Coping with the Federalist Reality In North American Energy Trade

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Paper presented at the
Forging North American Energy Security
Conference, Monterrey, Mexico
April 1-2, 2004

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FORGING NORTH AMERICAN ENERGY SECURITY
is a conference organized by the North American Forum on Integration, the Escuela de Graduados en Administración Pública y Política Pública (EGAP) of the Instituto Tecnológico y de Estudios Superiores de Monterrey (ITESM) and the Consejo Mexicano de Asuntos Internacionales (COMEXI).

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COPING WITH THE FEDERALIST REALITY IN NORTH AMERICAN ENERGY TRADE

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During much of my more than 30 years as an energy consultant, I have specialized in the formulation and analysis of national energy policy. That has often involved frustration.

It is difficult to deal with engineers who know very little about economics. It is disconcerting to discuss energy policy with economists who don't understand technology. And it is inevitably challenging to discuss policy with engineers *and* economists who know and care nothing about politics. But we need to do it . . . just as we ought to learn to get along with the effects of federalism on the energy sector.

Federalism is part of the dynamic in energy policy for Canada, the United States, and Mexico. North America is increasingly interdependent – especially in the energy sector; yet federalism means different things in each country. Those who deal with energy matters should appreciate the interrelationships of technology, economics and politics. It is *also* essential for us to think about how those features factor into *diverse regional interests* in various *parts* of Mexico, the United States, and Canada. Sometimes for better, sometimes for worse, regional interests underlie much of our continental energy trade and our efforts to cooperate continentally in the interest of mutual benefits through North American energy security.

I define "federalism" as *any* explicit or implicit formula by which a national government shares authority and responsibility with its constituent parts. As Earl Fry has noted[i], this sort of arrangement for the energy sector is most obvious in Canada. It is weakest in Mexico . . . although I believe that the decentralization of *real* power may be a trend even here. In that respect, I am eager to get reactions from this audience in the question period.

Canadian provinces effectively control that country's domestic energy resources; and this prompts remarkably independent attitudes on their part in respect to an issue such as the Kyoto Protocol to reduce the emissions of so-called "global warming gases". (Carbon dioxide and methane, of course, are both associated closely with energy production, delivery, and use.)

Not only did a large majority of provincial premiers send their nation's leader a letter of early opposition to his endorsement of the Protocol. One premier read it aloud at Jean Chrétien's news conference in the middle of a trade mission in Moscow, although the embarrassed Prime Minister himself had not yet even received the written protest. The premier of Alberta (the province that contains most of Canada's proved fossil energy reserves) has gone still further on occasion. Ralph Klein sent his environmental affairs minister to Moscow to lobby the *Russians* not to ratify either.

In the United States, by contrast, pressure for a more activist approach to the possibility of climate change from human activities has come "from the bottom up". The attorneys general of several U.S. *states* are suing the *national* Environmental Protection Administration in an effort to compel EPA to publish limits on the release of carbon dioxide.

Canada *did* ratify the Kyoto Protocol. Still, I have yet to meet an official from that country who believes that Canada will be able to meet the goals set for reducing specified gaseous emissions by the target period of 2008-to-2012. Only a month ago, a leading official in Canada's energy policy establishment at NRCan reiterated *twice* in a single speech the *very* careful wording used in the most recent annual Speech from the Throne. He said the Government in Ottawa "will respect Canada's climate change commitments in a way that produces long-term and enduring results while maintaining a strong and growing economy."[ii] Perhaps I've been living in Washington, DC, too long; but that strikes me as *hinting* a more flexible approach. In the end, I predict that Canada will find a way to postpone or back away from the rigid Kyoto timetable – just as California has delayed, modified, or eliminated its repeated pledges to achieve auto emission

results and renewable energy quotas on schedules that were unrealistic from an economic or technological standpoint.

Still, this raises a "federalism-type question":

Does Ottawa *ultimately* call the shots on "climate change" policy, or do government and corporate officials across Canada? If we could discern a *simple* answer right now, it would be very important to "North American Energy Security".

- It *might* tell us something about the pace at which Canada's prolific oil sands will be developed. (Remember that these deposits are now generally credited with 175 billion barrels of economically recoverable, refinable product.)

- It *can* affect the speed with which a new pipeline will bring Arctic natural gas from the Mackenzie Delta.

- It *could* even affect international trade in electricity, since Alberta has been a net importer of power from the United States as well as from provincial neighbors, yet has ample coal of its own to fuel additional generation capacity it might choose to build.

I won't try to offer a definitive answer to the federalism question in this particular instance – although any Canadians in the audience should feel free to do so during the Q&A. I sketched out this issue only as a backdrop to what many will find a new way of looking at energy policy overall. I think we all agree that policy, in turn, affects "the evolution of the North American energy sector" (the title of this specific session).

More than a quarter century ago, a political scientist named Graham Allison proposed a threefold explanation of how a national government reaches *foreign* policy decisions.[iii] I suggest that it also applies to *energy* policy.

The first method of policy decisionmaking is "rational choice" – by weighing all the options and potential consequences. Allison said this rarely happens, and I agree. The second involves what he called "bureaucratic politics". The various "players" within a usually small governmental circle (such as the national cabinet) argue for their respective preferred courses; and the outcome depends not only on their persuasiveness but on their relative power within the group and in respect to the chief executive. I can say from experience that this comes close to describing how a U.S. national energy policy document (several of which I have written in their entirety) gradually takes shape. According to Allison, the third way of reaching big decisions is through "organizational procedure". In this case, an order is issued by the top authority (with or without "rational choice" and "bureaucratic politics"); but it is *implemented* at various levels *throughout* the federal governmental structure, according to interpretation and past habit.

This third possibility may not offer an edifying picture, but it comes closest to reality in *energy* policy as we see it from day to day . . . in all three countries. National energy policy can be modified – or possibly turned around – at the regional (and even local) level. This is why it is worthwhile to examine the respective federal structures as Earl Fry has done. We also ought to consider diverse (sometimes conflicting) *regional interests*, as I shall do in the rest of my remarks.

In the United States, wholesale transactions of natural gas and electricity are regulated by the Federal Energy Regulatory Commission (FERC). But the rates that most end-users pay are set by *state* public utility commissions (PUCs). Those state authorities also have the final say on whether and where new pipelines, electricity transmission networks, and production facilities will be built, as well as how energy companies will operate. This explains why the investment climate for the energy sector in our two most populous states (California and Texas) can be so different from one another.

State regulations on gasoline vary so much throughout my country that there are dozens of different formulations (called "boutique fuels") that may not be legal for sale across the river in another state. This has not only caused higher prices; it has occasionally produced local shortages. Regardless of what national statutes say about energy use and "clean air", significant implementation takes place in a "distributed" fashion.

Since the power blackout of August 2003, the need for *mandatory* reliability measures in generating and delivering electricity has seemed crystal clear to most expert observers. Earl Fry has already mentioned a unique, *international* entity that exists to carry this out. It is the

North American Electric Reliability Council, a *non-governmental* (rather than supranational) entity. NERC involves representation from the private sector as well as governmental electric-power enterprises that range from rural cooperatives and municipal utilities to crown corporations and the *Comisión Federal de Electricidad* (CFE) here in Mexico. It embraces all of the Lower 48 states and all Canadian provinces; but it operates within regional councils rather than as a single unit -- since there is no true national grid in *any* of the three countries of North America, much less a synchronized and strongly interconnected continental network.

My main point here in respect to federalism is that NERC must now rely on peer pressure alone to see that standards and procedures agreed upon by consensus among its members are observed. This is inadequate. Canadian officials under both Prime Minister Chrétien and his successor (incumbent Paul Martin) have expressed support for a self-governing international organization with mandatory powers. In the current Bush administration, the very first recommendation of the "Cheney Report" regarding energy infrastructure called three years ago for "legislation providing for enforcement by a self-regulatory organization subject to FERC oversight."[iv] Yet that provision was stripped from the comprehensive energy bill that is still stuck in Congress, along with any reference to regional transmission organizations (except to try to delay their implementation). Why? Because of opposition from certain *states* . . . *through* their representatives in Congress. Certain *states* (predominantly in the Southeast and Far West) fear that stronger transmission ties with other parts of the country – while it might improve reliability and efficiency overall – could allow competition from "outsiders" for the relatively cheap electricity they have long enjoyed. It's ironic that much of that power comes from federally built and operated hydroelectric dams.

No wonder FERC has established its own Office of State and Local Outreach to try to improve communication among various levels of government within the U.S. on matters that concern it. Let's hope it succeeds.

Meanwhile, *trans-border regionalism* in electricity supply and demand is a fact. Several Canadian provinces exchange more electricity with U.S. states than they do with adjoining provinces. In 2003, four provinces (Alberta, Saskatchewan, Manitoba and Ontario) were net *im*porters while four others (British Columbia, Quebec, New Brunswick, and Nova Scotia) were net *ex*porters.[v] The grids in some provinces are synchronized with adjoining states rather than with neighboring provinces.

So much for examples from Canada and the United States. There is only time here to *hint* at how *national* policy in those two countries is swayed during its implementation by *regional* interests – a hallmark of federalism. What about Mexico?

Surely, the states of Mexico have no *institutionalized* role in forging energy policy. Yet, if that is the entire story, why has the national energy secretariat (SENER) courted governors and their staffs with briefings about the *regional* benefits to be enjoyed by enactment of certain national initiatives? I think the explanation lies in the fact that energy policy must be *implemented* as well as enunciated. Legislative initiatives must be *enacted* . . . by Senators and Delegates who must themselves be *elected* from distinct constituencies -- where party predominance varies, and where regional interests are obviously not uniform. Air conditioning is more important in hot, low areas around Juarez than it is on the high plateau of the Federal District. Natural gas is more critical as a fuel for certain industries around Monterrey than it may be in parts of the Yucatan –except perhaps to generate electricity.

I am not close enough to Mexican politics to state this as a fact; but I would be surprised if -- when "benchmark" natural gas prices became so volatile in Houston -- the decisions of Pemex and the *Comisión Reguladora de Energía* to offer reduced rates on long-term contracts with industries that depended very heavily on that fuel were not triggered by the importance of Monterrey to the national economy. When I speak of a real-life trend toward federalism, I am not talking only about what political scientists call "the devolution of power". I speak of "the decentralization of influence".

We would be naïve not to realize that there may also be established interests in Mexico's widespread use of "bottled gas" – which serves more than four out of five households, but is very slowly being replaced by natural gas for reasons of safety, convenience, and environmental protection. Astonishingly, some vendors of propane are even arguing (without *any* sound technical basis, so far as I can determine) that the accident-prone trucks

loaded with top-heavy cylinders are somehow safer than piped gas.[vi]

New energy installations of any kind, *anywhere*, require property-use approvals. In all three countries, they must meet environmental standards that are deemed appropriate to *local* circumstances. If state and municipal officials drag their feet handling applications, *delays* can lead to *cancellations*. This is especially relevant as applied to the receiving facilities for liquefied natural gas (LNG) that are proposed for both the Pacific and Gulf Coasts of Mexico. Not all of these "planned" facilities will be built; the first ones to move into the construction phase will likely win an unofficial, "winner-take-all" competition.

Local acceptance of LNG facilities is a factor in all three countries. In Baja California, for example, I understand that partisan division over the issue could play a role in July's local elections. In Harpswell, Maine, a few weeks ago, a mere handful of residents rejected a proposal by TransCanada and Conoco Phillips Company to build a $350 million (U.S.) LNG terminal on the site of an abandoned fuel depot. The vote was minuscule in continental terms – something like 1,930 to 1,520.[vii] But that *killed* the site.

Meanwhile, provincial premiers and governors may have something to say about this as they reach across both the northern and southern *international* borders with the United States; and this may be quite positive. Regional groupings of sub-national chief executives from Canada and the United States have met for years in the Far West, the Great Lakes Region, and the East. More recently, yet another group of Border Governors has started to come together. They govern California and Baja California, Arizona and Sonora, New Mexico and Chihuahua, Texas, Coahuila, Tamaulipas, and . . . Nuevo Leon. They meet, and they talk about a lot of things – including jobs, water . . . and *energy*.

Moving back to the national level, I suggest that differences in the *regional* effects on central energy policy are enhanced by the partisan split in the Mexican Congress – as well as by the fact that governors here no longer all represent a single party. Mexico's gradual move toward revenue sharing has begun to make this new generation of governors what one observer has termed "the modern viceroys".[viii] This may be somewhat exaggerated. I recognize sloganeering – whether it is President Zedillo's *Nuevo Federalismo*, the PAN's *Auténtico Federalismo*, or the *Federalismo Democrático* of the PRD. But one possible major structural reform (which seems to have gained support in more than one party) would allow re-election in Mexico. I believe that would *magnify* the expression of divergent regional opinions, since there is general agreement that it would make officials more responsible and responsive to their particular constituents.

What can be *done* – in any of the three countries – to *cope* with these "federalistic realities" while doing *energy* business? Obviously, an entrepreneur needs to do more "home work" – before proposing a project, during development, and once in operation. For a cross-border system (such as a pipeline a powerline, or any energy facility to serve more than one national market in North America), one must feel the pulse of the public and local public officials on *both* sides. Knowing the exact, intricate "rules of the game" in both countries is an absolute requirement. An ongoing "intelligence system" needs to keep track of what's going on in national capitals, but also "in the neighborhood".

Needless to say, the public officials involved at various levels have a parallel responsibility. Energy security is a prime objective and duty of the three central governments. Energy security is fostered in North America by smoothly working energy interdependence – whenever and wherever a consensus can be achieved on mutual benefits through trade and other forms of cooperation. But this means that central-government authorities need to reach out in understanding and good will to those who express regional interests . . . and vice versa.

In Canada, this might involve using the new "Council of the Federation" to consider energy matters as well as health care in discussions between Ottawa and the provinces. For the United States, perhaps there should be more contact between the Department of Energy and its representatives on the North American Energy Working Group and the regional groupings of governors I have mentioned. Mexico's Secretariat of Energy might choose to continue and *regularize* contacts with governors (and even with local authorities, in some cases). There is no simple, magic, "one-size-fits-all" solution. Many people must work at it.

There isn't time to spell this out any further, except for a few principles and my recommended methodology of approach. Recall

those three aspects I started with – trying to determine *economic* sense, *technological* sense, and *political* sense for any specific situation. National statistics (for example in relation to fuel-choice) can't be trusted to apply to all regions uniformly. The competition faced by coal in West Virginia is nothing like the alternatives in Washington State, much less Québec or Guerrero.

Unfortunately, it is usually easier to oppose a project than to initiate one. To complicate matters, what people *seek* from an energy project involves disparate goals that may conflict among themselves. They must be balanced. I suggest making a check-list of *five* objectives for any project proposal. I have found these goals to apply universally:

1) *Affordability* of the energy delivered (This doesn't mean the same thing in Tabasco, however, as it does in Toronto;
2) *Adequacy* (Photovoltaics may suffice for a remote village in the Sierra Madres or even in certain Inuit outposts, but probably not for Montreal or Minneapolis. A large wind-farm in Oaxaca makes sense *only* if excess power can be delivered to a broader market.)
3) *Reliability* (That's a major selling point for anybody who is fed up with blackouts . . . anywhere);
4) *Environmental acceptability* (This varies enormously by location and the requirement to achieve other goals); and finally . . .
5) *Timeliness* (There will not be much *popular* interest in an exotic source of natural gas like methyl hydrates if we haven't yet built the Mackenzie and Alaskan pipelines to tap more readily available Arctic gas).

Whenever possible, it is wise to try to anticipate local attitudes toward each and every one of these goals. Then, one can prepare to rebut unfair criticisms and to use points with the strongest *local* appeal to encourage a fair balance.

By focusing on regional interests in this presentation, I do not mean to discount the value of national goals . . . or even continental "harmonization" to the extent feasible. The trilateral North American Energy Working Group – which I expect one of the speakers on the final panel to mention – has been at work for some time on a document that is supposed to present "A Vision of the North American Natural Gas Market". Personally, I believe it will be even more important than the historic document NAEWG produced as its initial joint effort two years ago and is now in the process of updating and improving. That was entitled *North America: The Energy Picture*.[ix]

Still, a continental gas vision will not be *implemented* unless those who carry it forward recognize that Canada, the United States, and Mexico are all – in one way or another -- *federal* systems. During the question period and afterwards, I would welcome your individual experiences of how this may be hindering (or might *help*) specific projects you know of. We are united in seeking a more energy-secure North America, so we should *all* learn to *cope* with *realities*.

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[i] Earl H. Fry, "The Impact of Federalism on the Evolution of the North American Energy Sector", remarks prepared for delivery April 2, 2004, at the forum on "Forging North American Energy Security" in Monterrey (Nuevo Leon), Mexico.

[ii] Andre Plourde, keynote opening address at the North American Natural Gas Conference on "Prospects for Prices", sponsored by the Canadian Energy Research Institute (CERI) at Calgary, Alberta, March 1, 2004.

[iii] Graham T. Allison, *Essence of Decision: Explaining the Cuban Missile Crisis*, Little Brown and Company, Boston, 1971.

[iv] *National Energy Policy: Report of the National Energy Policy Development Group*, Washington, May 2001, p. 7-17.

[v] Canadian Electricity Association, *Canadian Electricity and the Economy: The Integrated North American Electricity Market*, March 2004, p. 5.

[vi] Ken Bensinger, "Tradition bottles up gas market", *Houston Chronicle*, March 6, 2004.

[vii] Kevin Cox, "Tiny Maine town kills LNG project", *Globe and Mail*, March 11, 2004.

[viii] Victoria E. Rodriguez, *Decentralization in Mexico: From Reforma Muinicipal to Solidaridad to Nuevo Federalismo*, Westview Press, Boulder, Colorado, 1997, pp. 25-27.

[ix] This document was published in June 2002, in English, French and Spanish. It is available from the energy departments of Canada, Mexico, and the United States on their respective Internet sites. The U.S. version is at *http://www.eia.doe.gov/emeu/northamerica*