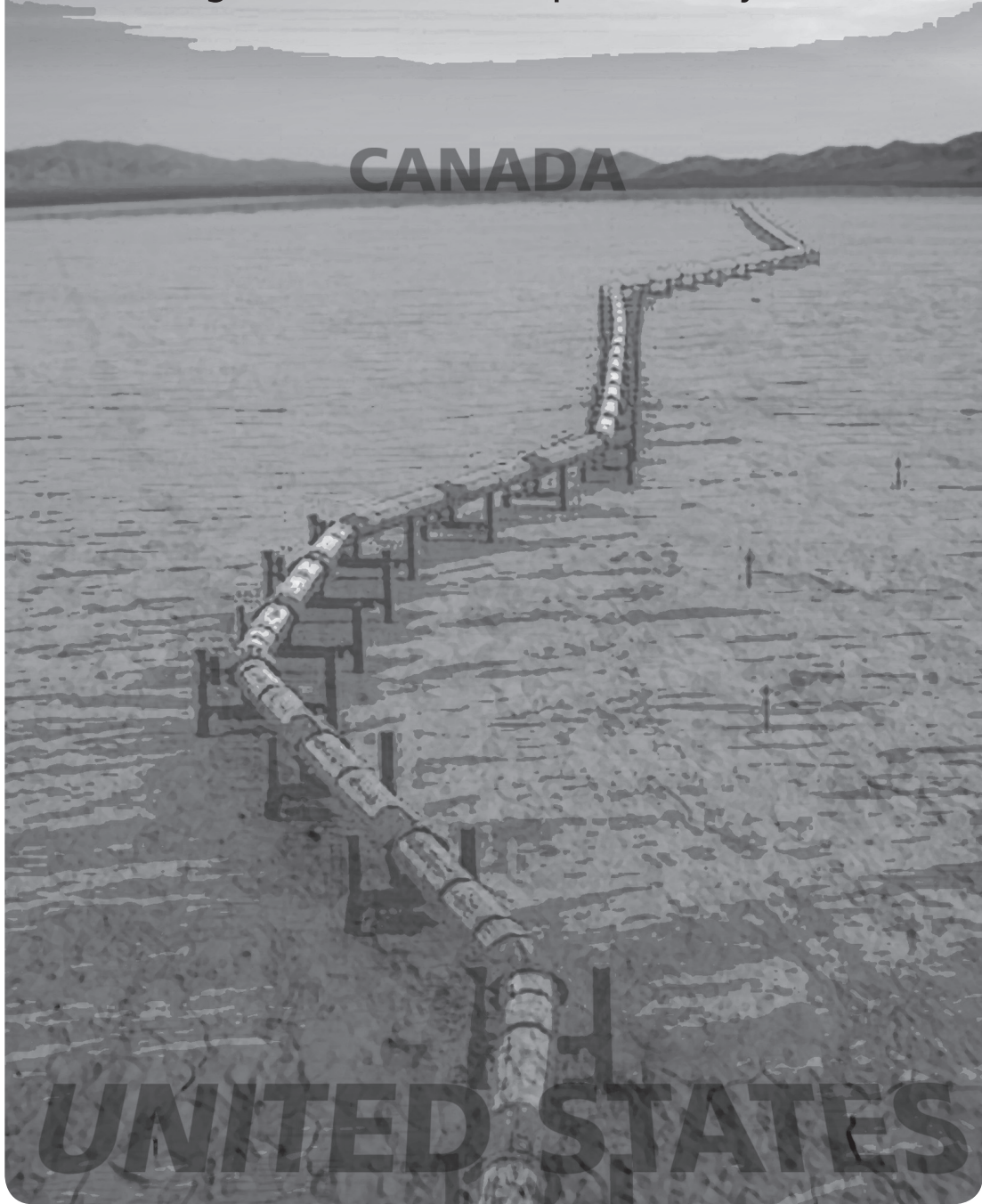
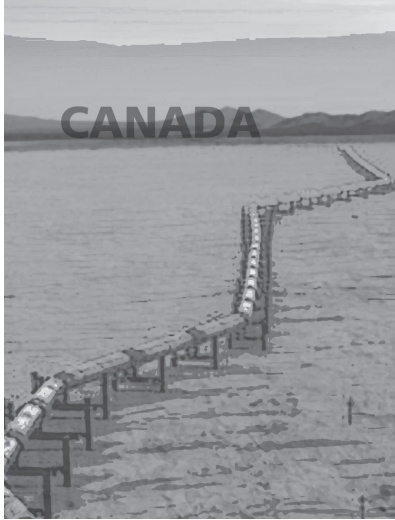


Over a Barrel:

Exiting from NAFTA's Proportionality Clause



by Gordon Laxer and John Dillon
Parkland Institute / CCPA • May 2008



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About the Parkland Institute

Parkland Institute is an Alberta research network that examines public policy issues. We are based in the Faculty of Arts at the University of Alberta and our research network includes members from most of Alberta's academic institutions as well as other organizations involved in public policy research. Parkland Institute was founded in 1996 and its mandate is to:

- conduct research on economic, social, cultural, and political issues facing Albertans and Canadians.
- publish research and provide informed comment on current policy issues to the media and the public.
- sponsor conferences and public forums on issues facing Albertans.
- bring together academic and non-academic communities.

All Parkland Institute reports are academically peer reviewed to ensure the integrity and accuracy of the research. For more information visit www.ualberta.ca/parkland.



About the Canadian Centre for Policy Alternatives

The Canadian Centre for Policy Alternatives is an independent, non-partisan policy research institute concerned with issues of social and economic justice, and environmental sustainability. Founded in 1980, the CCPA has the largest organizational and individual membership base of any think-tank in Canada. It is one of Canada's leading progressive voices in public policy debates. By combining solid research with extensive outreach, the Centre works to enrich democratic dialogue and ensure Canadians know there are workable solutions to the issues we face. The CCPA offers analysis and policy ideas to the media, general public, social justice and labour organizations, academia and government.

With its national office in Ottawa, and offices in Nova Scotia, Ontario, Manitoba, Saskatchewan, British Columbia, the CCPA addresses municipal, provincial, national and international issues. The CCPA is a registered charitable organization.

For more information about the CCPA, its programs and publications, visit our website at: www.policyalternatives.ca.

Parkland Institute Energy Security Research Program

This report is one of many issued from Parkland Institute's Energy Security Research Program. This program is a series of research papers addressing key energy challenges facing Canada in the coming decades. These papers provide both a political-economic analysis and policy recommendations for improving Canada's energy security.

The series was commenced with Parkland Institute's discussion paper, "Toward an Energy Security Strategy for Canada," published in December 2005. That paper introduced a range of long-term energy security issues.

"Fuelling Fortress America: A Report on the Athabasca Tar Sands and U.S. Demands for Canada's Energy," co-published with the Canadian Centre for Policy Alternatives and Polaris Institute in March 2006, examined the local costs of Alberta's tar sands developments, and critiqued the strategic support for exports to the U.S.

"Freezing in the Dark: Why Canada Needs Strategic Petroleum Reserves," published in January 2008, explored the need for Canada to develop strategic petroleum reserves – short-term stores of oil that can be released during supply shortages to meet regional needs. Eastern Canada is a net importer of oil, receiving up to 90 per cent of its oil from overseas, much of it from OPEC countries like Algeria, Iraq and Saudi Arabia. Eastern Canadians are vulnerable to global oil supply shocks, and strategic petroleum reserves would reduce that vulnerability and create a mechanism to insulate Canadians from price fluctuations.

The Energy Security Research Program complements a large number of other energy-related reports, all of which are available on the Parkland Institute website: www.ualberta.ca/parkland.

Executive Summary

Both conventional oil and gas have peaked in Canada. The nation is running out of natural gas. Yet Canada cannot stretch out dwindling stocks for Canadian needs by cutting exports. Instead, more than half of its gas has to be made available to the U.S. Canada could also be prevented from providing its own oil to its own citizens in an international oil shortage. The reason: the proportionality clause in NAFTA.

Proportionality is an obscure sounding clause which requires Canada to maintain its current share of energy exports to the United States, even if Canadians experience shortages. It effectively guarantees the U.S. access to Canada's energy resources in perpetuity, or until NAFTA and the FTA are renegotiated or ended, or the resources run out.

This clause is unique in all of the world's treaties. Even Canada's fellow NAFTA partner and major oil exporter, Mexico, is exempt.

This report starts off by looking at how NAFTA and the energy proportionality clause have been put back on the political agenda in Canada for the first time since the 1993 federal election. The report then explores several scenarios under which the proportionality clause could be invoked. These scenarios show how the clause could prevent Canada from:

- reducing exports to conserve oil,
- prioritizing natural gas for petrochemicals, or
- substituting Canadian oil for volatile foreign imports.

The report describes how NAFTA limits Canada's options for managing its energy future and recommends options for regaining Canadian energy security and sovereignty.

Putting NAFTA and Proportionality Back on the Table

The proportionality clause has been abruptly reawakened in a number of public debates. First, in the U.S. Democratic Party leadership race, Barrack Obama and Hillary Clinton called for renegotiating or ripping up NAFTA. Second, natural gas has peaked and is running out across Canada and in Alberta. In Alberta this has meant that the government is failing to enforce the 15-year rule meant to protect Alberta's supply. Third, debates surrounding liquid natural gas imports into Québec have focussed on the trade implications. Finally, tar sands and pipeline expansions are increasing exports, and thus increasing commitments under proportionality.

Running out of Natural Gas

Canada has only 9.3 years left of “proven” supplies of natural gas.

Yet Canada exports about 60% of its gas to the United States, a share that is locked in by NAFTA’s proportionality clause. After natural gas was deregulated in 1986, production doubled by 1999, but exports quadrupled. Production of natural gas peaked in Canada in 2002. During 13 out of the first 18 years after the FTA went into effect we have drawn down rather than increased reserves of natural gas.

There are only 8.07 years of established remaining reserves for Alberta.

Of course, potential reserves are higher than the level of established reserves. The Department of Energy estimates a further 51 tcf are “yet to be established.” But, given Alberta’s cold winters and the need to be cautious in planning for Albertans’ long-term future, it is best to count on established reserves only. Even Coalbed Methane can at best slow Alberta’s declining gas production. The EUB Report forecasts a decline in total gas production in Alberta by 2016, even with CBM.

Ironically Alberta does still have a supply safeguard, requiring a minimum of 15 years of proven supply before natural gas can be exported from the province. However, with just over eight years of proven reserves and falling, the government is failing to enforce its own law. No one has called the government to account for this. This report does so.

Compounding that short-sightedness is the burning of natural gas to extract oil from the tar sands, over 60% of which is exported to the U.S. This problem will increase exponentially as the tar sands expand from the current 1.2 million bpd to more than double that by 2016.

LNG in Québec reopens Proportionality Debate

Recent energy debates in Québec have centred on Québec’s vulnerability due to 90% of its oil coming from foreign imports. However, Québec’s proportionality debate broadened to include two planned, liquefied natural gas [LNG] terminals near Québec City. Concerns are that NAFTA’s proportionality clause would reduce energy security for Québec and Canada.

Currently, Québec gets all its gas from Western Canada. The LNG terminals would bring gas from Russia or other countries for use in Québec and for export to the U.S. Proponents are that this would increase the diversity of Québec’s sources of natural gas.

However, if Québec reduces its current purchases of natural gas from Western Canada because it is using imports, the Canadian gas Québec had formerly bought from the West will likely be sold in the United States. The resulting boost in Canada's natural gas exports would raise the proportion of total Canadian gas supply that is exported. This higher proportion would then be locked in by NAFTA as the share of total supply to which the United States would be entitled would rise.

Proportionality: Some Scenarios

To illustrate the probable effect of the proportionality clause, this report runs through three scenarios under which the clause might be invoked. This exercise shows how, under certain circumstances, proportionality could actually lead to energy shortages for Canadians.

First Scenario: Conservation

The need for a hydrocarbons conservation program is urgent and imperative given all the ecological and social costs of unrestricted, rapid development, particularly of the tar sands. Canada lags behind other countries in developing solar, wind, geothermal and other renewable alternatives. This calls into question the wisdom of exporting so much of our non-renewable hydrocarbon resources.

How would the proportionality clause affect a plan to achieve even a 10% reduction in oil production?

The application of the proportionality clause would require Canada to continue exporting 47.5% of total supply to the United States. **If Canada were to attempt a 10% cut in oil production while keeping domestic demand and imports at their average level over the years 2004 to 2006, there would be an eight million barrel annual shortfall in supplies available to meet domestic needs.** This is equivalent to about four days of domestic demand.

Second Scenario: Conserve Feedstock for Petrochemicals

As fossil fuels continue to run out, our goal should be to use remaining reserves for a socially and ecologically responsible transition to a post-petroleum economy with hydrocarbons prioritized for value-added applications such as lubricants, paints, fertilizers, nylon, medical equipment and plastics. Conserving natural gas feedstocks would be also save jobs in an important Canadian industry (it employs about 24,000 workers) that upgrades natural gas into higher, value-added products.

To this end this second scenario involves a decision to conserve natural gas as a feedstock for the petrochemical industry. As mentioned earlier, the Canadian natural gas supply situation is critical.

What would happen if 10% of natural gas production was set aside in order to ensure sufficient supplies for petrochemical feedstock at prices below the world price for liquefied natural gas (LNG)?

The proportion of total gas supply exported over the last three years for which data is available (2004 - 2006) is 51.5%. **Maintaining that ratio would result in a shortfall of 627 billion cubic feet for domestic needs or 66 days of average domestic demand.**

Third scenario: Import Substitution

Canadians need to debate the wisdom of relying on imports for half of our national consumption. Currently, Québec and Atlantic Canada rely on oil imports for 90% of their needs. OPEC countries now supply the largest portion of those imports.

Canadians need not rely on those imports. With a daily capacity of 240,000 barrels a day, Enbridge Line 9 can be reversed to ship oil east. The pipeline was reversed in 1999. It now brings foreign oil from Montréal westward to Sarnia. However, proportionality could restrict the Canadian government's ability to order this reversal. It is worthy of note that if Enbridge chose to reverse the pipeline for commercial reasons it would not run afoul of NAFTA's proportionality clause.

The report explores three options for substituting Canadian oil for those imports:

- Reversing the Sarnia to Montréal pipeline at its 240,000 barrels a day capacity (87.6 million barrels a year) to ship western crude to Montréal. This would bring the proportionality clause into play, but not result in a shortfall in overall supply available for Canadian needs. This would be the case even if the U.S. chose to import all 609 million barrels from Canada that would have to be made available to it under proportionality rules.
- Reversing the Sarnia to Montréal pipeline and redirecting Newfoundland's exports of 60.6 million barrels (in 2006) to domestic markets. Both measures would reduce imports by 148.2 million barrels. Since the U.S. would still be eligible to import 47.5% of Canada's total supply, it would be entitled to import 580 million barrels a year. If the U.S. took the full amount, Canada's shortfall would be 31 million barrels, or 17 days of domestic needs.

- Doubling the Montréal to Sarnia pipeline capacity to 175.2 million barrels a year. Canada's import dependence would fall from 49% of domestic demand to just 23% though this would take several years to implement. The U.S. would be entitled to import 46 million barrels more per year than would be available to meet Canada's domestic demand. Canada's shortfall would be 25 days of domestic demand.

NAFTA Investment Chapter Further Constrains Policy Choices

These scenarios look only at proportionality but it is worthy of note that NAFTA's Chapter 11 on investment also impinges on Canadian energy sovereignty. For example, it could prohibit provincial or federal governments from demanding that corporations upgrade natural gas or crude bitumen into petrochemicals or refined products in order to create jobs or capture the value added through local processing. The clause has been invoked a number of times already relating to energy policy in Canada.

Ending proportionality

Ending NAFTA would not automatically mean release from proportionality. The Canadian implementing legislation for NAFTA, known as Bill C-115, contains specific clauses designed to ensure that proportionality survives NAFTA's demise. This would need to be addressed as well.

Conclusions and Recommendations

Both conventional oil and gas have already peaked in Canada. Canada imports about 49% of its oil needs, with almost half its imports coming from very insecure sources – OPEC countries. Unlike all other IEA member countries, Canada has no Strategic Petroleum Reserves.

Meanwhile, Canada is obligated by NAFTA's proportionality clause to make two-thirds of its domestic oil production and 60% of its current natural gas production available for export to the U.S., even if Canadians experience shortages.

Most Canadians assume that Canadian energy supplies will be there when they need them. It hasn't dawned on most Canadians that their governments have signed away their right to have first access to their own energy supplies.

This report shows that NAFTA's proportionality clause stands in the way of Canada developing an effective energy security plan. Whatever the merits were of energy proportionality in 1988 and 1993, when the FTA and NAFTA were signed, energy proportionality is unduly restrictive for Canada now and it must go.

As the debate about NAFTA intensifies, Canadians must insist loudly and clearly that ending proportionality must be a non-negotiable priority. Canada should demand a Mexican-style exemption on proportionality. The timing to get this turned favourable after Barack Obama pledged in February to renegotiate NAFTA. If the Americans come to the table with their issues, the other parties can bring their own issues for renegotiation too. Getting out of proportionality must be Canada's number one goal in such talks. And we must be willing to, as Obama himself pledged, "use the hammer of a potential opt-out [of NAFTA] as leverage to ensure we actually get ..." what we demand.

I. Introduction

Canada could be prevented from providing its own oil to its own citizens in an international oil shortage. No other democratic and developed country is forbidden from guaranteeing its citizens access to their own resources. If there were an international supply disruption Canada would have to make two-thirds of daily oil production available for export to the U.S. and depend on insecure imported oil for Eastern Canadians.

Canada is running out of natural gas, yet Canada cannot stretch out dwindling stocks for Canadian needs by cutting exports because it has to make more than half of its gas available to the U.S.

Why does Canada have to offer so much of its energy for export even while its citizens shiver in the dark? Because proportionality, an obscure-sounding clause in the North American Free Trade Agreement (NAFTA), says we must. Proportionality is “unique in all of the world’s treaties,” writes Richard Heinberg (2008), a notable California author of books on energy. “Canada has every reason to repudiate the proportionality clause,” Heinberg continues, “and to do so unilaterally and immediately.”

If a Canadian government, federal or provincial, were to introduce measures to give Canadians first access to their own resources, NAFTA’s proportionality clause would require Canada, and Canada alone, to maintain its current share of energy exports to the United States, even if Canadians experience shortages. U.S. negotiators of the Canada-U.S. Free Trade Agreement (FTA 1989) insisted Canada agree to proportionality to prohibit Canada from ever again reducing oil exports to the U.S., as Canada did in 1975 in response to threats of energy shortages in Eastern Canada. When NAFTA superseded the FTA in 1994, the proportionality clause was retained.

Mexico, like Canada, is a member of NAFTA and a major oil exporter, but Mexico refused to sign on to proportionality. It was unwilling to lose sovereignty over energy.

1 The Mexican exemption also exempts the U.S. from having to make its natural gas available for exports to Mexico. Thanks to Larry Hughes for making this point. The U.S. imported 8.32 million barrels of oil per day in 2005 and exported 1.05 million b/day in 2004. The U.S. produced 490.1 billion cu ft of natural gas in 2005 and exported 19.8 b cu ft. that year (CIA, 2008). Thanks to Ryan Katz-Rozene for getting this information.

Proportionality prohibits Canada from lowering the share of its total export shipments in specific energy goods relative to its total supply in the most recent three-year period (NAFTA, article 605). Proportionality does not apply to all NAFTA countries. Mexico is exempt, which also lets the United States off the hook from exporting natural gas to Mexico.¹ So, proportionality is de facto a Canadian obligation.

Getting proportionality was the major coup of the Free Trade Agreement for U.S. negotiators. Proportionality means the U.S. has guaranteed access to Canada's energy resources in perpetuity, or until NAFTA and the FTA are renegotiated or ended, or the resources run out.

Reacting to the shock of learning it was so dependent on Middle East oil in the 1970s, the U.S. first tried to assure itself of access to overseas oil in the event of an emergency by creating the International Energy Agency. The IEA's Emergency Sharing System requires members to share oil supplies in the event of major shortages, defined as a 7% cut in international supplies. As a net exporter, Canada is obliged to share supplies, while as a net importer the U.S. would have access to other countries' stocks.

The IEA's system has never been tested fully. After Hurricane Katrina, which cut international oil supplies by much less than the 7% trigger level, the Europeans and Canadians supplied the U.S. with oil products for 60 days.² However, it was not a general sharing amongst net exporting and net importing members. It is unclear whether all members would comply with their obligations during an emergency, since the IEA has no enforcement mechanism, unlike Free Trade Agreements, where failure to comply can lead to trade sanctions. With the FTA and NAFTA, the U.S. won greater assurance of supplies of oil and natural gas from Canada. As the director for international trade for the U.S. National Association of Manufacturers told author Linda McQuaig (1991: 173) about the FTA, "When we got such a great deal on energy we were crusaders for the deal."

After a brief background on the evolution of NAFTA and the proportionality clause, this report starts off by looking at how NAFTA and the energy proportionality clause have been put back on the political agenda in Canada for the first time since the 1993 federal election. In February and March 2008, Democratic Party candidates Barrack Obama and Hillary Clinton declared their intentions to renegotiate NAFTA or abandon it. At the same time, debates around the supply of natural gas were taking place in Alberta and Québec. Natural gas supplies are running out in Alberta, and there is not enough proven supply to meet the province's rule which guarantees Albertans 15 years of supply before exports. No one has called the government to account for not upholding this law. This report does so.

2 Larry Hughes correspondence.

After discussing current energy and environmental debates in Canada, this report explores several scenarios under which the proportionality clause could be invoked. The report also examines how NAFTA's Investment Chapter prevents the federal and provincial governments from using crown-owned natural resources to foster employment and local research and development initiatives. Finally, the report describes how NAFTA limits Canada's options for managing its energy future and recommends options for regaining Canadian energy security and sovereignty.

Energy Superpower or Satellite?

When Prime Minister Harper refers to Canada is an “energy superpower,” it is clear he hasn't consulted a dictionary. Superpowers influence events by projecting economic, military, political and cultural power on a world scale (Miller, 2008). Proportionality makes Canada more like an energy colony. A colony or satellite is a people who lose control of their resources to a foreign power. When you cannot safeguard your citizens against freezing in the dark, nor control how much you export, nor set the price at which citizens buy back their own energy from foreign transnational corporations, you know you are not a superpower. Instead, Canadian energy policies are geared toward ensuring U.S. energy security.

U.S. preoccupation with getting assured access to Canadian energy goes back to at least 1952, when the Paley Report identified Canada as the most secure source for many kinds of raw materials needed by America's military economy. The U.S. offered generous tax incentives to encourage its oil companies to invest in Canada. Each dollar invested in Canada cost U.S. companies only 18 cents. Furthermore, “any losses in exploration and development could be written off against profits made at home” (Crane, 1982: 182).

In 1970, U.S. Labour Secretary George P. Shultz wrote a report that warned about oil exporting countries banding together. He recommended the U.S. seek “safe” sources of supply from Canada, saying, “The risk of political instability or animosity is generally conceded to be very low in Canada” (Clarkson, 1985: 59). Canadian Energy Minister Joe Greene was not only receptive to giving the U.S. the right to access Canada's energy resources, but criticized U.S. quotas limiting oil imports from Canada.

After an oil embargo was directed against the U.S. and the Netherlands by the Arab member countries of OPEC, U.S. Secretary of State Henry Kissinger persuaded other industrial countries to sign an oil-sharing pact. The 1974 International Energy Agreement requires member countries to share available oil supplies if international oil supplies fall by 7% or more³ (IEA, 2001: 9). The requirement has never been invoked.

Despite setting up such precautions, the U.S. has become more and more vulnerable to cuts in oil imports, because of its incredibly wasteful use of oil. The U.S. has 4.6% of the world's people,⁴ produces 10% of the world's oil and consumes 24% of it.⁵ If the U.S. implemented the goal Jimmy Carter set 31 years ago of the U.S. living off its own energy resources to attain independence, the average American would still have access to more than double the world's per capita level of oil consumption. Since the IEA was established, U.S. imports of petroleum have risen from 39.2% of consumption to almost 72.3% in 2005.⁶

To look into U.S. energy insecurity, George W. Bush appointed Vice-President Dick Cheney to lead a task force to develop a National Energy Policy (NEP). The task force noted that "Estimates of Canada's recoverable heavy oil reserves are substantial ... Their continued development can be a pillar of sustainable North American energy and economic security" (US NEPDG, 2001).

A year later, Bush's National Security Strategy asserted the right of the U.S. to take pre-emptive military action to forestall perceived threats to U.S. security. It declared that "We will strengthen our own energy security ... by expanding the sources and types of global energy supplied, especially in the Western hemisphere, Africa, Central Asia and the Caspian region" (Bush, 2002: 19-20).

The initiative to push for closer continental integration accelerated after the 9/11 terrorist attacks against New York and Washington, when transnational corporations straddling both sides of the Canada-U.S. frontier found their shipments stopped at the border. Corporate elites outlined a plan that would see Canada adopt what the U.S. government broadly conceives as its security agenda in return for the U.S. not blocking exports from Canada.

The Security and Prosperity Partnership (SPP) was formally initiated by Presidents George W. Bush and Vicente Fox and Prime Minister Paul Martin in Waco, Texas in March 2005. It gives a high priority

3 Member countries' full response includes "stockdraw, demand restraint, fuel-switching, and surge oil production."

4 U.S. Census Bureau. 'U.S. and World Population Clocks'. The U.S. had 303.76 million people in a world population of 6.659 billion. <http://www.census.gov/main/www/popclock.html>. Accessed 2Apr 08.

5 U.S. Energy Information Administration, 'International Petroleum' U.S. oil production averaged 8.48 million barrels per day in 2007. Total world supply was 84.64 million b/day. U.S. consumption averaged 20.7 million b/day in the third quarter of 2007, compared to 85.25 m b/day. Oil is defined by the EIA as crude oil (including lease condensate) natural gas plant liquids, and other liquids and refinery processing gains and losses. <http://www.eia.doe.gov/emeu/ipsr/t21.xls>. Accessed 2Apr 08.

6 These calculations are derived from two tables. Table 1.1 Energy Overview, 1949-2006 of the EIA [The U.S. Energy Information Agency] and Table 1.2 Energy Consumption by Source, 1973-2005, of the EIA. Both tables use quadrillion Btu as the unit of analysis. In 1974, when the IEA was created the U.S. imported 13.127 quadrillion Btu and consumed 33.45 quadrillion Btu. In 2005, the U.S. imported 29.259 quadrillion Btu and consumed 40.44 quadrillion Btu. <http://www.eia.doe.gov/emeu/aer/txt/ptb0101.html>. Accessed 1May 08. Petroleum includes crude oil and petroleum products. Thanks to Ryan Katz-Rosene for getting me these tables.

to energy integration. Beneath a thin veneer of talk about “North American” energy security, the real purpose of the SPP’s energy agenda is to mobilize Mexican and Canadian energy resources to enhance U.S. energy security. The North American Energy Working Group is one of the most active SPP sub-committees. An SPP-sponsored workshop on the tar sands held in Houston in January 2006 envisioned a five-fold increase in tar sands production to five million barrels a day by 2030, with most of the increased production exported to the U.S.

President Bush’s January 2006 State of the Union address contained his now-famous remark that “America is addicted to oil which is often imported from unstable parts of the world.” He pledged to replace “more than 75% of our oil imports from the Middle East by 2025”⁷ (Bush 2006A).

Bush’s policy promotes diversifying sources more than it promotes a continental energy strategy. While the U.S. expects to import more tar sands crude, it does not expect Canada to be its principal supplier of all types of hydrocarbons. This is particularly true of Canada’s natural gas, whose supplies are in steep decline. In July 2003, Federal Reserve Board chairman Alan Greenspan told the U.S. Senate Committee on Energy and Natural Resources that Canada had little capacity “to significantly expand its [gas] exports, in part because of the role that Canadian gas plays in supporting growing oil production from tar sands” (Pratt 2007: 466). Greenspan concluded that the U.S. had to increase imports of Liquefied Natural Gas (LNG) from overseas.

Larry Pratt cautions Canadians not to assume that Canada will remain the number one petroleum supplier to the U.S. Pratt argues that “exports of Canadian [natural] gas will decline, and the United States has many sources for its oil imports. It has the potential to become an LNG buyer on a large scale; and above all it has global interests that rule out an energy security strategy” uniquely focused on imports from Canada (Pratt, 2007: 478). Pratt notes that U.S. national security policy envisions importing oil and gas from 10 to 15 different suppliers outside of the Middle East, including West Africa and South America. However, Canada offers better security than all of them, even if costs are higher.⁸

7 The Persian Gulf supplies the U.S. with about 15% of its oil products. Bush’s pledge, if implemented, would drop Persian Gulf imports to about 4%. Larry Hughes’ correspondence.

8 Larry Hughes’ correspondence.

Proportionality: A Little History

After being intensely debated in the Free Trade election of 1988, the proportionality clause roused little attention. The 1980s and 1990s era of free trade was a lull before the current storms around energy and the environment. It was a period of energy glut, low oil and natural gas prices, and endless talk about a borderless world. Canada's problem appeared to corporate elites to be the opposite of energy sovereignty: how could "excess" western oil and gas find assured entry to the U.S. market? Based on that thinking, Canada agreed to the energy proportionality clause in the Free Trade Agreement and NAFTA.

Petroleum corporations and western provincial governments won their quest to get assured access for Canadian energy to U.S. markets in the proportionality clause. It is notable that the FTA and NAFTA prohibited U.S. restrictions on Canadian energy exports, while they failed to do so for other Canadian goods, such as softwood lumber. Thus, the severe limits the proportionality clause placed on Canadian energy sovereignty were generally overlooked.

There was an exception to a lack of interest in the 1993 federal election, which marked the end of the Mulroney Conservative era and the beginning of Jean Chrétien's 11-year reign. The Liberals won a majority and the Progressive Conservative Party was decimated, never to recover as "Progressive" Conservatives. The pro-Free Trade Conservatives fell from a majority government with 169 seats in 1988 to two seats in 1993. There were many reasons for the Progressive Conservatives' historic meltdown, which we do not have space to explore here (Plamondon, 2006).

The 1993 election was the Liberal Party's first time to the polls following their fierce opposition to the FTA in 1988. Naturally, they were wary of unreservedly endorsing the successor deal Brian Mulroney had recently concluded on NAFTA, bringing Mexico in and strengthening corporate rights. In their "Red Book" election platform, the Liberals stated that "A Liberal government will renegotiate both the FTA and NAFTA to obtain: a subsidies code; an anti-dumping code; a more effective dispute resolution mechanism; and **the same energy protection as Mexico**. Abrogation of trade agreements should be only a last resort if satisfactory changes cannot be negotiated" (Liberal Party of Canada, 1993. Emphasis added). Winning "the same energy protection as Mexico" could only mean one thing – escaping from the proportional sharing clause.⁹

⁹ The Mexican exemption is found in Annex 605 to Chapter Six of NAFTA.

The Liberals won a majority mandate in October 1993, two months before NAFTA was to enter into effect on January 1, 1994. Chrétien pledged not to sign NAFTA into force unless he got changes to energy, water and U.S. protectionist trade remedy actions.¹⁰ Only what happened on energy is relevant to this report. Having just received a strong mandate to change NAFTA, the Chrétien government approached U.S. authorities, but was summarily rebuffed.

President Bill Clinton made it clear he would not re-open NAFTA, especially on energy. “We will not weaken or renegotiate any energy provisions of the FTA or the NAFTA. Specifically, we will not allow the Canadians to opt out of the ‘proportionality clause,’” a leaked letter from Clinton to Congressman Edward Markey stated.¹¹ Rather than push back against U.S. resistance, the Chrétien government broke its election promises to Canadian citizens. To save face in backing down, the Canadian government issued an “interpretation”¹² of NAFTA pertaining to energy exports. The interpretation brought moral force to Canada’s declaration to “maximize energy security for Canadians” and could prove useful for future governments to dust off in the event of an energy shortage.

Don McRae has argued that Canada could feasibly maintain that the declaration on energy security is legitimate, given that it was made clear prior to the proclamation of NAFTA that the declaration is “an indication of what the government intends to do if a dispute issue arises under the agreement ... Whether the U.S. immediately disagrees, lets it rest without any comment or whether it seems to act in accordance with that interpretation, these are all things that a tribunal or a court or a panel might take into account.” He also noted that these types of statements carry greater weight if they remain uncontradicted over time. The lack of American protest to Chrétien’s declaration could be interpreted as the tacit approval of the U.S. administration for the Canadian interpretation.¹³

However, other experts doubted that Canada’s interpretation would stand up in a NAFTA dispute-resolution tribunal.¹⁴ The U.S. trade representative, Mickey Kantor, bluntly declared, “None of these statements change the NAFTA in any way.”¹⁵

10 Canada’s main objections were the U.S. government’s undiminished ability to use countervail, anti-dumping and subsidies to block Canadian exports.

11 The letter was leaked to the Council of Canadians. See “PM warned to keep vow on changing trade pact”, *Toronto Star*, November 20, 1993. Thanks to Erin Krekoski for her excellent research on the 1993 federal election.

12 “The Declaration on Energy”, *Edmonton Journal*, December 3, 1993.

13 McRae currently holds the Hyman Solway Chair in Business and Trade Law at the University of Ottawa, and is on the roster of panellists under Chapter 19 of NAFTA and on the Indicative List of Panelists of the World Trade Organization (David Vienneau, ‘PM’s gamble over energy may just work, experts say’. *Toronto Star*. Dec 3, 1993. A.27). Thanks to Erin Krekoski for excellent research on the 1993 election.

14 “Grits OK NAFTA, but no energy deal”, *Times-Colonist*, December 3, 1993.

15 Cited in the *Financial Post* Dec. 3, 1993, page 3.

II. Putting NAFTA and Proportionality Back on the Table

After the brief flurry on proportionality in 1993, the issue went to sleep for 15 years. It was abruptly reawakened by two things. First, in the midst of their hotly contested race for the Democratic Party presidential nomination Barack Obama and Hillary Clinton called in February and March 2008 for renegotiating or ripping up NAFTA. The political storm around this issue on both sides of the border brought the first opening that Canada could soon be released from the straitjacket of proportionality. Second, this political opening is likely to be sustained by deeper trends including the emerging challenges of the “triple crisis” of climate change, the end of the era of cheap fossil fuels and Canadians’ slow realization of the implications of “security trumping trade” after 9/11. We first look at the political opening and then the triple crisis.

a. Obama and Clinton Promise to Renegotiate NAFTA

In the past, whenever Canadians advocated renegotiating or ending NAFTA they were dismissed for raising a hypothetical issue. In Canada, NAFTA was widely seen as a done deal. But, Barack Obama and Hillary Clinton put NAFTA back on the political agenda in the Ohio primary when they pledged to renegotiate the agreement to bring in tougher environmental and labour standards.¹⁶ To show she was serious, Hillary Clinton added that “we will opt out [of NAFTA] unless we renegotiate the core labor and environmental standards – not side agreements, but core agreements.” To outdo his opponent, Barack Obama declared that “we should use the hammer of a potential opt-out as leverage to ensure we actually get labor and environmental standards that are enforced” (Tasini, 2008).

What had been a fairly minor American story became much louder as it reverberated back and forth across the border. Canadian officials were seen to be interfering in a U.S. presidential election. Then the Harper government added energy to the NAFTA issues on the table, unintentionally giving Canadian critics an opportunity to re-open the proportionality debate. In late February Trade Minister David Emerson loudly pointed to the U.S.’s unique access to Canadian oil and natural gas as a reason why they should be wary about reopening NAFTA (Chase, 2008). At the same time, Emerson initiated consultations with provincial governments concerning what Canada’s priorities should be if renegotiations do take place.

¹⁶ Both candidates also said they would take a look at Chapter 11, which gives investors the right to sue governments over actions which could hurt their profits.

A leaked memo from the Canadian consulate in Chicago was widely reported on both sides of the border. Austan Goolsbee, a senior economic advisor to Obama, was described as saying that much of Obama's rhetoric on trade may seem protectionist but "is more reflective of political manoeuvring than policy." Goolsbee adamantly denied having used that phrase in that way (Factcheck, 2008). Whether Goolsbee was misquoted or not, the story was said to have damaged Obama's credibility in the Ohio primary, which Clinton won handily.

There was speculation that Harper's government had been trying to help their Republican allies by hurting Democratic Party candidates. Whether the leak was deliberate or not, Canada's actions likely helped stiffen resolve within Democratic Party ranks to renegotiate NAFTA. The latter is anathema to the Conservative Party's continentalist agenda.

Chris Sands, senior associate of the Canada Project at CSIS (Center for Strategic and International Studies in Washington D.C.), stated that Obama's initial comments were open to interpretation, "but once [the candidates] are playing defence, they just make these commitments and the public will hold them to them." Mr. Sands believes that "the farther Obama goes trying to show, now that his credibility has been questioned, that he's prepared to be tough, the worse it is ... he's going to have to do something [about NAFTA]" (Berthiaume and Davis, 2008).

The Conservative government's reply to Obama's statements amplified the debate and added energy to the issues about labour and environment standards which the Democratic Party leaders put on the table. Canadian Trade Minister David Emerson warned that "If you open it [NAFTA] for one or two issues, you cannot avoid reopening it across a range of issues" (Greenaway, 2008). He added that "Americans' privileged access to Canada's massive oil and gas reserves could be disrupted if Washington cancels the NAFTA accord as Democratic presidential candidates threaten" (Chase, 2008). Prime Minister Stephen Harper made a similar subtle threat at the Security and Prosperity Summit in New Orleans in April 2008 (Delacourt, 2008).

By saying that the U.S. has a sweet deal with Canada on energy, Canadian officials raise the question of whether Canada got a raw deal. By trying to browbeat American politicians into not reopening NAFTA the Conservatives are putting renegotiating NAFTA's energy clauses right where they should be – on Canada's current agenda. This is good because there are substantive new reasons for revisiting it.

b. Running out of Natural Gas in Alberta

Albertans do not share Eastern Canadians' concerns about running out of oil any time soon. Estimated at 174 billion barrels of recoverable oil, the tar sands hold the second largest official reserves in the world. If daily production quadruples to five million barrels per day, they could still keep going for about a century,¹⁷ as long as water and natural gas shortages and environmental regulations do not stop or slow them. Tar sands mines consume three to four barrels of water to produce just one barrel of bitumen. Planned expansions threaten to become unsustainable "because the Athabasca River does not have sufficient flows" according to Natural Resources Canada (Nikiforuk, 2008: 48). But there is no danger Alberta will soon run short of oil; the major issues are at what financial and environmental cost it will continue to be extracted.

Natural gas is another matter, as Alberta is running short. A Mackenzie Valley pipeline, which is proposed to bring natural gas from the Arctic to the tar sands, is running into a series of road blocks – financial, regulatory and environmental – and from unsettled Native land claims.

Alberta is running short of natural gas partly because of its role in heating and supplying hydrogen to produce oil from the tar sands. The Steam Assisted Gravity Drainage (SAGD) production technique for extracting bitumen uses about a thousand cubic feet of natural gas to inject steam underground to extract a barrel of bitumen and another 500 cubic feet of gas to upgrade it into synthetic oil. This is a foolish way to use Canada's remaining supplies of natural gas, the least dirty of the fossil fuels. Jim Dinning, former Alberta treasurer, noted that "injecting natural gas into the oil sands to produce oil is like turning gold into lead" (Eaton, 2004).

Alternatives to natural gas are being explored, and while the jury is still out on their long-term viability, they show some promise. The first is the THAI process (Toe-to-Heel Air Injection). Whitesands In Situ Ltd. is conducting the first field pilot project at Christina Lake,

17 If the tar sands have 174 billion barrels of oil, it would take 95 years to deplete all of it, at a production rate of 5 million barrels per day.

Alberta. The second is the OPTI-Nexen coke gasification process at Long Lake Alberta, where asphaltene residue is used to produce virtually all of the fuel gas required, as well as hydrogen to feed the hydrocracker. The NEB is counting on both processes to cut gas consumption after 2015.¹⁸

The NEB in its reference case puts tar sands gas use at 20% of domestic consumption by 2015. Ultimately though, writes Andrew Nikiforuk (2008: 50), "SAGD could consume the equivalent of the entire gas supply of Western Canada."

Compounding that short-sightedness is that the drive for rising tar sands output is to feed the U.S.'s insatiable demand for oil. Three-quarters of tar sands oil is exported to the U.S., and Canada exports about 60% of its natural gas to the United States, a share that is locked in by NAFTA's proportionality clause.

Meanwhile, Canada has only 9.3 years left of "proven" reserves of natural gas at present rates of consumption (Hughes, 2008). David Hughes estimates that Canada has a further five years of possible resources and 45 years of undiscovered resources that are thought to exist from statistical analysis of discovery histories, geology and pool size distributions.

After natural gas was deregulated in 1986, production doubled by 1999, but exports quadrupled (see Figure 1 on page 31). Production of natural gas peaked in Canada in 2002. By 2004, the tar sands consumed about 4% of Canada's natural gas production. This is expected to rise 2.54 times¹⁹ when oil production from the tar sands reaches 3.1 to 3.2 million barrels per day by 2018, from its current level of about 1.2 million bpd (Hughes, 2008).

Alberta is relying on coalbed methane (CBM) to partially offset a forecast decline in the production of conventional natural gas of 2.5% per year. But, besides being a very environmentally destructive source of energy, CBM can at best slow Alberta's declining natural gas production. In 2006, CBM supplied 3% of Alberta's natural gas production. This is expected to rise to only 13% by 2016. The EUB Report forecasts a decline in total gas production in Alberta by 2016, even with CBM (EUB, 2007: 5-25, 4-8). The total supply of CBM is uncertain.

18 Dave Hughes' correspondence, 14 May, 2008.

19 The EUB's Report 'Alberta's Energy Reserves 2006 and Supply/Demand Outlook 2007-2016', forcecasts a 2.54 fold rise in natural gas use in the oil sands between 2006 and 2016 (5-30).

In 2007, Swedish researchers published a comprehensive study of the tar sands (Söderbergh et al, 2007: 1940). They concluded that in the near future “Canada’s supply of natural gas cannot any longer simultaneously meet the demand from the oil sands industry and the U.S.” That is true, but it leaves out the most important consumers of Canadian natural gas – Canadians to use to heat their homes, and Canadian – based industries for use in production.

The proportionality clause is a double impediment to Alberta and Canada conserving remaining supplies of natural gas. According to the latest available data, shown in Table 2 on page 32, if the proportionality provisions were applied today, the U.S. would be entitled to import 8.2 billion cubic feet of natural gas per day. If proportional sharing of oil supplies were also invoked, the U.S. would, in effect, import further amounts of Canadian natural gas indirectly since it is used to wring synthetic oil out of the tar sands.

Recklessly exporting so much natural gas runs against Alberta’s long-standing tradition of ensuring that Albertans receive it first and foremost. Access to natural gas has been seen as a birthright of Albertans in a way that oil has not. John Richards and Larry Pratt (1979: 62) wrote that “No development issue was so contentious, so loaded with potential friction, in post-Leduc Alberta as the question of exporting gas from the province.” In 1949, the *Edmonton Journal*, for instance, declared that “Alberta ... reserves the right to cut off gas exports in the event of any temporary emergency affecting this province’s users of natural gas” (63). Under such popular pressure, the Social Credit government mandated in 1951 that Alberta retain 30 years of supply of natural gas before the latter could be sent to other Canadians. Only after the needs of the rest of Canada were met could any be exported to the U.S. (Richards and Pratt, 1979: 63-4). Those are the right priorities – Alberta first, other Canadians second and exports third.

Alberta’s policy of reserving natural gas for Albertans, dovetailed well with the federal government’s 1959 Canada-first policy of reserving 25 years of “proven” supply before the National Energy Board could issue long-term permits to export gas.²⁰ These policies continued until the Mulroney government relaxed the enforcement of the 25-year rule without actually amending the NEB Act. Mulroney first reduced the 25-year surplus test to 15 years of supply and then effectively eliminated it. The 1989 Canada-U.S. Free Trade Agreement replaced the Canada-first policy with a U.S.-first priority. As a result, Canada

20 In 1959, this rule was brought in when the National Energy Board was created.

must make 60% of its natural gas available for the U.S., rather than guaranteeing long-term supplies of natural gas for Canadians.

It was little noticed that Alberta did not fully follow suit. It cut its 30-year rule in half, but mandated that Albertans must have 15 years of supply before gas can be removed from the province, to safeguard Albertans' birthright. The 2007 report "Alberta's Energy Reserves" explained Alberta's legislation this way:

The Alberta Gas Resources Preservation Act (first proclaimed in 1949) provides supply security for consumers in Alberta by "setting aside" large volumes of gas for their use before gas removals from the province are permitted. The act requires that when a company proposes to remove gas from Alberta, it must apply to the EUB for a permit authorizing the removal. **Exports of gas from Alberta are only permitted if the gas to be removed is surplus to the needs of Alberta's core consumers for the next 15 years** [emphasis added].

Alberta Fails to Apply 15-Year Rule

The EUB [now the Energy Resources Conservation Board, or ERCB] "reviews projected demand for Alberta's natural gas periodically" and calculates whether Alberta has surplus natural gas to Alberta's requirements [EUB, 2007: 5-28 to 5-33]. But although it restates Alberta's 15-year rule and then immediately makes calculations of gas available for permits, it fails to apply the 15-year rule. Instead the report obfuscates matters. It divides natural gas into core and non-core markets, which it doesn't define as being Alberta or non-Alberta. It then applies only a five-year supply rule to the non-core markets. If it applied 15 years to the latter, it would more than wipe out the 8.6 Tcf it is making available for permits [5-29].

As the analysis below shows, the EUB Report is violating the intent and spirit of Alberta's Resources Preservation legislation. At current production levels Alberta now has about eight years of remaining established reserves of natural gas (including coalbed methane²¹). No one has called the government to account for not upholding this law. This report does so.

21 "Undiscovered resources" are likely to boost this level. Very little CBM has been booked as "proven" but likely exists. Dave Hughes' correspondence 14 May, 2008.

Alberta requires licences to remove natural gas from the province to send to other provinces or for export. The ERCB issues short-term permits which allow shippers to get around the 15-year supply test. Long-term permits, though, are supposed to require that shippers

demonstrate that exports are surplus to a 15-year supply for Albertans. Short-term permits account for 37% of natural gas sent out of Alberta and long-term permits account for 63% [5-29]. But, although the Gas Resources Preservation Act allows for hearings, there have been no proceedings on an export for over a decade.²²

In a report for the CD Howe Institute, Paul G. Bradley and G. Campbell Watkins (2003) observed that “Should conventional supply [of natural gas] in Alberta start to dwindle without [being] offset by development of coal-bed methane or tight gas, the province’s removal-permit restrictions could bite.” They note that if Alberta enforced its 15-year rule, the U.S. might invoke NAFTA’s proportionality provisions. NAFTA provisions override regulations established by lower-level jurisdictions like provinces or municipalities. The outcome of such a proportionality challenge is “obscure,” the authors conclude, presumably because it has never been tested (11). The big questions are whether Alberta will enforce the 15-year rule or obfuscate its responsibilities to Albertans by replacing the arithmetic test of whether 15 years of supply for the province is guaranteed, by the “market-based” test.²³ The latter will not ensure that all Albertans will have the natural gas to heat their homes through cold winters.

Stocks of natural gas (including coalbed methane) in Alberta have already fallen well below the 15 year mark. In 2006, Alberta’s Department of Energy pegged “remaining established reserves” at 41 trillion cubic feet (Tcf), while annual production was 5.081 Tcf (Alberta, 2008). That means there are only **8.07 years** of established remaining reserves for Alberta. Of course, potential reserves are higher than the level of established reserves. The Department of Energy estimates a further 51 Tcf are “yet to be established.”

But, given Alberta’s cold winters and the need to be cautious in planning for Albertans’ long-term future, it is best to count on established reserves only. It is telling that of the 223 Tcf ultimate recoverable only 92 Tcf are left. What is left of the undiscovered potential is in much smaller and more numerous pools, which will take a lot more effort to recover, as David Hughes has shown. Because of the law of diminishing returns, expected flows from the remaining undiscovered gas can be expected to fall for the foreseeable future.²⁴

It would be very imprudent to expand the definition of remaining established reserves to include ultimate potential. The province’s definition of “remaining established reserves” is sufficiently loose, in that it already includes quantities that are only “interpreted” to exist

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- 22** Correspondence from Angela Burns, Leader, Library & Record Services, Energy Resources Conservation Board. 28 Mar 08.
- 23** An arithmetic test calculates remaining reserves by dividing by the most recent year’s production: e.g. 41 Tcf reserves divided by 5.081 Tcf 2006 production = 8.07 years of remaining reserves. Market-based procedures (MBPs) allow exports that would not be allowed under an arithmetic test:
- a. Under a complaints procedure, domestic buyers could in theory intervene by bidding for the same supplies that have been contracted for exports. In practice the absence of these bids is taken to mean that no Canadian buyer wants this gas, so it must be surplus to Canadian requirements.
 - b. For long-term licenses, the licensee has to inform potential Canadian buyers. If no Canadian buyer shows interest normally the license will be granted. Do not expect private companies to ensure security of supply for Albertans. That is the role of governments.
 - c. For short-term (less than 2 years) export contracts for example, the NEB does not look to long-term Canadian needs but applies a simple “market test” as to whether the supply is available for export. For Canada’s exports of natural under short-term contracts the complaints procedure does not even apply.
- 24** Correspondence from David Hughes. May 7, 2008.

“with reasonable certainty,” rather than proven reserves.²⁵ To get Alberta back to at least 15 years of “established” supply, Alberta would have to quickly phase out natural gas exports to the U.S. and the use of natural gas to produce tar sands oil. The latter, as we have seen, in effect indirectly exports natural gas to the U.S.

In 2006, Alberta consumed 1.422 Tcf of natural gas (including coalbed methane) (Alberta, 2007). Those numbers included the questionable use of natural gas to produce oil from the tar sands. Natural gas removed to the rest of Canada totalled 1.169 Tcf in 2006. Ending Alberta’s exports of 2.490 Tcf of gas [2006] to the U.S. would double the life of Alberta’s established reserves to 15.82 years.²⁶

Currently, about 250 Bcf are used in the tar sands each year. The NEB forecasts (2008) that this will rise to about 750 Bcf per year by 2015.²⁷ If tar sands expansion were halted, all other things being equal, this could save at least 500 billion cubic feet per year for the next 15 years. Such a saving could extend the life of Alberta’s proven natural gas reserves by something in the order of another three years. Alberta would then have about 19 years of proven supply left, compared to the current eight years.

It will be argued that Alberta has more conventional natural gas and coalbed methane than the test of remaining established reserves indicate. The province estimates that there are 92 Tcf of “remaining ultimate potential” gas in Alberta (Alberta, 2008). If this estimate is correct, Alberta has about 18 years of natural gas supply at current rates of production, three years more than the 15-year rule mandates.

On recent visits to Washington D.C., Alberta’s Conservative Premiers Klein and Stelmach expressed strong support for sending unlimited exports of Alberta oil to the U.S. Yet, when Hugh McCullum (2006) released “Fuelling Fortress America: A Report on the Athabasca Tar Sands and U.S. Demands for Canada’s Energy,” Alberta’s political leaders declared surprising support for ensuring that fellow Canadians receive Alberta’s oil first and foremost. Their promises and inclinations are noble, but fly in the face of NAFTA’s proportionality rules.

Then-Premier Ralph Klein made a remarkable pledge: “If we see oil drying up and we see the Alberta supply being threatened and the Canadian supply being threatened, we can do whatever is necessary to ensure that Canada receives its supplies first” (Haavardsrud, 2006: D4). It was an interesting reaction, because NAFTA’s proportionality

25 The EUB’s definition of Established Reserves are: ‘Those reserves recoverable under current technology and present and anticipated economic conditions specifically proved by drilling, testing, or production, plus the portion of contiguous recoverable reserves that are interpreted to exist from geological, geophysical, or similar information with reasonable certainty’ (EUB, 2007: A2).

26 Assuming export levels had remained constant.

27 The NEB report (2008) reported that 0.7 billion cu ft. are used in the tar sands each day and that this would rise to 2.1 bcf / day by 2015.

clause could prohibit Canada from supplying its citizens first. Klein followed these generous remarks with a dismissal of possible Canadian shortages. We have “a 300-year supply of oil in the tar sands,” he stated.

Former Premier Peter Lougheed, who did much in the 1980s to persuade Canadians of the benefits of the FTA, expressed a similar Canada-first commitment. In response to William Marsden’s question about how he could have agreed to NAFTA clause 605 on proportionality, Lougheed is reported to have replied, “I think when it comes down to it – and this was a judgment call we made – if for some unusual reason we have a problem with Canadian supply, I think that what would happen is the Canadian Parliament, including support by the government of Alberta, would say ‘We’ve got to serve the Canadians first.’” But Lougheed added that energy shortages for Canadians are “a very remote set of circumstances.” Like Klein, Lougheed claimed that we are saved by the tar sands. When pressed about natural gas running out, Lougheed conceded that “At best we can stay even,” but he did not remark further about how proportionality could affect Canada’s ability to supply Canadians first as domestic supplies of natural gas dwindle (Marsden, 2007: 74-5).

Premier Ed Stelmach has yet to pronounce on what to do if Canadians are running short of natural gas or oil. It is good to see that the former premiers of Alberta, Klein and Lougheed, express support for supplying Canadians first, despite NAFTA. Whether out of conviction or political expediency their views reflect the political difficulty of Alberta’s leaders letting fellow Eastern Canadians “freeze in the dark.” But the former premiers seem naïve as they leap from the undoubted amounts of oil in the tar sands to believing that this will somehow save Eastern Canadians from running short in an international oil crisis. Nothing could be further from the truth. Proportionality could prevent more western oil going east to ensure Eastern Canadians do not run out.

c. LNG in Québec Reopens Proportionality Debate

A few weeks before Obama and Clinton raised the NAFTA issue, a debate began in Québec on proportionality, first regarding oil and then natural gas. Two front-page stories in *Le Devoir*, Québec’s leading newspaper of opinion, touched off the debates. The ADQ and the PQ, the two opposition parties in Québec’s National Assembly then joined the discussion. Richard Bellini, the ADQ’s energy critic called for an investigation by Québec’s Parliamentary Committee for Economy and

Labour into Québec's plans in the event of an international oil supply shock. His Parti Québécois counterpart, Sylvain Gaudreault, felt Québec's Board of energy should take the lead.

Québec's debate was sparked by a front page story in *Le Devoir* on February 5, 2008 on a Parkland / Polaris report by political-economist Gordon Laxer (Francoeur, 2008a). Laxer's report, "Freezing in the Dark: Why Canada Needs Strategic Petroleum Reserves," argued that Eastern Canada, including Québec, which currently gets 90% of its oil from foreign imports, was extremely vulnerable to international oil-supply shocks. The report calls for strategic petroleum reserves to deal with short-term supply shocks and a strategy to reorient domestic oil supplies to Canadians first, rather than meet American energy security desires. The *Le Devoir* story focussed on how NAFTA's proportionality clause puts Canada in a policy straitjacket regarding ensuring energy security for Canadians.

On February 8, the day after the opposition parties called for oil security studies, Louis-Gilles Francoeur broadened the proportionality debate to include two planned liquified natural gas (LNG) terminals near Québec City. Discussion concerned whether NAFTA's proportionality clause would reduce energy security for Québec and Canada (Francoeur, 2008b). Charles-Emmanuel Côté, a professor of international law at Laval University, was quoted as arguing that the recently approved LNG terminals would reduce rather than increase energy security in Québec. Although Côté had written a legal signed opinion in January 2007, it did not make news in Québec until *Le Devoir*'s February 8 story.

At public hearings on the LNG terminals, the commissioners of the Bureau of public hearings on the environment (BAPE) accepted the arguments of the promoter of the Rabaska LNG terminal that it should increase Québec's energy security. Currently, Québec gets all its natural gas from Western Canada. The proposed LNG terminals promise to bring gas from Russia²⁸ or other countries for use in Québec and for export to the U.S. The case for the terminals in Québec's public hearings was that they would raise the diversity of Québec's sources of natural gas which, it was contended, would boost energy security for Québeckers.

28 On May 16, 2008, it was reported that Gazprom had struck a deal to supply the Rabaska terminal with Shtokman natural gas starting in 2014 (Seguin and McCarthy, 2008).

On the contrary, Professor Côté holds that LNG terminals will weaken Québec's security. His argument runs as follows. If Québec reduces its current purchases of natural gas from Western Canada because it is using imports, the Canadian natural gas Québec had formerly

bought from the West will likely be sold in the United States, where demand is particularly strong. The resulting boost in Canada's natural gas exports would raise the proportion of total Canadian natural gas supply that is exported. This higher proportion would then be locked in by NAFTA, as the share of total supply to which the United States would be entitled would rise (Francoeur, 2008b).

In the event of an energy crisis, if foreign supplies are reduced or stopped, argued Côté, the United States would require Canada to make the higher percentage of total supply²⁹ available for export. This would mean that less natural gas would be available for Canadian provinces already served by the West, including Québec.

The implication of Professor Côté's argument is that when Québec wants to revert to buying western Canadian natural gas, because Russia or Algeria proved to be insecure suppliers, it could be prevented from doing so by NAFTA's proportionality clause. Québeckers would then rely on Russian supplies to heat their homes in winter. This is not a good idea. Russia used natural gas exports to Ukraine as a political weapon several times in the past few years. Russia could play a similar game with Canada if the federal government criticized Russian foreign or domestic policies.

As well, there are questions about Russia as a reliable supplier of LNG gas to Québec. In February 2008 TransCanada's plans for a re-gassification terminal in Québec were suspended when Russia's OAO Gazprom cancelled a Baltic Sea plant that was expected to provide steady supply. But, Gazprom reversed itself in May 2008 by announcing a partnership with Enbridge and two other parties to bring natural gas to Québec from the Barents Sea starting in 2014 (Seguin and McCarthy, 2008).

Professor Côté also argued that the strong relationship between oil and natural gas would likely accentuate Québec's energy insecurity. It is reasonable, he continued, to believe that an energy crisis that hit oil also would increase demand – and even a considerable shock – to the natural gas market. This would make Québec even more vulnerable because, by relying on foreign supplies of LNG in addition to oil imports, would mean that Québec would depend on two foreign sources for most of its fossil fuels.

Québec's debate on proportionality had some resonance in English Canada at the same time.³⁰ The combination of the Obama-Clinton opening on NAFTA and Québec's discussion on energy security and proportionality meant the latter was back on the table in Canada.

29 This assumes that total supply includes natural gas imports as well as Canadian production of natural gas.

30 CBC Radio's the Current did a 30-minute segment on the issue on February 6, 2008. New Brunswick's Energy Minister expressed interest in energy security issues Energy Minister to review idea of petroleum reserve (Linke, 2008: A2).

d. How New Pipelines Will Affect Proportionality

There has been a tendency for the proportion of Canadian oil supply exported to the U.S. to rise over time. It went up from 45.2% in 2003 to 50.5% in 2006.

The approval of new pipelines to export raw tar sands oil to the U.S. means this proportion is set to rise. As Diana Gibson and David Thompson point out in an op-ed published in the Edmonton Journal the “Keystone pipeline ... will eventually ship 590,000 barrels per day of Alberta oil to the U.S. It’s already been given the nod by Canada’s National Energy Board, which also recently approved the Alberta Clipper pipeline which can carry 800,000 barrels per day. This is enormous capacity. To give a sense of scale, these two pipelines alone will exceed Alberta’s total 2006 oil exports – all of it. They have more capacity than the current total production of the tar sands” (Gibson and Thompson 2008).

In April 2008, TransCanada Corp. announced its intention to add another export pipeline to its Keystone project with a capacity of 750,000 barrels a day to deliver Alberta crude to Texas’ Gulf Coast (Harding, 2008).

As Gibson and Thompson emphasize, “Even one 450,000 bpd pipeline can send 18,000 jobs south along with that bitumen.” If an additional 450,000 bpd were added to 2006 Canadian production levels and entirely exported to the U.S. the proportion of total supply going to the U.S. and our vulnerability under the proportional sharing clause, would rise from 50.5% to 55.4%. If the entire capacity of both Keystone pipelines and of the Alberta Clipper were filled with new production from the tar sands then the proportion of total supply that Canada would be prohibited from withholding from the U.S. could eventually rise above 65%.

Moreover another sub-clause in the proportionality clause would make it difficult, if not impossible, to divert crude from pipelines running south to the U.S. to other pipelines running to Eastern Canada. Article 605 (c) prohibits the “disruption of normal channels of supply” whenever proportionality is invoked.

III. Proportionality: Some Scenarios

NAFTA's proportional sharing clause actually appears twice in the agreement, once in a general way in Chapter Three on Market Access for Goods (Article 315) and again in Chapter Six on Energy and Basic Petrochemicals (Article 605). It also occurs twice in the FTA (Articles 409 and 904).

The clause says that if any Canadian jurisdiction were to take measures that had the effect of reducing the availability of an energy good or a basic petrochemical for export to the United States, Canada would still be obliged to make available for export the same proportion of the total supply of that good that was sold to the U.S. over the most recent three-year period for which data is available. Note that the clause does not refer to a proportion of "production" but to "total supply" which is defined as including production, imports and drawdowns from domestic inventory.

Article 605 adds a caveat that effectively says that in meeting its requirements an exporter cannot disrupt "normal channels of supply" or "normal proportions among specific energy ... goods" by, for example, substituting a heavy grade of crude for a lighter variety.

Mexico won an exemption from proportionality but paid a heavy price by agreeing to liberalize its rules on government procurement and to open parts of its petrochemical and electrical industries to foreign investment (Dillon, 1993B: 326).

Although its very existence acts as a deterrent to government initiatives that might have the effect of asserting greater sovereignty over Canadian resources, the fact is that the proportionality clause has not yet been invoked. It would apply if a federal or provincial government were to institute a measure that would affect the availability of supplies for export. The clause does not apply to changes in export share due to private corporate decisions, for example, to ship more western crude to Eastern Canadian markets.

The proportionality clause applies to government measures which would otherwise be permitted under provisions of the General Agreement on Tariffs and Trade (GATT). These provisions were incorporated into the World Trade Organization. Specifically, proportionality applies if governments take actions under either GATT Article XI or Article XX. The former article lays out conditions under which export quotas, which are generally prohibited, would be allowed. GATT Article XX concerns General Exemptions to the rule of free trade.

To illustrate the probable effect of the proportionality clause, we have constructed three scenarios under which the clause might be invoked. This hypothetical exercise will show how, under certain circumstances, proportionality could actually lead to energy shortages for Canadians.

First Scenario: Conservation

The first scenario involves measures Canada could take to conserve declining reserves of non-renewable hydrocarbons. GATT Article XX (g) allows governments to take measures “relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production and consumption.”

Hence, to be WTO/GATT (and by extension NAFTA or FTA) legal, conservation measures would have to involve efforts to curb domestic consumption and production, not just exports to the U.S.

The need for a hydrocarbons conservation program is urgent and imperative given all the ecological and social costs of unrestricted, rapid development particularly of the tar sands. Several studies have made this case very well, so there is no need to repeat it here. We point the reader to several of these reports: Hugh McCullum 2006, Woyillowicz 2005 and Hatch and Price 2008.

While commentators from all sides of the debate acknowledge that sooner or later there must be a transition towards a post-fossil fuel society, we do not know how long this transition will take or the challenges it will bring. While energy efficiency/energy intensity measures are decreasing our dependence on fossil fuels per unit of output, Canada lags behind other countries in developing solar, wind, geothermal and other renewable alternatives. Prominent Canadian “soft path” energy proponents Susan Holtz and David Brooks argue that we cannot rely on renewable energy sources alone to make the transition to an ecologically responsible future. They argue that while we must first emphasize conservation and energy-efficiency improvements to reduce demand, we will still have to rely on non-renewable fossil fuels far into the future. They also question the wisdom of exporting so much of our non-renewable hydrocarbon resources (Holtz and Brooks, 2005).

Since the 1970s Canadians have made great strides towards more efficient energy use. Analyst Ralph Torrie (2002: 21) calculated the dramatic effect of increased energy productivity, defined as output of

goods and services for each unit of energy used, from 1970 to 1998. He shows how increased energy productivity contributed more “new” energy than all the expanded production of oil, natural gas, coal, hydro, nuclear and biomass combined.

However, we have not made much progress on reducing our overall consumption of energy, nor much progress in developing renewable alternatives to fossil fuels, especially for transportation. Holtz and Brooks are “soft energy” advocates who approach energy issues as means to social ends, rather than energy as a goal in itself. They note a “striking difference between the 1970s and the present is that in the 1970s, exported energy was about one-fifth of [Canadian] domestic demand, whereas now it is around four-fifths and moving toward equality” (Holtz and Brooks: 2005, 231).

Our goal should not be just to keep reserves-to-production ratios at target levels such as 15 or 25 years worth of Canadian supply. Rather, we should use remaining reserves for a socially and ecologically responsible transition to a post-petroleum economy in which hydrocarbons will be used less for fuel and more for value-added applications such as lubricants, paints, fertilizers, nylon, medical equipment and plastics.

The question is not just “How much oil and natural gas do we have left?” Posing the question that way leads to defining energy security narrowly in terms of hydrocarbons alone. The real questions are: 1) “What are all of our national and regional energy resources, both renewable and non-renewable, and how can each be best used, now and in the future, to meet our energy needs?” (GATT-Fly 1981, 19-20) and 2) How can we reduce energy consumption overall?³¹

The David Suzuki Foundation’s visionary document on “Sustainability Within a Generation” enunciates the goal that Canada move to “the forefront of the global clean energy revolution, reducing fossil fuel production, use, and export, harnessing low-impact renewable energy sources” (Boyd 2004: 15). The Suzuki Foundation’s study suggested cuts to fossil fuel usage of 10% by 2008, 30% by 2020 and 50% by 2030.

How would the proportionality clause affect a plan to achieve even a 10% reduction in oil production?

31 Larry Hughes’ correspondence.

Based on the most recent data available from Statistics Canada for production, trade and total supply for the years 2004-2006, as shown in Table 1, the application of the proportionality clause would require Canada to continue making 47.5% of total supply available for export to the United States.

Table 1

Crude Oil Production, Trade, Supply and Demand
(Millions of barrels/year)

	1	2	3	4	5	6
	Production	Imports	Total Supply	Domestic Demand	Exports to USA	Exports to USA as % of Total Supply
2003	911	331	1242	679	561	45.2%
2004	938	341	1279	694	592	46.3%
2005	920	338	1258	675	576	45.8%
2006	969	310	1279	650	646	50.5%
Total 2004-2006	2827	989	3816	2019	1814	47.5%
						Domestic Shortfall
2007 base case	1040	330		673		
2007 10% production cut	936	330	1266	673	US entitled to 601	-8

Sources: Statistics Canada Energy Statistics Handbook, January to March, 2007
Table: 4.1 Crude oil and equivalent - Supply and disposition, Canada.
Canadian Association of Petroleum Producers, Crude Oil Forecast, Markets and Pipeline Expansions, June 2007.

If Canada were to attempt a 10% cut in oil production while keeping domestic demand and imports at their average level over the years 2004 to 2006 there would be an eight million barrel annual shortfall in supplies available to meet domestic needs. This would not be a huge cut, being equivalent to about four days of domestic demand. Nevertheless, the exercise illustrates shortfalls for Canadians would occur were we to cut back on oil production. If cutbacks in total production were larger in future years, as called for by the David Suzuki Foundation, if domestic demand were to grow or if imports became unavailable, then the domestic shortfall would be larger.

Second Scenario: Conserve Feedstock for Petrochemicals or to Meet Alberta's 15-Year Rule

A second scenario involves a decision to conserve natural gas as a feedstock for the petrochemical industry or as a necessary measure to conserve 15 years worth of supplies for use within Alberta.

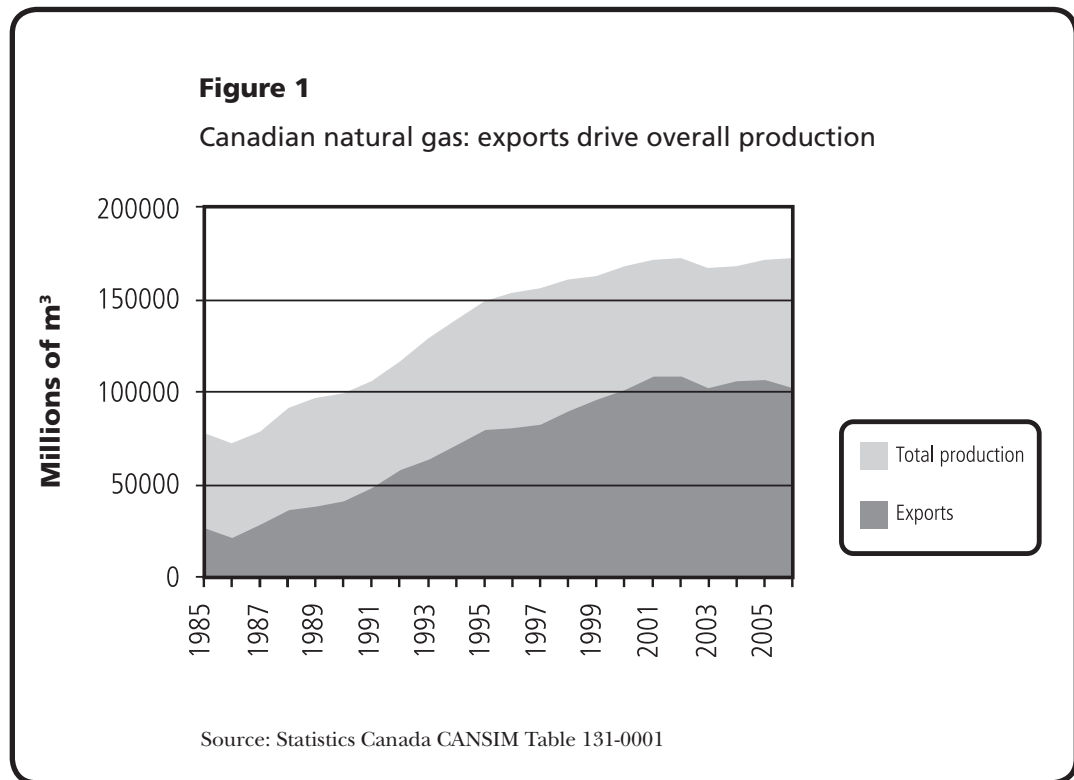
Under GATT Article XX (i) a member of the WTO is allowed to curb exports of a good in order to ensure that “essential quantities [are available for] a domestic processing industry during periods when the domestic price of such materials is held below the world price as part of a government stabilization plan; [and] provided that such restrictions shall not operate to increase the export of or the protection afforded to such domestic industry ... ”

Hence to be GATT/WTO (and NAFTA/FTA) legal, any set-aside of natural gas would have to be in the context of a price stabilization program and could not be used to protect Canadian industry or increase petrochemical exports.

The economic rationale for conserving natural gas feedstocks would be to save jobs in an important Canadian industry that upgrades natural gas into higher, value-added products. A report by the Communications Energy and Paperworkers union argues that “While just 10 per cent of Canada’s natural gas is used in petrochemical industries, it results in the employment of 24,000 workers, about half in basic petrochemicals and the remainder in value added products” (CEP Energy Policy, 2002: 17).

Mexican petroleum analyst Heberto Castillo (1984) often observed how hydrocarbons create work and wealth where they are consumed, not only where they are extracted. Castillo says burning a valuable resource like natural gas just to produce heat (or to produce steam for in situ tar sands extraction) is like using fine mahogany for firewood.

The Canadian natural gas supply situation is more critical than that of oil. During 13 out of the first 18 years after the FTA went into effect (i.e. 1989 through 2006) we have drawn down rather than increased reserves of natural gas. Total marketable gas reserves have fallen from 94.3 trillion cubic feet at the end of 1988 to 57.9 trillion in 2006, a decline of 39% (Statistics Canada CANSIM Table 128-0004).



What if we wanted to set aside 10% of natural gas production in order to ensure sufficient supplies for petrochemical feedstock at stable prices below the world price for liquefied natural gas (LNG)? Would the proportionality clause allow this to happen?

The proportion of total natural gas supply exported to the U.S. over the last three years for which data is available (2004 - 2006) is 51.5%, or four percentage points higher than for oil over the same period.

Assuming natural gas production at the same level as in 2006 (and assuming no change in the small amount of natural gas we annually import) what would happen if we wanted to set aside 10% for petrochemical feedstocks?

The results of this exercise, illustrated in Table 2, are that there would be a shortfall of 627 billion cubic feet for domestic needs. This is 66 days of average domestic demand. This simulation shows how proportionality would have a much more devastating effect on the availability of natural gas than for a similar cut back in oil production where, as we saw in the first scenario, the shortfall would be only four days of domestic demand.

Table 2

Natural Gas Production, Trade, Supply and Demand
(Billions of cubic feet/year)

	1	2	3	4	5	6
	Production of Marketable gas	Imports	Total Supply (includes inventory depletion)	Domestic Demand	Exports to USA	Exports to USA as % of Total Supply
2003	5878	342	7288	3705	3583	49.2%
2004	5915	384	7180	3463	3717	51.8%
2005	6030	336	7289	3536	3753	51.5%
2006	6063	341	7051	3445	3606	51.1%
Total 2004-2006	18008	1061	21520	10444	11076	51.5%
						Domestic Shortfall
2006 minus 10% set aside 606	5457	354	5811	3445	US entitled to 2993	-627 or 66 days of domestic demand
2006 minus half Alberta exports to USA 1245	4818	354	5172	3445	US entitled to 2664	-937 or 99 days of domestic demand
2006 minus Alberta exports to USA 2490	3573	354	3927	3445	US entitled to 2002	-1540 or 163 days of domestic demand

Source: Statistics Canada Energy Statistics Handbook, January to March 2007.
Table 6.1 Natural Gas Supply and disposition, Canada.
Alberta Dept of Energy. 'Natural Gas - Statistics. 2006 statistics'. 2008.

The consequences of applying Alberta's 15-year rule prohibiting exports of natural gas from the province unless it is surplus to core needs over the next 15 years is also illustrated by the calculations summarized in Table 2. If Alberta were to reduce by half its exports of natural gas to the U.S. at their 2006 level of 2,490 Bcf and the U.S. were to claim all 51.5% of total supply to which it is entitled, the Canadian shortfall would amount to 937 Bcf or 99 days worth of domestic demand. If Alberta wanted to cut all its exports to the U.S., the Canadian shortfall would be 163 days of consumption. Although these calculations are hypothetical, they illustrate the incompatibility of NAFTA's proportionality clause with enforcing Alberta's 15-year supply rule.

Third scenario: Import Substitution in a Time of Crisis

In the event of a major international crisis like the embargo of oil shipments that occurred in 1973, Canadians would expect all regions of the country to have first call on Canada's own oil production. Regrettably the proportionality clause would frustrate a Canada-first response.

The danger of supply shortages is much greater today than in 1973. It is widely accepted that the world will reach peak oil production relatively soon. The main debates are about whether this will occur in the next few years or as late as the 2020s (Laxer, 2008: 11). Oil production has exceeded discoveries since 1984. In 2006, 65% of oil production was from countries past their peak. Surplus capacity fell from 6.3 million barrels of oil per day in the fall of 2002 to 2.25 million bpd in the spring of 2007 (Hughes, 2008). If one averages the predictions of peak oil of 23 leading authorities, as David Hughes (2008), has reported, 2014 is the average peak year.

With oil markets entering general tight supplies Canadians need to debate the wisdom of relying on imports for half of our national consumption. Currently, Québec and Atlantic Canada rely on oil imports for 90% of their needs. A declining share of Canada's imports come from North Sea producers – Norway and Britain (37%), and OPEC countries now supply 45%, the largest portion of Canadian oil imports. Algeria, Iraq and Saudi Arabia are Canada's biggest sources of OPEC oil. None are secure suppliers.

If overseas suppliers were to suddenly cut off crude shipments, one would expect our government to invoke NAFTA's national security clause and take all necessary actions to protect Canadians from disastrous shortfalls. The wording of NAFTA Article 2102 on National Security would seem to allow for overriding other provisions including the proportional sharing clause: "nothing in this agreement shall be construed ... to prevent any Party from taking any actions that it considers necessary for the protection of its essential security interests ... in time of war or other emergency in international relations."

In his memoir, *Wrestling with the Elephant*, Canadian FTA negotiator Gordon Ritchie seems to agree that Canadian national security would override other considerations. Ritchie pays down critics' concerns about the FTA's energy provisions, stating that market principles would apply "provided the national security was not endangered" (Ritchie, 1997: 125).

However, what this reassuring scenario overlooks is that a second narrower national security clause was slipped into the energy chapters of both the FTA and NAFTA. Article 907 of the FTA and its identical twin Article 607 of NAFTA essentially narrow the scope for the application of national security provisions with respect to fossil fuels to military concerns excluding actions designed to secure civilians' security. NAFTA Article 607 says "[N]o Party may adopt or maintain a measure restricting imports ... or exports of an energy ... good to another Party ... under Article 2102 (National Security) except to the extent necessary to:

- (a) supply a military establishment ... or enable fulfillment of a critical defense contract ... ;
- (b) respond to a situation of armed conflict involving the Party taking the measure."

Thus Canada would have to be involved in a war before it could invoke the national security clause to restrict exports under section (b). Further evidence that this article is designed to make sure that the proportional sharing clause still applies is the fact that Mexico had to negotiate an exemption to this article. The Mexican exemption is found in NAFTA Annex 607, which parallels its exemption to the proportional sharing clause in Annex 605.

The application of proportionality to a situation of global or regional supply shortages falls under GATT Article XX (j) which refers to "measures ... essential to the ... distribution of products in general or local short supply."

Canadians need not rely on the vagaries of imports to get vital supplies. The needed infrastructure to ship more western crude to Eastern Canada partially exists. The Interprovincial Pipeline from Western Canada to the U.S. Midwest and ending at Sarnia, Ontario can move 1.9 million barrels of oil a day. This is enough to supply all of Ontario, Québec and the Atlantic provinces if the oil could be moved farther east.³²

32 Not all the oil would be needed, since Newfoundland and Labrador produces about enough oil to satisfy the demands of the four Atlantic provinces, if Canada diverted its production to supply domestic markets.

33 Imports were 52.1 million cubic metres in 1973. By 1983, these had fallen to 14.6 million cubic metres. CAPP, 2008: 2000.

Enbridge Pipeline 9, from Sarnia to Montréal, was built in the 1970s to bring Western Canadian oil to Québec to replace imports and promote energy security. It was part of a federal government initiative to reduce Eastern Canada's dependence on oil imports. The combination of conservation measures, reductions in oil demand due to rising prices, policies to switch energy use away from oil, and Enbridge Pipeline 9 to Montréal worked. By 1983, Canadian oil imports had fallen to 28% of their 1973 level.³³

With a daily capacity of 240,000 barrels a day, Enbridge Line 9 was reversed in 1999. It now brings foreign oil from Montréal westward to Sarnia. The pipeline can be reversed again to ship oil east. In fact Enbridge is considering doing this, at an estimated cost of about \$100 million (Haggett, 2008).

Since Canada currently imports about 850,000 barrels of oil per day, this is a golden opportunity to replace 28% of Canadian imports. Montréal refineries would probably have to be retooled to replace foreign crude with synthetic crude or bitumen from Alberta's tar sands.

In March 2008, Enbridge announced that it is considering reversing Line 9 because oil shipments through it have been declining since 2004 and the pipeline now operates at half capacity. But Enbridge's reversal is not necessarily aimed at supplying Montréal and is not meant to supplant oil imports to Canada. Instead, an Enbridge spokesperson says crude derived from the tar sands could continue past Montréal to Portland Maine, where it could be shipped to U.S. refineries by tanker. Enbridge is also considering constructing "a new line to Philadelphia from southern Ontario" (Haggett, 2008).

If Enbridge reverses the pipeline for commercial reasons it would not run afoul of NAFTA's proportionality clause. However, if a Canadian government ordered Enbridge to reverse the line to send all its supplies to Eastern Canada, the proportionality restriction would apply.

In a genuine supply emergency, the federal government would have to explore ordering a reversal of Line 9 along with as other options. One relatively expensive alternative would be to ship crude from Sarnia east by railway tanker cars or by tanker ships small enough to navigate the St. Lawrence Seaway during shipping season. In the case of a sudden shortfall, the most expeditious option would be to divert crude oil exports from offshore Newfoundland platforms to domestic refineries (about 185,000 barrels a day).

Table 3 explores three options. The first involves reversing the Sarnia to Montréal pipeline at its 240,000 barrels a day capacity (87.6 million barrels a year) to ship western crude to Montréal. Such an order would bring the proportionality clause into play, but not result in a shortfall in overall supply available for Canadian needs even if the U.S. chose to import all 609 million barrels from Canada that would have to be made available to it under proportionality rules.

The second scenario explored in Table 3 involves reversing the Sarnia to Montréal pipeline and redirecting Newfoundland’s exports of 60.6 million barrels (in 2006) to domestic markets.³⁴ Both measures would reduce imports by 148.2 million barrels. Since the U.S. would still be eligible to import 47.5% of Canada’s total supply, it would be entitled to import 580 million barrels a year. If the U.S. took the full amount, Canada’s shortfall would be 31 million barrels, or 17 days of domestic needs.

If Canada doubled the Montréal to Sarnia pipeline capacity to 175.2 million barrels a year, Canada’s import dependence would fall from 49% of domestic demand to just 23%. Doubling capacity would take several years to implement. The third simulation in Table 3 shows the impact of such an initiative. The U.S. would be entitled to import 46 million barrels more per year than would be available to meet Canada’s domestic demand. Canada’s shortfall would be 25 days of domestic demand.

Table 3
Effect of Reversing the Sarnia to Montréal Pipeline or Reversing the Pipeline and Diverting Exports from Newfoundland or Reversing the Pipeline and Doubling its Capacity on Crude Oil Imports, Trade and Domestic Supply (Millions of barrels/year)

	1	2	3	4	5	6
	Production	Imports	Total Supply	Domestic Demand	Exports to USA	Exports to USA as % of Total Supply
2003	911	331	1242	679	561	45.2%
2004	938	341	1279	694	592	46.3%
2005	920	338	1258	675	576	45.8%
2006	969	310	1279	650	646	50.5%
Total 2004-2006	2827	989	3816	2019	1814	47.5%
						Domestic Shortfall
2007 base case	1040	330		673		
2007 with imports cut by capacity of Enbridge Line 9	1040	330 – 87.6 = 242	1282	673	US entitled to 609	0
2007 with imports cut by capacity of Line 9 and diverting exports from Newfoundland	1040	330 – 148 = 182	1222	673	US entitled to 580	-31
2007 with imports cut by double the capacity of Line 9	1040	330 – 175.2 = 155	1195	673	US entitled to 568	-46

34 Source Table 4.6-1 “Crude oil and equivalent - exports by province” Statistics Canada Energy Statistics Handbook, January 1 to March 31, 2007.

Sources: Statistics Canada *Energy Statistics Handbook*, January 1 to March 31, 2007
Table: 4.1 Crude oil and equivalent - Supply and disposition, Canada.
Table 4.6-1 Crude oil and equivalent - Exports by province.
Canadian Association of Petroleum Producers, Canadian Crude Oil Production Forecast 2006-2020.

IV. NAFTA Investment Chapter Constrains Policy Choices

NAFTA's Chapter 11 on investment impinges on Canadian energy sovereignty principally through Article 1106, which bans performance requirements, and Articles 1115 through 1138, the notorious investor-state provisions.

In the words of Larry Pratt, Chapter 11 “nullifies the past option, utilized by many provincial and federal governments, of using Crown-owned resources for purposes of economic development. As an example, Alberta has, since the 1970s, tried to foster a petrochemical complex based on chemicals extracted from natural gas prior to its export from the province” (Pratt 2007, 470).

The NAFTA ban on performance requirements applies to all corporations operating in Canada whether domestic or foreign owned. However it is particularly significant for U.S.-owned corporations because they alone (along with any Mexican firms) have access to NAFTA's dispute settlement mechanism to enforce the ban. The application of Article 1106 could prohibit provincial or federal governments from demanding that corporations upgrade natural gas or crude bitumen into petrochemicals or refined products in order to create jobs or capture the value added through local processing. Furthermore, there is a specific prohibition on requiring corporations “to transfer technology, a production process or other proprietary knowledge” (NAFTA Article 1106: 1. (f)). Thus, if a company uses a relatively cleaner, but more expensive, production process to comply with environmental laws in California, for example, a Canadian province could not compel that company to use the same technology in Canada. This prohibition could interfere with regulations requiring firms to use state-of-the-art pollution abatement technologies.

Transnational corporations have used Chapter 11's investor-state mechanism to sue NAFTA member governments for a variety of measures they deem as limitations on their ability to do business without interference from state regulations. For example, an early test of the investor-state mechanism was the suit brought against Canada by U.S.-based Ethyl Corporation alleging that a Canadian ban on the import of a gasoline additive known as MMT, a suspected neurotoxin, violated its right to be treated as favourably as any Canadian corporation and constituted a prohibited performance requirement. After a preliminary NAFTA tribunal ruled against Canada, the Canadian government repealed the MMT ban, issued an apology to the company and settled “out of court” with Ethyl for US\$13 million.

Exxon Mobil and Murphy Challenge Newfoundland Requirements

The most recent investor-state cases to be brought against Canada concern allegations by Exxon Mobil Corporation and Murphy Oil Corporation that the Newfoundland government has forced them to make millions of dollars in research and development (R&D) expenditures as part of their long-standing investments on the Hibernia and Terra Nova oil fields. Specifically, the companies allege that Newfoundland cannot impose such an additional performance requirement.

In separate notices of intent that contain virtually identical wording, Exxon Mobil and Murphy claim that Newfoundland authorities are requiring them to spend “a fixed percentage of the project’s revenue on local services and goods for research and development” (Murphy Oil Corporation 2007). Exxon Mobil is claiming damages worth \$40 million and Murphy is suing for \$10 million in damages from Ottawa which must bear the costs of provincial actions under NAFTA’s investor-state rules.

While the companies acknowledge that they did file “benefits plans” with the Canada-Newfoundland Offshore Petroleum Board giving preference to local goods, services and workers, they insist that these plans did not commit them to spending any particular amount on R&D. The suits were occasioned by new guidelines issued by the Canada-Newfoundland Offshore Petroleum Board in 2004 and 2005 requiring the firms to spend a fixed percentage of revenues on R&D amounting to millions of dollars a year.

Beyond the questionable substance of the two suits lies a clear political message. The companies are signalling their resistance to what they view as an overly aggressive stance by Newfoundland. Exxon Mobil and Murphy launched their NAFTA suits in the midst of negotiations with Newfoundland over a deal to develop the Hebron offshore oil field, in which Exxon Mobil held a 37.5% stake.

In their filings of NAFTA claims both Exxon Mobil and Murphy cite the same words from a July 12, 2006 news release from Premier Danny Williams: “The time has come for these oil and gas companies to start sharing more of the tremendous financial benefits from our province’s resources. ... [Our provincial share of revenues] is a mere pittance compared to that of the companies. In these times of extremely high oil prices where ... the companies are taking in exorbitant profits, the time has come for new arrangements.”

After tough bargaining, Premier Williams clinched a deal to give the province a 4.9% equity stake in the Hebron project. Newfoundland also announced a new “super oil royalty” on some offshore projects that would transfer an additional 6.5% of net revenues to the province in any month when crude sells for more than US\$50 a barrel (Scott, 2007). The NAFTA suits serve as reminders to Newfoundland and any other government that might take on the oil corporations that NAFTA’s Chapter 11 is a powerful tool to resist government action to diversify the economy.³⁵

Investor-State Suits Could Challenge Environmental Rules for Tar Sands

In March 2008, the federal Department of Fisheries and Oceans revoked a permit that had been allotted to an Imperial Oil tar sands project on the grounds that its water use could disrupt or alter fish habitat. However, this precedent-setting decision could be challenged by Imperial’s U.S. parent Exxon Mobil under NAFTA’s investor-state provisions. In 2007 the University of Toronto’s Faculty of Law review published a study showing how a U.S.-owned company could challenge the cancellation of a water withdrawal licence as an “indirect expropriation” and launch a suit against Canada for compensation (Nikiforuk, 2008: 49).

Investor-state suits could also be launched by Canadian firms against U.S. environmental policies. For example, California has decided to penalize oil, such as the tar sands, which damages the environment more than conventional oil. Although it has since been open to various interpretations, the U.S. Energy Independence and Security Act, passed into law in December 2007, also prevents federal departments from purchasing oil if its extraction generates more greenhouse gases than conventional oil (US, 2007: interpretation reference). A Canadian-based tar sands company could potentially use NAFTA to challenge such measures as disguised import barriers.

35 Williams’ bargaining position improved after Exxon Mobil pulled out of Venezuela. Larry Hughes’ correspondence.

V. Ending Proportional Sharing

The Paul Martin government missed an opportunity to challenge the proportionality clause in the timid way in which it responded to a NAFTA ruling on softwood lumber. The Martin government failed to invoke another NAFTA clause, Article 1905, after the U.S. refused to abide by a ruling of a NAFTA extraordinary challenge panel favouring Canada's softwood lumber policies in 2005.

Like Article 605, NAFTA Article 1905 has never been tested. It provides a recourse for a NAFTA partner when another party to the agreement fails to implement a decision handed down by a dispute resolution panel. Under Article 1905 Canada would first have to assert that the U.S. had failed to implement a softwood lumber decision "with binding force" and then, after referring the dispute to a special committee that in effect would give the U.S. one last chance to change its mind, Canada could proceed to the next step, suspending "the application to the [U.S.] of such benefits under this Agreement as may be appropriate under the circumstances" (NAFTA Article 1905.8 (b)).

What NAFTA benefits would have been appropriate to suspend? A key trade-off in the original FTA negotiations (and by extension NAFTA) was Canada's access to a mechanism to resolve disputes involving countervailing duties or anti-dumping measures in return for assured U.S. access to Canadian energy supplies. Although the original FTA never achieved guaranteed market access for softwood lumber and other goods, Prime Minister Mulroney signed the deal anyway, settling for the flawed dispute settlement procedures under Chapter 19.

A five to seven year period was set aside to negotiate a substitute system of rules for anti-dumping and countervailing duty cases (FTA Article 1906). Since no substitute regime had been found within seven years after the January 1, 1989 inauguration of the FTA, that is, by the end of 1995, the Chrétien government could have terminated the FTA on six months notice. He did not do so, thereby breaking a key undertaking in the 1993 election campaign in his famous "Red Book."

Pulling Out or Renegotiating?

Due in part to the publicity around the "NAFTAgate" affair, in which the Harper government implied that Senators Obama and Clinton were not serious about renegotiation, both presidential candidates had to reiterate their resolve to reopen the treaty. Both senators promised to use the abrogation clause (Article 2205) which gives any party the right to withdraw from NAFTA on six months notice

as leverage for winning changes to the agreement favourable to U.S. government positions.

At first glance it would seem that ending NAFTA would automatically mean release from proportionality. However, simply terminating NAFTA without also withdrawing from the bilateral FTA would not mean the end of provisions governing energy trade between Canada and the United States. In fact the Canadian implementing legislation for NAFTA, known as Bill C-115, contains specific clauses designed to ensure that proportionality survives NAFTA's demise.

When the Mulroney government introduced Bill C-2 in December of 1988 to implement the bilateral Canada-U.S. Free Trade Agreement, it included amendments to the National Energy Board Act. Section 142 of Bill C-2 specifically gives the NEB the power to implement proportionality.³⁶ At the time, a study from the Library of Parliament and a statement from a former chairperson of the NEB, Marshall Crowe, asserted that this was not necessary as the NEB already had enough power to enforce continental energy sharing (Dillon 1993A). The fact that the Mulroney government included this legislative overkill points to the centrality of proportionality in the FTA deal.

When Chrétien's government wrote NAFTA's implementing legislation, they took care to include provisions saying that Section 142 of Bill C-2 is merely "suspended" as long as NAFTA remains in force. Bill C-115 adds new amendments to the NEB Act implementing all the energy provisions of NAFTA.³⁷ Thus, if NAFTA were ended for any reason the proportionality provisions of the FTA would automatically snap back into place unless Bill C-2 were also repealed or amended.

Of course, the real issue is political and not narrowly legal. An informed Canadian public would not allow politicians to appear to amend or even dispense with NAFTA while preserving proportionality through the back door.

As the debate about NAFTA intensifies, Canadians must insist loudly and clearly that ending proportionality must be a non-negotiable priority. It must not be a bargaining card for winning concessions on other issues as Trade Minister Emerson and John Manley, former Liberal deputy prime minister, contend.³⁸

36 Section 142 of Bill C-2 amended sections 119.1 through 119.6 of the NEB Act effectively implementing Article 904 (the proportional sharing clause) of the FTA.

37 Section 192 of Bill C-15 says "The operation of sections 119.1 to 119.6 [of the NEB Act] is suspended during the period in which Division III.1 is in force." Then follows Division III.1 which adds new clauses 120 through to 120.5 to the NEB Act implementing not just the proportional sharing clause (Article 605) but also Articles 602, 603, and 606 of NAFTA.

38 Manley says that energy be the key Canadian bargaining card in a NAFTA renegotiation. See John Manley "The World's Longest Undefended border" in the *Globe and Mail*, April 7, 2008.

Building a Canadian renegotiation agenda and hence the case for ending the entire agreement will involve more than just invoking the constraints on energy sovereignty posed by the proportional sharing clause. It will include reminding Canadians how the investor-state mechanism allows foreign companies to sue Canadian governments for imposing measures that would protect human health and our environment.

VI. Conclusions and Recommendations

The world is experiencing tighter and tighter supplies of oil, which is why international prices have quadrupled in the past five years. The world is about to undergo a series of international oil supply shocks over the next decade, and while no one is sure when the first one will strike, it likely will be soon. Despite its abundance of oil, Canada is the most vulnerable member of the International Energy Agency (IEA) to short-term shocks.

Canada imports about 49% of its oil needs, with almost half its imports coming from very insecure sources – OPEC countries. Unlike all other IEA member countries, Canada has no Strategic Petroleum Reserves. Meanwhile, Canada is obligated by NAFTA's proportionality clause to make two-thirds of its domestic oil production available for export to the U.S., even if Canadians experience shortages.

Natural gas will not save the day. Despite being the third-largest exporter of natural gas in the world, Canada has only 1% of the world's reserves. There are only 9.3 years of proven reserves of natural gas at current rates of production. Again, because of proportionality, Canada must make available the majority of its natural gas supplies for export to the US – 60% of Canada's current natural gas production.

Not only is Canada on the verge of running short of domestic supplies of natural gas, Alberta is too. But, unlike Canada, which upon signing the FTA irresponsibly ditched its security provision that there must be 25 years of proven supply before it would allow exports, Alberta retained its safeguard of natural gas supplies for Albertans. The Alberta Gas Resources Preservation Act requires that Alberta have 15 years of proven supply before natural gas can be removed from the province. However, Alberta does not enforce its own law and

the province now has only 8.1 years of proven reserves of natural gas at current production rates. No one has called the government to account for not upholding this law. This report does so. The Act assumes Albertans have first call on the province's natural gas, other Canadians second call, and that only if there are still long-term surpluses should exports be allowed. Those are the right priorities.

Thus Canada, a country where its citizens can literally freeze in the dark if oil supplies run short during an Arctic cold front, has no plan to deal with oil and natural gas shortages. We are woefully unprepared. In 2005, the people of New Orleans learned the tragic and painful costs of their governments failing to plan for them before a powerful hurricane hit. Similarly, for Eastern Canadians, the time to plan for energy shortages is now, before energy supply shocks strike.

Most Canadians assume that Canadian energy supplies will be there when they need them. It hasn't dawned on most Canadians that their governments have signed away their right to have first access to their own energy supplies. When an energy supply crisis hits and Canadians are trying to cope under difficult conditions the outcry for Canada to override NAFTA's proportionality clause will be deafening. Instead of waiting for such a crisis and such an outcry, the time to act is now.

This report shows that NAFTA's proportionality clause stands in the way of Canada developing an effective energy security plan. Whatever the merits were of energy proportionality in 1988 and 1993, when the FTA and NAFTA were signed, energy proportionality is unduly restrictive for Canada now and it must go.

We recommend that Canada demand a Mexican-style exemption on proportionality. The timing to get this turned favourable after Barack Obama pledged in February to renegotiate NAFTA. If the Americans come to the table with their issues, the other parties can bring their own issues for renegotiation too. Getting out of proportionality must be Canada's number one goal in such talks. And we must be willing, as Obama himself pledged, to "use the hammer of a potential opt-out [of NAFTA] as leverage to ensure we actually get ... " what we demand.

Making sure all Canadians get through the long, cold winters overrides other considerations. As the Americans said after 9/11, "security trumps trade."

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