



CANADIAN GLOBAL AFFAIRS INSTITUTE
INSTITUT CANADIEN DES AFFAIRES MONDIALES

ENERGY, TRADE AND GEOPOLITICS IN ASIA: THE IMPLICATIONS FOR CANADA

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SUMMARY

Canada's growing interest in trade with countries in the Indo-Pacific region corresponds with an ominous growth in geopolitical instability and insecurity in that part of the globe. With Indo-Pacific hunger for oil expected to soar – especially in China, where demand will translate to 80 per cent of imports in 10 years – Canada needs to develop policies to deal with the region's turbulent realities.

The Indo-Pacific comprises countries in South Asia and Southeast Asia, and includes such unstable and unpredictable players as North Korea and Pakistan, both of which have nuclear weapons and long-simmering border tensions. India is an emerging economic and military rival to China. In the next 20 years, China and India are expected to lead the global demand for gas as coal consumption continues to decline, and Canada has a stake in this prosperous future.

Along with territorial squabbles in the region, Canada will have to deal with complex issues such as terrorism, human trafficking, transnational crime, piracy and cyber-crime, as well as the struggle for global dominance between China and the U.S.

One key area for potential conflict is China's recent construction and militarization of artificial islands in the South China Sea. The Canadian government's new military strategy, Strong, Secure, Engaged does little more than make a plea for peace and the rule of law in the South China Sea. However, more trade crosses the Pacific Ocean from Canada than crosses the Atlantic. And with Canada signing on to the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP), the region's troubles will need to be resolved by more than good intentions on paper.

Canada must shift more diplomatic, security and military resources to the Indo-Pacific; otherwise, its efforts will be spread too thinly to be effective in the region.

Trade, especially through a major route like the Strait of Malacca, could easily be disrupted by any one of a number of disputes, such as a conflict between China and Taiwan or if historic resentments boil over among competing territorial claimants in the region. Thus, Canada needs to step up and reaffirm its security commitments to the Association of Southeast Asian Nations (ASEAN) as a partner in the region. Participating in maritime exercises and Freedom of Navigation (FON) operations would also help to reinforce to countries in the region the importance of abiding by international law.

Meanwhile, Canada should set aside for now any intentions to negotiate a free trade agreement with China. China does not share some of Canada's key trade and security goals and its aggressive behaviour in the South and East China Seas clearly signal that now is not the time to talk about a trade pact. China must demonstrate that it is willing to take a more cooperative approach to resolving trade and security issues in the Indo-Pacific and to support and respect the rule of law in the region.

Canada has the potential to become a reliable, stable source of energy for Indo-Pacific countries. There is also an opportunity for provinces such as Alberta to strike their own strategic deals to provide energy resources to countries in that region, in return for trade and investment benefits. However, while investing at home in the necessary infrastructure and export capability to expand its role, Canada must also strive to bring its own unique approach to enhancing regional and energy security in the Indo-Pacific.

INTRODUCTION

The important link between trade and security is often lost on Canadians in their discussions about international trade. This is not surprising when over 80 per cent of Canada's exports go to the United States, with whom we traditionally have had a peaceful and relatively stable relationship. As Canada's trade relationship with the U.S. becomes increasingly uncertain and as it seeks to diversify its trading partners by pursuing free trade agreements with other countries and regions, the link between security and trade will intrude on these discussions, especially with respect to parts of the world where peace and security cannot be taken for granted.

With the recent decision to join the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP), Canada will gain free trade access to 11 countries in the fast-growing Indo-Pacific.¹ At the same time, however, geopolitical risks are rising in that region, driven by economic competition, military build-ups, territorial disputes, the North Korean nuclear threat and China's actions in the South China Sea (SCS). This paper reinforces the important link between trade and security and argues that establishing and sustaining Canada's credibility in the Indo-Pacific will inevitably depend on whether and how Canada assumes additional responsibilities and takes actions where necessary to help enhance peace and security in the region.

Opportunities in the Indo-Pacific

The Indo-Pacific is on track for the largest economic transformation and the biggest shift in the distribution of wealth in history, presenting unprecedented opportunities for increased trade with the region. The economic prospects for the countries in this region have been well-described and discussed by many researchers and writers. For example, a recent briefing paper discussed economic growth rates for Indo-Pacific countries and found that the U.S., China, India, Japan and Indonesia are projected to be the largest markets in the world in 2030, measured by GDP. The fastest growing economies will be China, South Asia (India, Bangladesh, Pakistan); and Southeast Asia (Cambodia, Indonesia, Vietnam) (Sloan, 2017). By 2030, two of every three middle-class consumers in the world will be in Asia (Kharas, 2017). As these economies take off and incomes improve, demand for all kinds of products and services will dramatically increase and along with it, the prospects for increased trade.

With regard to energy specifically, the International Energy Agency (IEA) projects that the Indo-Pacific will lead global demand for energy for at least the next several decades.

Already, China, Japan and South Korea are the world's largest importers of crude oil and liquefied natural gas (LNG). By 2040, demand for crude oil will increase by nine million barrels per day (mb/d) while 70 per cent of global crude oil shipments will be to this region. China's dependence on imported oil will grow from around 65 per cent today to 80 per cent within a decade. China will replace the United States as the largest oil consumer around 2030, and its net imports are forecast to reach 13 mb/d by 2040. China will also account for 25 per cent of the projected rise in global gas demand and will import around 280 billion cubic metres in 2040, making China a hub for the global gas trade. Oil demand in India is expected to soar by almost 30 per cent and its share of global energy demand will rise to 11 per cent by 2040. In fact, much of the 80 per cent of projected growth in gas demand will take place in the Indo-

¹ The "Indo-Pacific" is a broader term than "Asia-Pacific". It is generally understood to include the region bordering the Indian Ocean (and therefore includes India, Pakistan, etc.) and the western and central Pacific, including the South and East China Seas. The term has been used widely for several years in Australia, Japan and India and is also commonly used in global strategic/geopolitical discourse.

Pacific, led by China and India. Meanwhile, global coal demand is expected to fall steadily and China is expected to reduce coal consumption by about 15 per cent by 2040 (IEA, 2017).

These shifts hold significant implications for Canada. Indo-Pacific countries will represent the area of greatest economic growth and demand for goods and services, including energy. For Canada, much will depend on whether the country is able to build and maintain the necessary pipelines and export terminals to get energy resources into international markets. However, the good prospects on the economic and trade front must be tempered by increasing concerns over a range of security issues simmering in the Indo-Pacific that threaten the region's continued prosperity and security.

Challenges in the Indo-Pacific

Traditional security concerns² have been steadily building in strategically important parts of the Indo-Pacific region, especially in the East and South China Seas. Within this region, there are long-standing disputes over territorial boundaries, including islands and ocean features. Ongoing friction between Taiwan and mainland China could lead to military action if Taiwan should move toward independence. North Korea is unpredictable and appears to have developed nuclear weapons and missiles to deliver them. India and Pakistan, both nuclear powers, continue to eye each other suspiciously. Non-traditional security concerns in the region include terrorism, human trafficking, transnational crime, piracy and cyber-crime. In the midst of all these challenges, great-power rivalry between the U.S. and China is heating up as the U.S. moves to check China's economic and military ascendancy.

To a certain extent, resource competition also plays a role in the region's increasing tensions. The Energy Information Administration (EIA) (2013) estimates that the South China Sea contains approximately 11 billion barrels of oil and 190 trillion cubic feet of natural gas in proved and probable reserves. China's sweeping claims of sovereignty over the SCS, including the oil and gas reserves there, have angered competing claimants such as Vietnam, Brunei, Taiwan, Indonesia and the Philippines. For example, a Spanish drilling company that Vietnam hired to drill within its exclusive economic zone has been forced to stop drilling twice due to Chinese pressure on Vietnam (Reuters, 2018). In the East China Sea, China and Japan have overlapping claims to an area north of Okinawa where the two countries have been facing off over the Chunxiao/Shirakaba gas field (Shim, 2016).

Other than the North Korean nuclear threat, most of the current tensions in the Indo-Pacific arise from the challenge that China's dramatic economic, political and military rise presents to the region's status quo. At the 19th Party Congress in October 2017, President Xi Jinping, no longer encumbered by term limits on his presidency, set an ambitious plan for China to become a global economic and military "strong power" by 2050. In the meantime, China has been gradually building up its navy in order to challenge the U.S.'s military presence in the SCS. It has dispatched submarines and ships into the Indian Ocean, opened its first overseas base in Djibouti and is looking to establish military bases in other overseas locations. China has laid claim to most of the SCS within its self-declared "nine-dash line" and claims historic rights over reefs and ocean features there. Despite the fact that the Permanent Court of Arbitration ruled China's claims invalid in July 2016, it promptly rejected the ruling (to which it is bound

² For the purposes of this paper, "traditional security" concerns are the use of military forces to defend territory and national interests while "non-traditional security" includes threats such as terrorism, transnational crime, piracy and cyber-crime.

through the United Nations Convention on the Law of the Sea (UNCLOS)) and proceeded to construct artificial islands on reefs and other features in the Spratly and Paracel Islands and to militarize some of them (see Figure 1).

Canada’s foreign and defence/security policies

Canada’s policy response to these challenges is still evolving, and there are hopeful signs that some of them are being recognized. On June 6, 2017 Foreign Affairs Minister Chrystia Freeland delivered a major policy speech on Canada’s foreign policy priorities. She stated that Canada should do its fair share to support and participate in international security partnerships and advocated the “principled use of force” together with its partners to back up Canada’s diplomatic and soft-power initiatives where required. Freeland also stressed that Canada has a deep stake in, and benefits greatly from, maintaining the international rules-based order that governs both trade and security relationships. She called for Canada to play an active role in preserving and strengthening this global order.



Source: *The Economist*

Also in June, the government released *Strong, Secure, Engaged*, a long-term defence policy for Canada. It commits to new investments in critical core capabilities and equipment and plans to grow annual defence spending. References to Asia or the Indo-Pacific in the policy are few and very brief. However, the report does note that “China is a rising economic power with an increasing ability to project influence globally” and calls for adherence to the rule of law and the peaceful resolution of disputes in the SCS. The report acknowledges that Canada is an Asia-Pacific nation and that it is “committed to being a reliable player in the region, through consistent engagement and strong partnerships”.

CANADA'S TRADE INTERESTS IN THE INDO-PACIFIC

More of Canada's trade takes place across the Pacific to Asia than across the Atlantic. In 2016, goods and services exports to the Indo-Pacific (\$65 billion) exceeded our exports across the Atlantic (\$60 billion) (APFC, 2018a). In addition, more than half of all new immigrants to Canada come from the Indo-Pacific.

Canada has taken some significant steps toward diversifying export markets, opening up new opportunities for Canadian exporters by completing several trade agreements with countries in the Indo-Pacific. This includes the CPTPP in 2018 and the Canada-South Korea FTA which was signed in 2014. In addition, Canada has signed foreign investment promotion and protection agreements (FIPAs) with China, Thailand and the Philippines. In August 2016, Canada announced that it would undertake a feasibility study toward a Canada-ASEAN FTA.

The CPTPP encompasses 11 member³ countries with a combined GDP of \$13.5 trillion, representing 13.5 per cent of the world economy (Government of Canada, 2018a). Bilateral trade between Canada and other CPTPP countries, including both goods and services, amounted to \$105 billion in 2016, accounting for 8.1 per cent of Canada's total trade (Government of Canada, 2018b). By contrast, Canada's bilateral trade with China, which is outside the CPTPP, amounted to \$89.5 billion in 2016 (APFC, 2018b; Government of Canada, 2016). Bilateral foreign direct investment between Canada and CPTPP countries amounted to \$122.2 billion in 2016. The CPTPP is a "high standard agreement"⁴ that incorporates the terms of the original Trans-Pacific Partnership (TPP) agreement with the exception of several provisions relating mainly to intellectual property and investor-state dispute settlement. Like the original TPP, the CPTPP can be seen as a balancing response to China's rising economic dominance in Asia, which is the subtext of the Canadian government's claim that "the CPTPP will strategically set the terms of trade in the Asia-Pacific region".

CANADA'S SECURITY INTERESTS IN THE INDO-PACIFIC

Canada takes a very broad approach to what it considers "security". It includes the traditional approach focused on military defence but also includes human security and non-traditional security issues such as terrorism, piracy, cyber-crime and transnational crime. These very broad concerns, however laudable, do tend to spread Canada's limited military, diplomatic and foreign aid resources very thin. As a consequence, we do a lot of things, but we are very limited in how much we can do in any one of them.

Canada's engagement in security-related initiatives

Canada has taken some significant and positive steps toward increasing its role and presence in security-related initiatives in the Indo-Pacific region. Here we will focus on Canada's involvement in the Association of Southeast Asian Nations (ASEAN) and on traditional security activities.

³ The countries are Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam.

⁴ Like the original TPP, the CPTPP includes new regulations for online commerce, treatment of foreign investors, more comprehensive protection for intellectual property, labour codes, environmental commitments and other provisions not found in other trade agreements.

Currently, ASEAN⁵ represents the most important regional trade and security grouping for Canada in the Indo-Pacific. The ASEAN (2018) community is built on three pillars: the political-security community, the economic community and the socio-cultural community. Canada's involvement with ASEAN to date has been focused primarily on the economic pillar as evidenced by the FTA feasibility study and pursuit of membership in ASEAN. To its credit, the government has been making moves toward pursuing deeper ties with ASEAN, most recently by appointing ambassadors to three ASEAN member countries and with Prime Minister Justin Trudeau attending the East Asia Summit in Manila as an observer. Trudeau reiterated Canada's desire to join the summit⁶ "to be able to engage with its current 18 members on strategic, political and economic issues" and also requested admission to the ASEAN defence ministers' meeting-plus meetings which are focused on strengthening security and defence co-operation.

Notwithstanding ASEAN's importance, its emphasis on consensus-building and non-interference in the affairs of member states puts limits on how effective it can be in mitigating security concerns in the Indo-Pacific. For example, at its 2017 summit, ASEAN was unable to formulate a strong response to China's building and militarizing artificial islands in the SCS. This failure was reportedly due to China's pressure tactics on certain members with the result that neither ASEAN nor the ADM-plus group has produced a consensus position on responding to China's actions (Grinius, 2016; Mogato, 2017).

Meanwhile, China is pushing for a "new regional security cooperation architecture" that it would lead (Tiezzi, 2014a). This proposal calls for a "code of conduct for regional security and [an] Asian security partnership program." In this context, Xi has called for Asian problems to "be solved by Asians themselves", implying that non-Asian countries (including the U.S.) would have no role in such an organization (Tiezzi, 2014b).

In terms of traditional security activities, Canada increased the level of participation in naval exercises in the East and South China Seas in 2017. After China's rejection of the Permanent Court of Arbitration's ruling on its territorial claims, the U.S. Navy increased the level of naval exercises and began to undertake freedom-of-navigation (FON) operations designed to demonstrate the right of free passage through the waters China claims. With the successful refit of Canada's frigates completed, two Canadian frigates joined the U.S., Japanese, Korean and Australian navies in naval exercises in the East and South China Seas in 2017 (Fisher, 2017). Canada has also begun to strengthen military partnerships in the region. For example, in April, 2018 Canada and Japan signed a bilateral Acquisition and Cross-Servicing Agreement (ACSA) that will allow for stronger cooperation between the Canadian Armed Forces (CAF) and the Japanese Self-Defense Forces (Global Affairs Canada, 2018).

Trade and security

Canada has a huge stake in the preservation of peace and stability in the Indo-Pacific because its future prosperity will increasingly depend on the smooth flow of trade with that region. The UN estimates that 60 per cent of global maritime trade passes through Asia, with the SCS carrying an estimated one-third of global shipping (UNCTAD, 2015). A recent analysis of the

⁵ The ASEAN bloc consists of 10 members including the Philippines, Indonesia, Brunei, Singapore, Malaysia, Thailand, Vietnam, Laos, Cambodia and Burma.

⁶ The 10 members of ASEAN plus Australia, China, India, Japan, New Zealand, the Republic of Korea, the United States and Russia.

total value of maritime trade passing through the South China Sea was estimated at US\$3.37 trillion in 2016. Of this amount, Canada accounted for US\$21 billion (Cdn\$27 billion) – not an inconsequential figure as it represents 16 per cent of Canada’s total Indo-Pacific trade (Center for Strategic and International Studies, 2017) (see Table 1).

Any number of events including a conflict with North Korea, a China-Taiwan military conflict or skirmishes over territorial claims could interrupt the free passage of marine traffic in the SCS with significant consequences for regional economies. The Strait of Malacca connects the SCS with the Indian Ocean and is the primary chokepoint in Asia. About one-third of global maritime crude oil shipments pass through the strait and it is also an important transit route for LNG (EIA, 2017). China, Taiwan, Japan and South Korea all rely on the Strait of Malacca, which connects both the SCS and the Indian Ocean, to remain free and open. All of these countries are therefore highly dependent on the security of long sea lanes running mostly from the Middle East, across the Indian Ocean, through the Strait of Malacca and up through the South and East China Seas (see Figure 1). Energy security is therefore seen as an important policy goal by many countries in the Indo-Pacific who seek multiple supply sources for crude oil and LNG in order not to be too dependent on any single country or region.

TABLE 1 CANADA’S TRADE WITH THE INDO-PACIFIC (2016)

Item	2016 (Cdn) Billions	2016 Per cent of totals
Merchandise exports to the Indo-Pacific:		
China	\$20	39%
Japan	\$11	20%
South Korea	\$ 4	8%
Other Indo-Pacific countries	\$17	33%
Total merchandise exports	\$52	80%
Services exports to the Indo-Pacific	\$13	20%
Total Exports of Goods and Services	\$65	
Merchandise trade with the Indo-Pacific:		
Exports	\$ 52	30%
Imports	\$121	70%
Total trade with the Indo-Pacific	\$173	
Maritime trade flows:		
Through South China Sea	\$ 27	16%
Through East China Sea/Pacific Ocean*	\$146	84%

Note: Table constructed from raw data sourced from Center for Strategic and International Studies, China Power project, 2017; Asia-Pacific Foundation of Canada.

*Estimated by subtracting Canada’s trade through the SCS from Canada’s total trade with the Indo-Pacific.

TRADE AND SECURITY POLICY IMPLICATIONS FOR CANADA

Trade and security recommendations

The security implications of Canada’s evolving trade relationship with the Indo-Pacific are sure to become more significant and intrude on the national discourse. Despite the fact that the centre of gravity of future political and economic power is shifting to the Indo-Pacific, Canada’s institutional memberships, security relationships and the resources that go with them remain skewed toward Europe and institutions such as NATO. This increases the risk of

Canada being blindsided by geopolitical, economic and diplomatic events that could negatively impact on trade flows and the relationships it is trying to build in the Indo-Pacific.

On the diplomatic security front, Canada should focus on making tangible commitments to ASEAN's political security community, which could also go a long way to assisting Canada in gaining membership in the 2019 East Asian Summit. It is likely that ASEAN and allies such as the U.S. will expect more robust security commitments as our trade and diplomatic engagement with the region increase. As great-power rivalry continues to build between the U.S. and China and regional tensions persist or worsen, Canada may well be compelled to take a stronger stand on traditional security issues in the region. If this is the case, it could affect Canada's overall relations with China. Nonetheless, Canada must demonstrate tangible support for the rule of law in solidarity with its allies and partners in line with Canada's foreign policy priorities.

Canada's contribution to traditional security in the Indo-Pacific does not correspond to the benefits it currently receives from the preservation of security in the region. These benefits include free and open sea lanes and relative peace and stability backed by the U.S. and its partners in the Indo-Pacific. The Trump administration is currently pressuring Canada to meet NATO's spending target of at least 2% of GDP on defence. Canada's chronic underspending on defence could be resolved by allocating additional hard-power resources to Indo-Pacific security in order to bring resource commitments in line with Canada's long-term trade, diplomatic and security interests in the region. Beyond soft-power and non-traditional security initiatives Canada should help secure the sea lanes that carry its goods to and from the Indo-Pacific as trade continues to grow, increase its participation in maritime exercises in the region in support of UNCLOS and reinforce the importance of adhering to international law and to demonstrating its support for freedom of navigation (FON) operations in a region of vital strategic importance to Canada. The forward deployment of a Canadian navy ship(s) in Asia would go a long way to demonstrating that regional security in the Indo-Pacific is also in Canada's interest.

Not the time for an FTA with China

Since China has now clearly stated that it will not negotiate on "non-trade related issues" (Canadian Press, 2018) that the Trudeau government has said should be part of a new Canada-China FTA, the Canadian government should put aside the pursuit of FTA negotiations with China for now. Short-term trade tensions with the U.S. over NAFTA should not drive Canada into hasty FTA negotiations with China. It is hard to see how authoritarian China's values have much in common with the government's progressive trade agenda as it now stands. China, through its ambassador to Canada, is making things even more difficult for the Canadian government by criticizing Canada's national security review process and stating that it is "immoral" for Canadians to be opposed to Chinese takeovers (Fife and Chase, 2018).

China is a big part of the Indo-Pacific economic success story but it's not the only part. India is an up-and-coming economic powerhouse; Canada and India share a common language and British parliamentary traditions. In the near term, Canada should take the opportunity to develop an action plan for taking full advantage of the CPTPP while strengthening economic and security ties with the 11 member countries as well as with India. The Canadian government claims that the CPTPP will strategically set the terms of trade in the Asia-Pacific region. If that is true, it potentially gives Canada leverage in future trade negotiations with a China that still maintains significant trade and investment barriers and support for state-owned enterprises.

Taking its time would also enable Canada to observe how trade-related conflict between China and the U.S. will play out, without antagonizing the U.S. by getting too chummy with China. It would be naive and presumptuous to think that having an FTA with China at this point would somehow enable Canada to blunt some of China's sharper edges. Only when the diplomatic and security environment is conducive should Canada re-engage with China on FTA discussions.

Energy security recommendations

Free and democratic societies such as Canada and the U.S., with a surplus of energy to export, can have a positive influence on global energy security. Our exports can replace imports from exporters in unstable regions (such as the Middle East) and from authoritarian exporter states (such as Russia), reducing their geopolitical leverage, keeping energy prices lower and lowering political risk for importers.

Canada should use its energy resources strategically to leverage trade agreements and our energy endowments to make broader gains. Canada's energy exports to the Indo-Pacific provide a number of benefits to the region, including reduced competition for resources and enhanced regional energy security.

Although Canada has almost no LNG or oil export capacity at the moment, it is not too early for Canada to propose an energy security and co-operation mechanism for CPTPP member states. Currently, there are no regional governance mechanisms equipped to accommodate greater co-operation on energy security. APEC has been unable to engage in any real joint action to enhance regional energy security despite pan-Asian energy co-operation discussions that have been ongoing for years but have added up to very little (Ravenhill, 2013). The CPTPP possibly provides a new vehicle for moving forward since members are not geopolitical rivals. Many, such as Japan and South Korea, are net energy importers and Canada can benefit from complementary supplier-buyer relationships. Building an energy co-operation mechanism within the CPTPP would likely attract new investment in helping build Canada's energy infrastructure while enhancing regional energy security and providing new markets for Canadian energy supplies.

Provinces could also potentially use their publicly owned oil and gas resources as tools of international trade policy in order to strengthen partnerships within the CPTPP and help enhance energy security in the Indo-Pacific. Although private sector energy firms extract and market most of Canada's oil and gas, Alberta in particular is able to take possession of oil-in-kind as an alternative to a cash royalty. If they wished to do so, Alberta and other provinces (with the federal government's support) could position themselves to strike deals with Asian governments and importers for guaranteed supplies of oil (or gas) as part of an energy co-operation agreement or strategic energy partnership. In this way, provinces may gain certain investment and/or trade benefits in exchange for guaranteeing long-term energy resource supplies.

The transformation in global energy markets amid geopolitical tensions is ushering in a new international order built around energy, climate and security. In the absence of effective regional security institutions that can help manage the transformation in the Indo-Pacific, the U.S. and China will continue to compete to take the lead on shaping this order. Canada has an opportunity to bring a unique perspective and approach to enhancing regional and energy security as long as it makes the investments at home in required infrastructure and export capacity. It must also commit the required resources to both traditional and non-traditional security initiatives that will help preserve peace and security in the Indo-Pacific.

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Dr. Kucharski holds a Doctor of Energy Science degree from Kyoto University, Japan (2016) and is currently an Associate Faculty member at Royal Roads University. His research interests include energy policy, energy trade, low-carbon transitions and the geopolitics of the international energy business. Dr. Kucharski also holds MBA (2001) and BCom (1981) degrees from the University of Alberta.

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ISSN

ISSN 2560-8312 The School of Public Policy Publications (Print)
ISSN 2560-8320 The School of Public Policy Publications (Online)

DATE OF ISSUE

July 2018

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