry submission that the international price comparison presumption should focus on the upper end of the international price range rather than on median. The Board observed that this approach would lead to Canadians paying the highest prices in the world for new medicines and that the seven countries designated for international price reporting purposes provide "a reasonable basis of comparison; these are highly industrialized countries which enjoy a substantial level of investment in pharmaceutical research and development". Finally, the Board noted that restricting analysis to the high end of the range would not eliminate measurement problems and would be no less arbitrary than the median. However, the Board stated that it intended to consult further with the industry and interested parties on methodological matters relating to implementing the international price comparison.

A further important analytical element of the supplementary guidelines is a therapeutic class price comparison involving patented, non-patented, and generic copies of medicines within the therapeutic class. Some patentees objected to including medicines other than patented medicines for this comparison. In response, the Board noted that the *Patent Act*, in describing the therapeutic class, does not differentiate patented medicines from non-patented or generic medicines. The Board's guidelines for new medicines permit the new medicine to be priced at the upper end of the therapeutic class range. The constituents of the range and the dispersion of the therapeutic class are, therefore, not directly relevant for excessive price analysis. The only exception would be where there are no patented medicines in the therapeutic class. This, the Board concluded, is an unlikely situation.

The Board also concluded that it should not alter its guidelines to provide for a higher price for new medicines on the ground that comparable medicines were brought on the market some time ago or that, today, it is more expensive to bring new medicines to the market. In reaching this conclusion the Board considered that the prices of medicines in a therapeutic class could have been depressed by generic competition but that assessing this impact would be very difficult. Even if there was evidence of such price suppression, the Board noted that, for new medicines not representing substantial improvements in terms of therapeutic effect or cost savings to the health system, it is not evident that the price suppression should form a further criterion for judging excessive price.

The Board recognized the concerns of some parties that, under the supplementary guideline, new medicines offering no substantial improvement could be priced at the top of the

therapeutic class price range. In this regard the Board concluded as follows:

> In general the Board considers that this will not pose a serious problem since market forces should penalize any new medicine priced as high as the best existing medicine where it does not at least offer comparable benefits. However, the Board will monitor the pricing behaviour of new medicines over time in order to determine whether its guidelines are appropriate.

A number of comments from the pharmaceutical industry criticized the Board's definition of break through and substantial improvement medicines as vague. Some commentators also suggested that it would be useful to involve industry representatives in periodic reviews of the application of these terms. In reply, the Board noted that it cannot abdicate its statutory responsibility and that a review panel therefore could perform only a recommendation-giving role. The Board noted that the principal definitional problem relates to borderline substantial improvement cases and that, accordingly, it intended to consult further to develop more guidance on the definition of substantial improvement.

A further criticism from the pharmaceutical industry of the guidelines was that they did not provide any apparent incentive or reward for modest improvements in medicines. It was recommended that there should be no classes of new medicines and that if the price of any new medicine did not exceed both the therapeutic class comparison and the range of prices in the seven comparable countries, the price should not be considered excessive. The Board rejected this industry proposal on the grounds that it failed to take into account any differences in the degree of therapeutic improvement among new medicines and that, accordingly, no distinction would be made between a "me too" medicine and a truly innovative and important discovery. The proposal could also lead to Canadians paying the highest prices in the world for all new medicines.

The industry also suggested a third new medicine class for medicines that demonstrate a moderate improvement. These would be given a premium above the therapeutic class equal to the relative improvement of the medicine over existing drug therapies. The Board rejected this suggestion on the grounds that it leaned towards reintroduction of the "therapeutically adjusted price" concept which the Board had replaced in its supplementary guidelines on the ground that it led to uncertainty and greater subjectivity. The Board also reminded patentees that its guidelines only create presumptions and that significant evidence to the contrary with respect to a finding of no substantial improvement could be introduced in order to justify a higher price.

The Board has also undertaken to consult on the development of criteria determining whether a reasonable relationship exists between the price of a new strength of an existing dosage form and the prices of substitute medicines.

DIRECTOR TACKLES COMPETITION ISSUES IN CHICKEN MARKETING

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The Director of Investigation and Research, responded to an invitation from the Ontario Chicken Producers' Marketing Board with an August, 1989, submission on the economic and competitive implications of proposed chicken marketing arrangements and the jurisdiction of the *Competition Act* in the area. The Director took the opportunity to question the quota restrictions imposed by the Canadian Chicken Marketing Agency.

The Director's submission focused on the "premium" problem and the "lock-in" arrangements. Premiums are payments by processors to chicken producers over and above the Board-established cost of production. The Director provided an economic analysis of the cause of premiums and argued that they are not a novel and transitory phenomena but have existed in Ontario for some 15 years. The Director's analysis shows that, apart from possible

technologically-motivated behavior which is transitory in nature, market conditions and prices at the final consumption level determine the level of premiums. Premiums at the producer-processor level can be passed on only to the extent of the value for product as determined by the conditions and the profit potential in the final market.

Supply has not grown as quickly as demand for chicken products. The Director noted that, as a result, the value of live chicken product to processors far exceeds the cost to obtain it. Under these conditions, the Director believes that efforts to restrict premiums merely deal with the symptoms of the problem rather than the problem itself. Premiums simply reflect the true value of chicken to processors. Furthermore, the Director argued, restricting the payment of premiums at the producer-processor level does not prevent the existence of a high price at subsequent levels in the industry. Restricting the payment of premiums simply determines which tier of the industry will capture the extra income that is available from access to a supply-constrained product in the face of strong growing demand. With or without premiums, consumers will face roughly the same price as determined in the final end-use market. The Director argued that the accuracy of this analysis of the basic economic features of the market is shown clearly by the high wholesale and retail prices that have continued to exist following a December, 1988, attempt by the Board to prohibit premiums and impose cost-of-production pricing.

The Director contended that, beyond the short run, it is impossible to prevent the emergence of payments to producers in excess of those established by the Board given the tight quota restrictions and the strong end-use demand for chicken. Payments to producers may take many forms such as lump sum payments, bonuses or gifts; the Director argued that expense clearly indicates market participants will circumvent any efforts to prevent the realization of market value for a product.

"Lock-in" arrangements have been implemented in Ontario in an effort to prevent producers from seeking out the best premiums. Under these arrangements, market shares are frozen and processors and producers are tied. In the Director's view, these arrangements do not, in any way, directly affect conditions in the final market and, therefore, do not and cannot eliminate the value processors attach to chicken and the prices processors expect to receive. While lock-in arrangements may restrict the choice of producers, producers still hold a strong bargaining position in the form of jeopardizing product quality, delivery date, and other means of raising processor costs. Over time, premiums to producers will emerge either directly in terms of lump sum payments or in the form, for example, of gifts as processors act on an obvious incentive to transfer and share the available income with producers, thus ensuring that they can continue to meet their obligations in downstream markets.

The Director's recommendation was that the Board attempt to institute a market-based pricing system for live chicken founded upon either an auction system or a price-setting system where the price reflects market conditions without strict reference to cost of production levels. Both of these alternatives enable producers to obtain the income which is created by supply management and which is intended for their benefit. Given the existing provincial and national quota allocations and projections, a move toward pricing that reflects the true value of the live product is, in the Director's view, the most viable solution to improving the functioning of the market and the effectiveness of supply management. The Director also recommended against the implementation of any type of lock-in arrangement.

The Director is of the view that there is an obvious and inescapable interplay between the pricing options open to the Board and the degree of restrictiveness imposed by the Canadian Chicken Marketing Agency in its quota allocations to Ontario. The Director is convinced that a more liberal distribution of provincial quota allocations is the most direct and least costly solution to these problems and would enable enhanced product and market development and growth in increased alotment of provincial quota.

The Board invited the Director to address the applicability of the *Competition Act* to the options which were being considered by the Board. The Director reviewed the criminal and civil sanctions in the *Act* and discussed the regulated conduct

defence. The Director noted that the case law on regulated conduct has focused on criminal law. The status of provincial regulation in relation to the civil provisions of the *Act* is yet to be settled. The Director noted that the Board would seem to have the general authority to implement the proposals being considered and, in principle, the relevant legislation appeared capable of supporting an argument that the *Competition Act* should not apply. The Director, however, avoided any specific comment. The Director stated that the specific manner in which regulatory authority is exercised must be known before any definitive statement can be made.