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In-House Counsel

Regulating the carbon market: Canada's federal carbon pricing regime

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(October 20, 2022, 8:54 AM EDT) -- In our previous article "Sustainable finance and carbon market: An overview," we introduced sustainable finance and provided an overview on carbon financing. In this article, we will focus on the Canadian carbon compliance market set by carbon pricing rules at the Canadian federal level. We wish to highlight that the following applies to large industrial facilities emitting 50,000 tonnes or more of CO2e (carbon dioxide equivalent) annually, as well as facilities that have opted into the Output-Based Pricing System (OBPS) (to be defined and described below).

Background

In light of the Pan-Canadian Framework on Clean Growth and Climate Change (PCF), a federal plan to cut down on greenhouse gas (GHG) emissions, the federal government adopted the *Greenhouse Gas Pollution Pricing Act* (GGPPA) on June 21, 2018, under which a federal carbon pollution pricing system was implemented. There are two components to this system: 1) a regulatory charge on fuel (the Fuel Charge), and 2) a trading system for large industries, also known as the Output-Based Pricing System, administered by Environment and Climate Change Canada (ECCC). This federal pricing system applies to any province that requests it or fails to implement its own curated system complying with the strict federal requirements.

In 2021 the legality of the GGPPA was challenged by several provinces. However, the Supreme Court of Canada explicitly recognized the existential threat of climate change and the importance of carbon pricing by confirming that the federal government has the legal authority to take co-ordinated, national action and impose a minimum carbon price nation wide to ensure that no province is a stumbling block to progress. This should provide some certainty for business professionals and transactional lawyers that carbon pricing is here to stay (in some form or another) and that climate change considerations including carbon financing will become increasingly more important in the context of capital raising and business transactions.

The Fuel Charge is administered by the Canada Revenue Agency (CRA). It is set out in Part 1 of the GGPPA and the Fuel Charge Regulations. The Fuel Charge is a carbon tax that applies to the sale of 22 different types of fuel set out in Schedule 2 of the GGPPA. The amount of tax is based on a fuel's carbon intensity (how much CO2e a fuel emits when burned); the more CO2e that a fuel emits, the higher the tax.

As of 2022, the Fuel Charge is $50 per tonne of CO2e. Starting in 2023, the Fuel Charge will be $65 per tonne of CO2e, increasing by $15 dollars annually, until it reaches $170 per tonne of CO2e in 2030. Businesses that are producers, distributors, importers, emitters, certain users of fuel, as well as air, marine, rail, or road carriers, may be required to register with the CRA (the Registrants). Registrants must pay the Fuel Charge to the CRA on the fuel that they produce or distribute and must file an annual net Fuel Charge report. In most cases, the Fuel Charge applies early in the supply chain and is payable by the Registrants. Hence, end users generally have no obligations in respect of the Fuel Charge. Fuel that is purchased by a consumer or business will already have the Fuel Charge embedded into the purchase price. For instance, when consumers or businesses pay their electricity and natural gas bill, the Fuel Charge is built into the total amount owing. To improve the affordability of the Fuel Charge, the federal government offers the climate action incentive (CAI) payment to individuals or families, subject to eligibility.

Generally, OBPS works by allocating a "baseline" amount of emissions that each regulated facility (as defined within the GGPPA) is allowed to release (the GHG Emissions Limit). In most cases, the GHG Emissions Limit is set as a percentage of the average emissions output for the industry in which a facility operates. If a facility emits less emissions than the GHG Emissions Limit, they earn "credits." If a facility emits more emissions than the GHG Emissions Limit, they must buy credits.

The goal is to give major GHG polluters a financial incentive to cut their emissions while simultaneously providing them with certain protections, such as exemption from the Fuel Charge. For instance, instead of paying the Fuel Charge on purchased fuels used in the facility, the regulated facilities pay a carbon price on their emissions output if it exceeds the GHG Emissions Limit. As of April 1, the federal carbon tax is $50 per tonne. A gradual hike of $15 per tonne is expected until the rate reaches $170 per tonne by 2030 for Canada to meet its obligations under the *Paris Agreement*. The rates are based on global warming potential factors and emission factors used by ECCC to report Canada's emissions to the *United Nations Framework Convention on Climate Change*.

Participation in the Federal OBPS is mandatory for facilities that meet the following criteria:

1. Are located in a Federal Backstop jurisdiction (Saskatchewan — applies in part — Manitoba, Prince Edward Island, Yukon, and Nunavut);
2. Have reported emissions of 50,000 tonnes of CO2e or more in 2014 or a subsequent year to the Greenhouse Gas Reporting Program; and
3. Carry out a "covered activity" (oil and gas production, mineral processing, chemical production, pharmaceuticals, iron, steel and metal tube production, mining and ore processing, nitrogen fertilizer production, food processing, pulp and paper production, automotive production, electricity generation and cement).

Voluntary participation in the federal OPBS is permitted for facilities that are located in a Federal Backstop jurisdiction, have reported emissions of 10,000 tonnes or more of CO2e in 2014 or a subsequent year, and carry out a covered activity (as described above). A facility may want to opt-in to the Federal OBPS because, among other things, it will exempt them from the Fuel Charge.

Canada's GHG Offset Credit System

On June 8, the Government of Canada enacted the *Canadian Greenhouse Gas Offset Credit System Regulations* (the Offset Regulations). The Offset Regulations have been enacted under ss. 192 and 195 of the Act and s. 5 of the *Environmental Violations Administrative Monetary Penalties Act*, and it enables projects governed by the federal OBPS to generate and sell carbon credits. These carbon credits can be used by facilities covered by the Federal OBPS to meet their GHG emissions compliance obligations. Requirements for projects registered under the Offset Regulations are further set out in applicable federal offset protocols (the Offset Protocol(s)), which describe the approach for quantifying GHG reductions or removals for a given type of project.

In order for a project to generate federal offset credits under the Offset Regulations, project proponents must meet a number of requirements. These requirements include:

- Registration of the project in accordance with specified conditions (e.g. exclusive entitlement to the credits produced, no registration under any other offset credit system, and necessary authorization to carry out the project activities);
- Maintaining a GHG Offset Credit System Account in the credit tracking system;

- Implementation of a project that generates GHG reductions that are real, additional, quantified, verified, unique and permanent;
- Preparation of project reports and verification of project reports by an accredited verification body; and
- If applicable, the implementation of a reversal risk management plan to mitigate the risk of GHG reversal.

Applicable Offset Protocols set forth the requirements in more detail. These protocols also outline the method for calculating GHG removals or reductions for a particular project type.

The Compendium of Federal Offset Protocols (Compendium) specifies the approved offset credit protocols that project proponents must follow in order to generate offsets. Environment and Climate Change Canada is currently prioritizing the development of the following protocols:

1. Direct Air CO2 capture and Sequestration;
2. Improved Forest Management;
3. Advanced Refrigeration Systems;
4. Enhanced Soil Organic Carbon; and
5. Livestock Feed Management.

The only approved and recognized Offset Protocol in the Compendium is Landfill Methane Recovery and Destruction, published on June 8, which is intended for use by a proponent undertaking a project that actively records and destroys LFG (landfill gas) and that is registered under the Offset Credit System to generate offset credits. We wish to highlight that protocols may not be developed for all the project types noted above. According to ECCC, the choice of protocols for development depends critically on a thorough evaluation of additional project kinds.

Concluding thoughts

The GGPPA and the Offset Regulations demonstrate the commitment of the federal government to address climate change. The GGPPA sends a pricing signal to businesses while the Offset Regulations together with the Offset Credit System invites businesses to look for creative ways to reduce carbon and GHG emissions.

In our next article, we will set out a province-by-province review of key climate change legislation each province has adopted, in part, as a substitute or supplement to the regime identified by the GGPPA.

Stay tuned!

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