
A Northern Warm Front: Canadian Climate Change Regulation Moves Forward

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Climate change remains among the most topical issues in Canada and has now become one of the country's main sources of political debate. As countries prepare to meet in Copenhagen in December 2009 to discuss a successor to the Kyoto Protocol, the Canadian federal government has begun to roll out a series of policy initiatives at home, many influenced by developments in the United States. Meanwhile, citizens, businesses, litigants and institutional investors are increasingly urging the government to take action to mitigate and adapt to the effects of global warming. This article summarizes the rapidly developing body of Canadian climate change regulation, with a particular focus on current trends.

CURRENT REGULATORY CLIMATE

Federal Government Proposal

The federal government continues to characterize the economic consequences of complying with Canada's binding greenhouse gas (GHG) reduction target under the Kyoto Protocol as potentially disastrous. It instead advocates flexible, domestic and long-term goals for emissions reduction. Leading up to the Copenhagen Conference of the Parties in December 2009, the federal government has indicated that a long-term approach to dealing with climate change will be a pillar of its negotiating position. It will also focus on creating incentives for technological innovation and ensuring that all developed and developing countries make commitments to reduce their emissions.

At home, the federal government is also increasingly looking to coordinate its mitigation efforts with those of its trading partners, particularly the United States. In this regard, the government is paying close attention to the US federal proposals for a cap-and-trade system, including the proposed *American Clean Energy and Security Act of 2009* (the bill sponsored by US House Representatives Henry Waxman and Edward Markey). In recent speeches, Environment Minister Jim Prentice indicated that his government will seek to develop

a Canadian system that is compatible with any system that may come into force in the United States, with the ultimate goal of establishing a "common cap-and-trade system that would allay competitiveness concerns in both countries." As far back as its *Turning the Corner* release, described below, the federal government had already indicated that "any decision in Canada on the transition to a fixed-cap regime for greenhouse gas emissions would take into account developments occurring in other countries, especially the United States, with the aim of establishing a North American emissions trading system once the United States implements a greenhouse gas regulatory system."

Given these signals, many commentators believe that the Canadian government will not implement a cap-and-trade system until the United States does first, and that current federal proposals for GHG emissions-intensity limits will ultimately be set aside. Until that time, however, the federal government remains technically committed to the regulatory framework for controlling industrial GHG emissions that it first announced in the spring of 2007 and supplemented in the spring of 2008. Titled *Turning the Corner: Canada's Regulatory Framework for Industrial Greenhouse Gas Emissions* (the Framework), it promises to reduce Canada's total GHG emissions by 20 per cent below 2006 levels by 2020, a significantly less aggressive target than the country's Kyoto commitment of 6 per cent below 1990 levels between 2008 and 2012.

To implement the Framework, the government plans to issue sector-specific regulations made under Canada's federal omnibus environmental statute, the *Canadian Environmental Protection Act, 1999*. Although the government previously indicated that these regulations would come into force in January 2010, it now suggests that drafting will only begin in 2010, with the regulations taking effect on a sector-by-sector basis beginning in 2011 or later. That said, the Framework currently includes the following key features, which would likely inform any future cap-and-trade regime:

- **Regulated Emitters.** Facilities in the major industrial sectors would be required to meet published GHG emissions reduction targets, provided that their emissions exceed certain thresholds.
- **Emissions-Intensity Targets.** Although a joint Canada-US regime would likely feature absolute emissions caps, the Framework's targets would be based on intensity (or emissions per unit of production), potentially allowing an increase in GHG emissions if production also increases.
- **New Facilities.** Facilities that began operation after 2003 and existing facilities that underwent a major expansion or transformation would not be required to reduce emissions in the first three years of operation, transformation or expansion.
- **Technology Fund and Pre-certified Investments.** Until 2018, regulated emitters would be able to get credit for a percentage of the required reductions by contributing to a technology fund – or, in certain circumstances, to other investments pre-certified by the federal government – at the rate of \$15 per tonne of excess carbon dioxide equivalent (CO₂e) from 2010 to 2012, rising to \$20 per tonne in 2013 and escalating annually thereafter by the growth rate of Canada's nominal gross domestic product. The technology fund would invest primarily in technology and infrastructure projects that are likely to reduce GHG emissions.
- **Tradable Emissions Credits.** The government would also issue credits to each regulated party with emissions intensity below its limits for the same year. Parties would be able to bank these credits for compliance in future years or sell them to other regulated parties, including on an emissions trading market that the federal government has indicated it will leave to the private sector to establish. In that respect, the Montréal Climate Exchange, a joint venture between the Montréal Exchange and the Chicago Climate Exchange, has launched trading of physically settled futures contracts with respect to Canadian CO₂e units. Canadian CO₂e units under the Framework that would be eligible for physical delivery would include both credits issued to regulated entities and domestic offset credits (the latter is described below). The contracts provide that, if there is no nationwide system in place by the time of the first delivery date, the delivery of other mandatory allowances, such as those from the European Union's Emissions Trading System, the Regional Greenhouse Gas Initiative or any other state or regional program would be permitted.
- **Domestic Offset System.** Regulated emitters would also be able to purchase domestic offset credits, each representing one tonne of verified CO₂e reduction or removal achieved by a project not otherwise required to do so by regulations under the Framework. To be eligible for offset credits, projects must fall into a category of activity approved by the federal government and measure their emissions reductions under a protocol developed for that activity (a quantification protocol). On August 9, 2008, Environment Canada released draft guidance to parties wishing to develop

quantification protocols for offset project types. And on June 10, 2009, the government released additional draft guidance for offset project proponents and offset verification bodies.

- **Early Action Credits.** The Framework would allow a small one-time allocation of credits for regulated parties that previously (between 1992 and 2006) reduced emissions.

Existing Federal Regulation

Because Canada has a minority government, the three federal opposition parties can work together to have considerable influence over Parliament – if sufficient opposition members can agree on an issue, they can form a majority with the power to pass binding legislation. For example, on June 22, 2007, the Opposition passed a private member's bill called the *Kyoto Protocol Implementation Act* (the *Implementation Act*), which requires the federal government to take action designed to ensure that Canada meets its obligations under the Kyoto Protocol. Notably, it requires the Minister of the Environment to prepare and report on the implementation of periodic climate change plans that describe how the government will ensure that Canada reduces its emissions by 6 per cent below 1990 levels between 2008 and 2012.

On August 21, 2007 and May 31, 2008, the government released Climate Change Plans through Environment Canada, as required by the *Implementation Act*. Although these Plans highlight Canada's compliance with various requirements under the Kyoto Protocol, such as providing financial assistance to developing countries and submitting national reports to the United Nations Framework Convention on Climate Change, they also reiterate the Conservative government's view that achieving the country's Kyoto targets through domestic reductions would have grave economic consequences and that purchasing international credits would not necessarily promote real, verifiable and incremental reductions to global emissions.

Despite the apparent binding nature of the *Implementation Act*, there is some question whether and how it can be enforced in the face of a sitting government with a very clear contrary policy stance. That issue came squarely before the Federal Court of Canada in the context of an application for judicial review brought by the environmental organization Friends of the Earth Canada with respect to whether the government's first Climate Change Plan complied with the requirements of the *Implementation Act*. On October 20, 2008, the Court dismissed the application on the grounds that the reasonableness of the government's response to its Kyoto obligations was not a justiciable issue. Even if it found otherwise, the Court concluded that it would decline to make an order, as "such an order would be so devoid of meaningful content and the nature of any response to it so legally intangible that the exercise would be meaningless in practical terms." Friends of the Earth Canada has since appealed the decision, with a hearing expected in summer 2009.

Provincial Regulation

So far the most concrete initiatives on GHG regulation have been taken by Canada's provinces. Alberta was the first jurisdiction in North America to set regulatory limits on GHG emissions. The province's *Specified Gas Emitters Regulation* came into force in July 2007, and like the federal Framework, it employs an emissions-intensity approach: depending on its age, every facility that emits more than 100,000 tonnes of CO₂e

per year must reduce its GHG emissions intensity by up to 12 per cent of its average 2003–2005 emissions between July 1 and December 31, 2007, and maintain these reductions in subsequent years. New facilities are required to start reducing emissions intensity by 2 per cent per year only after the third year of operation. This regulation also uses some other features found in the federal Framework:

- **Climate Change and Emissions Management Fund.** Regulated facilities can pay \$15 for every tonne of CO₂e emitted in excess of compliance targets to the province's Climate Change and Emissions Management Fund. According to Alberta Environment, in the 2008 compliance period (January 1, 2008 to December 31, 2008), regulated emitters contributed approximately \$82.3 million to the Fund.
- **Tradable Emissions Performance Credits.** Regulated facilities with actual emissions intensities that are below their specified targets can earn emissions performance credits, which can then be sold to others. In the initial compliance period, most companies earning these credits did so through engaging in cogeneration initiatives rather than making actual improvements to emissions intensities.
- **Domestic Offset Credits.** Regulated parties may also purchase offset credits *generated by projects in Alberta* that are independently verified as having reduced GHG emissions after January 1, 2002 when not otherwise required by law to do so. According to Alberta Environment, in the 2008 compliance period, retired offset credits accounted for approximately 2.75 megatonnes of emissions reductions.

Other Canadian provinces have also taken initial steps toward implementing cap-and-trade regimes, particularly those provinces that have joined the Western Climate Initiative (WCI), an initiative of several US states and some Canadian provinces – including British Columbia, Manitoba, Ontario and Québec – to reduce regional GHG emissions of, at first, large industrial emitters and, later, certain other smaller residential, commercial, industrial and transportation sources. According to the “Design Recommendations for the WCI Regional Cap-and-Trade Program,” released in September 2008, each WCI partner will be allocated emissions allowances (an allowance budget), calculated with reference to the state or province's population growth, economic activity, electricity consumption and other factors. WCI partners would then have significant flexibility in distributing these allowances to regulated entities within their jurisdictions. Although allowance budgets for WCI partners have not yet been set, the regional cap would be lowered between 2012 and 2020, in three-year compliance periods, so that by 2020 regional emissions would have been reduced by 15 per cent below 2005 levels. To obtain the data necessary to establish emissions baselines, the WCI has released a final draft of its mandatory GHG reporting requirements, with which all WCI-regulated entities will be required to comply when reporting their emissions. According to the WCI's *2009-2010 Work Plan*, over the coming year, various subcommittees will also be recommending a methodology for setting the initial 2012 cap, assessing ways to allocate allowance budgets to each WCI partner and making recommendations on the design and operation of the WCI's offset system.

On May 28, 2008, British Columbia passed its *Greenhouse Gas Reduction (Cap and Trade) Act* to facilitate its participation

in the WCI regime. Although the Act will only come into force on a date yet to be announced by regulation, when it does, it will provide the framework for a provincial cap-and-trade regime that can be integrated with other similar regimes in other jurisdictions. Under the Act, regulated emitters could comply with their emissions caps by making actual GHG emissions reductions; by purchasing credits from other emitters whose actual GHG emissions were less than their prescribed limits; by purchasing credits from certain offset projects; and by purchasing certain approved credits from other jurisdictions. Future regulations under the Act will set exact caps, based on the allowance budget the province receives under the WCI.

Ontario and Québec have also begun to facilitate their own WCI participation: on June 2, 2008, they signed a Memorandum of Understanding (MOU) committing to establish a joint GHG emissions cap-and-trade regime. In that regard, and to enable their participation in the WCI, both provinces have begun bolstering the legislative framework for future cap-and-trade regulations. Québec, for example, introduced Bill 42 on May 12, 2009, and Ontario introduced Bill 185, the *Environmental Protection Amendment Act (Greenhouse Gas Emissions Trading)*, 2009 shortly afterward, on May 27, 2009. The bills would give the two provinces broad authority to regulate and implement the various aspects of a cap-and-trade system. Ontario has also begun to highlight how its own system may take shape. In recent discussion papers, it described the design principles for the province's proposed cap-and-trade system, which it plans to bring into force by 2012 to coincide with the expected start date of the WCI regime. These papers highlight various issues for discussion, including the application of the system to smaller sources of emissions, including transportation sources and smaller residential, commercial and industrial buildings; whether emissions allowances should be auctioned or allocated for free to capped emitters; and the number of offset credits that capped emitters could use to meet their compliance obligations.

It is unclear how overlapping federal, provincial and other cap-and-trade systems will coexist. To alleviate industry anxiety over a regulatory patchwork, the federal government has proposed entering into equivalency agreements with certain provinces, which would allow provincial regulations that are not inconsistent with and at least as stringent as the federal laws in the area.

British Columbia and Québec have also implemented another market-based mechanism designed to mitigate GHG emissions, becoming the first two jurisdictions in Canada to introduce a tax on carbon-based fuels. In October 2007, Québec imposed a so-called carbon tax on approximately 50 companies that sell hydrocarbon products in bulk to retailers operating in Québec and using a significant amount of hydrocarbons. The tax rate varies for each fuel, depending on the amount of carbon that it produces during combustion. The carbon tax is expected to raise \$200 million (obviously with the potential to escalate over time) in annual tax revenues for the province's Green Fund, which was established in 2006 to help fund reductions in GHG emissions and improvements to public transportation.

British Columbia implemented its own, much broader carbon tax on July 1, 2008. This tax applies to the purchase and use in British Columbia of gasoline, diesel fuel, natural gas, home heating fuel, propane, coal and other fossil fuels. It also

applies to certain transfers of fuels into the province or into ships, trains and airplanes. Designed to be revenue-neutral, the tax is being phased in, starting at a rate of \$10 per tonne of CO₂e emissions released from the burning of each particular fossil fuel, with the revenue being distributed to BC citizens through a variety of tax cuts, rebates and other programs. Although the initial price per tonne of CO₂e is lower than that advocated in many jurisdictions, the tax rate will increase to \$15 per tonne on July 1, 2009; \$20 per tonne on July 1, 2010; \$25 per tonne on July 1, 2011; and \$30 per tonne on July 1, 2012. The BC Liberal government, which brought the tax into force, was re-elected in 2009, although the tax was a contentious issue throughout the campaign.

THE CHANGING REGULATORY CLIMATE

Regional Cooperation

Another significant source of change is coming from regional North American efforts to mitigate global warming. Several provincial governments have become increasingly interested in North American regional initiatives, most notably the WCI, described above. Ontario and New Brunswick have also, in the past, expressed interest in partnering with the Regional Greenhouse Gas Initiative (RGGI), a cooperative effort by northeastern and mid-Atlantic states to reduce carbon dioxide emissions from certain electricity generators. The eastern Canadian provinces are already participating in this initiative as observers. All Canadian provinces and most US states have also joined The Climate Registry, a non-profit partnership that is developing a GHG emissions measurement protocol to support various voluntary and mandatory reporting policies.

Although regional initiatives are multiplying as more provinces embrace the benefits of a multijurisdictional approach to mitigating climate change, some entities have challenged the authority of regulators to implement them; for example, Indeck Energy, owner of a 128-megawatt cogeneration plant in Albany, New York, filed suit that state regulations implementing RGGI are unconstitutional and were implemented without the necessary statutory authority. Indeck argued, among other things, that under the RGGI regulations, it is unable to pass on the costs for purchasing carbon dioxide allowances because it is obligated to a long-term fixed-price contract for electricity with a New York City utility, whereas other electricity generators without such contracts are permitted to pass on the costs for purchasing the allowances to their customers.

Regardless of such challenges, British Columbia continues to work closely with California to implement vehicle emissions standards, having agreed to develop an equivalent Low Carbon Fuel Standard that will require the carbon intensity of transportation fuels sold in the province to be reduced by at least 10 per cent by 2020. Also influenced by California's *Global Warming Solutions Act of 2006*, BC premier Gordon Campbell has promised to reduce the province's GHG emissions by 33 per cent below current levels by 2020. British Columbia also plans to require electricity produced in the province to have zero GHG emissions by 2016.

The Canadian federal government, through yet-to-be-drafted Motor Vehicle Fuel Consumption Regulations, also plans to establish national mandatory fuel-efficiency standards that would match those proposed in April 2009 by the Obama administration. Those standards would raise fuel-efficiency targets to approximately 35.5 miles per gallon for new passenger vehicles and light trucks by 2016, four years earlier than what

would have been required under the US *Independence and Security Act*. The Canadian federal government issued its notice of intent to develop more stringent regulations earlier in 2009.

Energy Trends

To reduce GHG emissions, many states and provinces are encouraging a transition to lower-carbon or carbon-neutral energy sources. In the Powering the Plains policy directive, certain Upper Midwest states are aiming to achieve a carbon-neutral infrastructure by 2055. As of June 3, 2009, 34 states, including Connecticut, New Jersey, California and Texas, have adopted some form of renewable portfolio standards. So too have more Canadian provinces focused on energy-related initiatives. Notably, the Ontario government plans to increase its renewable energy capacity to help achieve its aggressive GHG reduction targets of 6 per cent below 1990 levels by 2014; 15 per cent below 1990 levels by 2020; and 80 per cent below 1990 levels by 2050. In particular, the Ontario government has issued regulations requiring that all of the province's coal-fired generation plants be retired by 2014, by which time power plant emissions are expected to have dropped by 85 per cent. To encourage new capacity, the province has passed the *Green Energy and Green Economy Act, 2009*. Among other things, this legislation allows the Minister of Energy and Infrastructure to direct the Ontario Power Authority to establish a feed-in tariff program for new renewable-source power generation. This program will offer standard long-term contracts for the purchase (at premium prices) of all electricity generated by new wind, solar, biomass, biogas and other renewable-source generation projects.

Carbon Disclosure

Institutional investors and capital markets commentators are continuing to examine how climate change regulation and the physical effects of global warming could affect investment. Many Canadian investors have urged companies to disclose the business risks and opportunities that climate change presents, backing voluntary reporting mechanisms such as the Carbon Disclosure Project as well as seeking enhanced disclosure from public companies through shareholder proposals made at shareholders' meetings.

Avenues for reporting GHG emissions are already developed. The federal Department of the Environment has required large facilities in the industrial sectors to which the Framework will apply to report certain information regarding designated air pollutants, GHGs and other substances for the 2006 calendar year – the Framework's proposed baseline. More recently, Environment Canada issued a notice requiring any person that operates a facility that emitted 100,000 or more tonnes of CO₂e in the 2008 calendar year to submit certain information about those emissions to the federal government no later than June 1, 2009.

Securities law continuous disclosure requirements for publicly traded issuers are also being re-examined in the context of climate change. In this light, Canadian securities laws, like US securities laws, require that management's discussion and analysis (MD&A) disclose any known trends, demands, commitments, events or uncertainties that are reasonably likely to have an effect on the company's business or that will materially affect the company's performance. Arguably, for certain issuers, this requirement captures risks related to climate change and climate change regulation.

On November 26, 2008, the Canadian Institute of Chartered Accountants (CICA) released its publication *Building a Better MD&A: Climate Change Disclosures* (the Guide). Building on the 2005 CICA guidance, the Guide is designed to assist issuers in deciding how to assess the business and financial impact of climate change issues for the purpose of their MD&A. The Guide identifies various types of information that investors and analysts are increasingly seeking, including information relating to whether the company has factored climate change issues into its business strategy; whether climate change poses physical, regulatory, reputational or litigation risks to the company; the company's direct and indirect GHG emissions; whether climate change issues have or are expected to have an impact on a company's financial operations, cash flow or financial condition; and what governance processes and resources a company has dedicated to these issues. As part of considering whether any particular information is material and thus to be disclosed, the Guide suggests that management should consider whether the impact of a climate change issue might reasonably be expected to grow over time, potentially making early disclosure of the issue important to long-term investors.

Securities disclosure rules may also require a public issuer's Annual Information Form (the equivalent of a US Form 10-K) to discuss the financial and any operational effects of environmental protection requirements on the capital expenditure, earnings and competitive position of the company in the current financial year and the expected effect in future years; environmental policies fundamental to a company's operations and the steps taken to implement them; and risk factors and regulatory constraints that would be likely to influence investor decision-making.

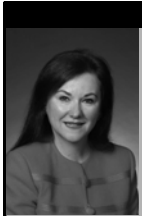
Securities regulators in Canada are paying attention to these issues. On February 27, 2008, the Ontario Securities Commission (OSC) issued a notice on environmental reporting (Notice 51-716), highlighting its findings and recommendations following a staff review of the environmental disclosure of 35 reporting issuers. Although the notice did not deal specifically with climate change, it did mark the first time that the OSC had issued a notice that dealt with environmental disclosure. Many of its recommendations regarding the assessment and disclosure of material environmental issues are relevant to the consideration of climate change disclosure questions. Furthermore, on April 7, 2009, a private member's resolution was passed in the Ontario legislature, instructing the OSC to undertake a consultation on best practices for corporate social responsibility and environmental, social and governance reporting standards.

Canadian securities regulators will also be watching developments south of the border, where a broad coalition of investors, state officials and environmental groups have been petitioning the Securities and Exchange Commission (SEC) to issue an interpretive clause clarifying that material climate-related information must be included in disclosure under existing reporting requirements. Meanwhile, legislators are also pressuring the SEC; on July 18, 2008, the Senate Appropriations Committee approved language in the *Financial Services Appropriations Bill* calling on the SEC to issue guidance for publicly traded companies to assess and fully disclose their financial risks from climate change. In the meantime, other government actors have taken up the cause. For example, the New York Attorney General's Office, in connection with a disclosure investigation conducted under New York State securities legislation, has entered into settlement agreements with power companies Xcel Energy Inc. and Dynergy Inc. Under these agreements, the companies will make specific and significant climate change-related disclosure in their annual Form 10-K filings with the SEC. The agreements require the power companies to disclose, among other things, an analysis of financial risks from present and probable future climate change regulation and legislation, climate change-related litigation and the physical impacts of climate change on their operations.

CONCLUSION

Canadian climate change regulation is expanding rapidly, with almost weekly announcements of new initiatives and developments. While the federal government prepares to regulate GHG reduction targets, opposition parties are exerting their influence to press the government to meet its Kyoto commitments, and environmental groups are doing the same through the judicial process. Moreover, various investors and concerned citizens are increasingly urging governments to consider new regulations requiring companies to disclose the impact of climate change on their businesses and to help mitigate and adapt to impacts on the global climate.

Governments are responding to these calls – especially in the provinces, which are experimenting with a variety of initiatives, from carbon taxes in British Columbia and Québec to emissions trading regimes in Alberta and, soon, WCI partner jurisdictions. With the federal government now willing to coordinate its initiatives with those south of the border, and with the tendency of the provinces to favour regional integration, the only thing that is certain is that the regulatory climate will continue to change rapidly.



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Dennis Mahony is the head of Torys' Environmental, Health and Safety Practice Group and co-chair of the firm's Climate Change and Emissions Trading Practice. Dennis's climate change practice involves helping clients navigate through this multifaceted field, including keeping them informed on the numerous domestic and international developments in the area, and working on project-specific teams for everything from assessing the ever-evolving securities disclosure requirements to emissions trading.



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