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Mythology, Fantasy and Federalism: Canadian Climate Change Policy and Law

Alastair R. Lucas
University of Calgary Faculty of Law

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*Alastair R. Lucas**

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* Alastair R. Lucas, QC, is Professor and Chair of Natural Resources Law at the University of Calgary Faculty of Law. The research assistance of Veronica Potes is gratefully acknowledged. A version of this paper was published in 2006 International Energy Law and Taxation Review.

I. INTRODUCTION

Canadian corporate boardroom mythology has it that Al Gore's eloquence and persuasiveness at the 1997 Kyoto Conference enticed Canada into signing an unduly ambitious greenhouse gas ("GHG") emissions reduction commitment. Canada agreed to a 6% reduction over 1990 levels, even though Canadian negotiators lacked solid information on emissions and projections. At the time, the commitment was quite serious, based on Canadian government leadership aspirations dating from the 1998 Toronto Conference, an early landmark in international climate-change policy development.

The result has been a policy-development fantasy, in which national climate change planning began with little recognition of what was achievable, and particularly what the 6% reduction target actually required. As Canadian knowledge of GHG emissions improved, quantified reduction numbers became more explicit, but achievability remained a question.

On July 16, 2005, the Canadian Federal Department of the Environment published in the *Canada Gazette* a notice of intent to regulate greenhouse gas emissions by Large Final Emitters ("LFEs")[1]. In the decade-long development of Canada's climate change policy and strategy for meeting national obligations under the UN Framework Convention on Climate Change and Kyoto Protocol, this notice was the first clear signal that regulatory instruments would be central implementation tools. To that point, nearly a year and a half after Canadian ratification of the Kyoto Protocol, climate change action had consisted of voluntary industry and public programs, relatively small-scale federal government direct spending and subsidies, and public information and education.

Why did the Canadian government labor for so long under the apparent illusion that a policy based primarily on voluntarism and public education could solve such a large environmental challenge? What prompted the rather late adoption of an emissions trading system supported by a regulatory cap? And what are these Large Final Emitters that find themselves squarely in the federal government's regulatory sights?

This article assesses the law and legal process factors relevant to this instrument choice. This article's thesis is that constitutional jurisdiction, or at least federal-provincial relations perceptions of constitutional jurisdiction, played a role. But two other factors were significant: (1) Canada's natural-resource-intensive economy, in which the energy sector accounts for a significant and growing proportion of GHG emissions; and (2) timing prescribed by the Kyoto Protocol's first commitment period.

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1. Dept. of the Environment, *Canadian Environmental Protection Act, 1999: Notice of Intent to Regulate Greenhouse Gas Emissions by Large Final Emitters*, CAN. GAZETTE Part I, Vol. 139, No. 29, July 16, 2005, at 2489 [hereinafter "*LFE Notice of Intent*"].

To set the context, the next section looks at Canada's energy sector and its prominence in the LFE group. Then, Canada's national climate-change strategy is reviewed, beginning with its first steps in the late 1990s. The 2005 Climate Change Plan,[2] part of the broader environmental policy "Project Green," is assessed against this course of climate change policy development. Provincial climate change policy, particularly of major energy producer Alberta, is also reviewed. The focus is on the proposed federal system for regulation of LFEs and the proposed federal GHG emissions offset system. These programs are intended to be the basis for Canada's GHG emissions trading scheme. Finally, a postscript looks at the early policy direction signals sent by the new Canadian government formed following the January 23, 2006, general election.

II. THE KYOTO "GAP"

In global terms, Canada's GHG emissions are not large, amounting to 2.2% of global emissions.[3]

However, on a *per capita* basis, Canada ranks ninth among nations.[4] Seventy-three percent of total Canadian emissions are produced by fossil fuel combustion, and the energy sector is responsible for 80.3% of overall emissions.[5] Between 1990 and 1999, the energy sector contributed 96.6% of the 91.4 Mt.[6] increase in total GHG emissions.[7] However, over the same period, total Canadian GHG emissions per unit of gross domestic product ("GDP") decreased, mainly as a result of improved efficiency and fuel switching away from fossil fuels.[8]

Projecting emissions for the year 2020 reveals what has been described as the "Kyoto Gap"—the difference between projected business as usual ("BAU") emissions and Canada's Kyoto target of emissions 6% below 1990 levels. An important factor in this projection is the prediction that energy use from all sources is likely to double to approximately 750 exajoules in 2025.[9] Canadian officials acknowledge that this gap of approximately 36% -- or about 45% above Canada's Kyoto target -- is the largest among Kyoto Protocol signatories.[10] The 2005 Climate Change Plan explanation is that "Canada has an energy intensive

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2. *Moving Forward on Climate Change: A Plan for Honouring our Kyoto Commitment*, PROJECT GREEN (Gov't of Can./Public Works and Gov't Serv., Ottawa), 2005 [hereinafter "*2005 Climate Change Plan*"].

3. Canada, *Third National Report on Climate Change*, 2001, at 23, *available at* http://www.climatechange.gc.ca (last visited June 3, 2007) [hereinafter "*Third National Report*"].

4. *Id.*

5. *Id.* at 30.

6. One megaton (Mt) = one million metric tons.

7. *Id.* at 28.

8. *Id.* at 26.

9. *Energy Needs, Choice and Possibilities: Scenarios to 2050*, EXPLORING THE FUTURE (Shell Int'l/Global Bus. Env't), 2001, at 60, *available at* http://www.shell.com/static/media-en/downloads/scenarios.pdf (last visited June 3, 2007).

10. *2005 Climate Change Plan*, *supra* note 2, at 41 (discussing that the 45% gap is "being revised upwards").

economy due to a combination of factors that make it unique among industrialized countries: a cold climate, large distance between population centres, and Canada's resource-based economy."[11]

In 2003, the oil and gas and electricity generation sectors accounted for 36% of total emissions. Mining and manufacturing added 16% and transportation a further 25%.[12] Alberta, the major energy-producer province accounted for just over 50% of the oil and gas and electricity generation total, while the rest of Canada produced only 21% of these emissions.[13] These energy sector's emissions are projected to increase by 64% between 1990 and 2010. According to Canada's Third National Report, "[th]is increase largely reflects the growth in oil sands production and higher natural gas exports to the United States that are anticipated to occur during this period."[14]

III. LARGE FINAL EMITTERS —COLLABORATION AND VOLUNTARISM

Large Final Emitters are major companies in the energy, natural resources and manufacturing sectors. They are responsible for a little more than 50% of total Canadian GHG emissions. Beginning in the 1990s, before the Kyoto Protocol, the government engaged these LFEs in a collaborative process for emissions reduction. Initially, the focus was on voluntary measures, particularly the Voluntary Challenge and Registry ("VCR")[15] discussed below. LFEs became the focus of a collaborative process involving industry, federal, provincial and territorial governments, aboriginal peoples, environmental Non-Governmental Organizations ("NGOs"), and citizens. Out of this long-running negotiation emerged federal GHG emissions quantity and price guarantees for the energy sector, and ultimately, the current federal GHG regulatory proposals discussed below.

IV. THE CLIMATE CHANGE PLANS

A. *Federal Plans*

The first federal climate change plan in 2000[16] was relatively nonspecific: it pointed to the Kyoto Gap; outlined a series of existing, proposed, and voluntary spending measures, including VCR; and proposed a variety of "targeted

11. *Id.*

12. Canadian Association of Petroleum Producers, Climate Change: GHG Emissions by Sector, 2003.

13. J. Donner, *Alberta Environment Strategic Directions*, Alberta ENVIRONMENT, Feb. 5, 2002.

14. *Third National Report*, *supra* note 3, at 85.

15. VCR's background and organization is available at http://www.csa.ca/climatechange/services/carbon/Default.asp?language=english (last visited June 3, 2007).

16. *Canada's National Implementation Strategy on Climate Change*, NATIONAL CLIMATE CHANGE PROCESS (Gov't of Can./Public Works and Gov't Serv., Ottawa), Oct. 2000, *available at* http://www.nccp.com.

measures." Building on this, the 2002 Climate Change Plan[17] identified a 270 Mt. target reduction and allocated this target to various sectors and programs.

An emissions-trading system was proposed, but little detail was included. However, it was clear that LFEs had a major role to play in this trading regime. Finally, the 2005 Climate Change Plan[18] provided much of the detail of Canada's overall approach. Significantly, the 2002 Plan places considerable emphasis on demonstrating continuing commitment to targets, as well as approach and specific quantitative commitments, such as those made to the energy sector by the Prime Minister and the Minister of Natural Resources. These commitments are specifically shown in a table that compares the 2002 Plan with the 2005 Plan.[19]

The 2005 Plan begins by adjusting the difference between Canada's projected BAU emissions and its Kyoto target, which, according to the 2002 Plan, was 240 Mt. This is a consequence of "economic growth in key emissions-intensive sectors. . . expected to be greater than had previously been projected."[20] "As a result the emissions gap is more likely in the area of 270 Mt. and could be greater."[21]

Elements of the Plan include the following (with projected emission reductions in parentheses):

- Market-based approaches, including the LFE system (36 Mt. reduction).
- A climate fund that will purchase domestic and international emission-reduction credits on behalf of the Government of Canada (75-115 Mt. reduction).
- A specific covenant between the federal government and the auto industry (5.3 Mt. reduction).
- Federal, provincial and territorial cooperation projects. A federal Partnership Fund will, on the basis of government-to-government cost-sharing agreements, support various subsidy programs for new technology development. This includes clean-coal technology, CO_2 capture and storage, and electricity-grid coordination (55-85 Mt. reduction).
- Incentives for creation of beyond-BAU agricultural and forest sinks, based on agricultural and forest practices changes. An offset system

17. Canada, *Climate Change Plan for Canada*, Nov. 2002, *available at* http://www.climatechange.gc.ca (last visited June 3, 2007) [hereinafter "*2002 Climate Change Plan*"].

18. *2005 Climate Change Plan*, *supra* note 2.

19. *Id.* at 40-41.

20. *Id.* at 12.

21. *Id.*

for greenhouse gases is under development. A consultation process, based on papers that outline a system for offset creation and certification (discussed below) is underway (10-30 Mt. reduction).

- Federal spending and tax incentives promoting renewable energy technologies (15 Mt. reduction).
- A voluntary "One Tonne Challenge" program aimed at individual citizens (5 Mt. reduction).
- Various federal spending programs, including energy efficiency and promotion (40 Mt. reduction).

B. *Alberta's Plan*

Alberta's climate change plan was released in 2002.[22] It has three major elements: (1) an emission-intensity-based target of reducing emissions to 50% of 1990 levels by 2020, (2) voluntary (negotiated) reduction agreements with specific sectors, including electricity, petroleum, transportation, and municipalities, and (3) an emissions trading system. The latter two are the main subjects of the Climate Change and Emissions Management Act.[23] Regulations under this Act to implement targets under negotiated covenants, define emission rights and their use to meet targets, and to establish reporting requirements, were under development in May of 2006.

V. THE LEGAL REGIME

A. *Funds and Subsidy Programs*

Federal subsidy programs will promote renewable energy production, particularly wind energy. Small hydro, biomass, and tidal power projects will also be eligible for support. Tax incentives will also be used for these purposes.[24]

The Climate Fund Agency[25] is intended to serve both emissions-reduction and technology-development objectives. As a purchaser of domestic emissions-reductions and international Kyoto credits, it will stimulate the development of a domestic emissions-trading system. It will partner with private sector firms in emissions-reduction projects.

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22. *Albertans and Climate Change: Taking Action,* ALBERTA ENV'T. *(Gov't of Alberta, Edmonton, AB),* Oct. 2002.

23. Climate Change and Emissions Management Act, 2003 S.A., ch. 16.7 (Can.).

24. *2005 Climate Change Plan, supra* note 2, at 20.

25. *Id.* The "Climate Fund" will be the Canadian Emission Reduction Incentives Agency Act, Part 14 of the Budget Implementation Act, 2005, S.C., ch. 30 (Can.).

A federal Partnership Fund,[26] created as part of the 2005 Budget, will be a basis for Memoranda of Understanding with provinces and territories to establish cost-shared emissions-reduction programs and projects. The idea is to promote changes in industrial and construction technology and infrastructure development. Candidates include clean-coal technology, CO_2 capture and storage, and phase-out of coal-fired electricity generation plants. It is expected that these cost-shared initiatives may also be supported by the Climate Fund and the Technology Investment Fund.

The Greenhouse Gas Technology Investment Fund, established by the Budget Implementation Act of 2005,[27] is another element of the federal strategy. Beginning in 2008, contributors to the fund will receive Technology Investment Units that LFEs can use to meet emissions targets. In line with the federal price assurance to LFEs,[28] the maximum contribution rate for the first commitment period will not exceed $15 per ton.[29] However, these units will not be tradable, and total units that can be counted toward emissions compliance will be limited to 9 Mt. annually.[30]

B. Regulation of Large Final Emitters

1. Policy and Legislative Authority

Environment Canada's Notice of Intent to regulate greenhouse gas emissions by LFEs is reasonably precise as to instrument choice and specific regulatory method, but it is surprisingly uncertain about legal authority and timetable. It begins by stating that the "working assumption"[31] is that the proposed regulations will be developed under Parts 5 and 11 of the Canadian Environmental Protection Act ("CEPA")[32] and will be administered by Environment Canada.

This signals that the legal regime will not be designed from the ground up, but is likely to be tailored using existing CEPA powers. Part 5 is a system for assessment, scheduling, and regulating toxic substances. This power is necessary to establish legally enforceable emissions caps. Part 11 includes Cabinet powers in the exercise of Part 5 powers to regulate systems for "tradable units," including testing and monitoring, description and the nature of tradable units (baselines and maximum limits, conditions for participation in the system, conditions for creation, sale and cancellation of tradable units, records, reports

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26. *Id.* at 25.

27. Budget Implementation Act, 2005, S.C., ch. 30 (Can.). *See LFE Notice of Intent*, *supra* note 1, at 2497.

28. *See infra* Regulation of Large Final Emitters. *See LFE Notice of Intent*, *supra* note 1, at 2498.

29. All dollar amounts discussed in this article refer to Canadian dollars.

30. *Id.*

31. *Id.* at 2491.

32. Canadian Environmental Protection Act, 1999, S.C., ch. 33 (Can.) [hereinafter "*CEPA*"].

and forms, and a public registry).[33] The Environment Minister has the power to set conditions, suspend or cancel trading or invalidate trades where the Ministers of Environment and Health are of the opinion that a trade has or may have an immediate or long-term harmful effect on the environment, constitutes a "danger to the environment on which human life depends," or "constitutes a danger in Canada to human life or health."[34]

An immediate issue arose concerning whether GHGs are "toxic" substances within the meaning of CEPA Part 5. Debate briefly flared about whether the word "toxic" is defined broadly enough for this purpose, but a ministerial order adding GHGs to the toxic-substance list was made in November 2005,[35] and there has been no challenge.

The reason for using existing legislative authority is that CEPA includes a convenient mechanism for federal-provincial coordination of environmental legislation. Where provincial laws are equivalent in terms of effect and include a mechanism for citizen petitions for investigation of alleged non-compliance, the federal and provincial Ministers can enter into an "equivalency agreement,"[36] which is the basis for an order by the federal Cabinet that effectively withdraws operation of the equivalent CEPA regulations in the province or provinces.

This is the proposed mechanism for federal-provincial partnerships on a cap-and-trade system for LFEs. Though not widely used, equivalency agreements have been negotiated in other areas.[37] They are an example of the collaborative federalism approach that has come to characterize Canadian environmental policy.[38] All levels of government perceive that legitimacy requires more than legislation presumptively grounded in constitutional competencies. Provincial consent based on a reasonably transparent collaborative process has become essential.[39]

a. Proposed Regulation-Making Process

Development of CEPA regulations has been proposed. A ministerial order to add GHGs to the list of substances under Part 5 of CEPA has been made[40] based on the IPCC's Third Assessment Report.

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33. *Id.*, s. 326.

34. *Id.*, s. 327.

35. *Order Adding Toxic Substances to Schedule 1 to the Canadian Environmental Protection Act, 1999*, SOR/2005-345 s.1 (Can.), Part II, November 21, 2005, at 2626 [hereinafter "*Order Adding GHGs*"].

36. *CEPA*, s. 10.

37. *E.g.*, Alberta Equivalency Order, SOR/94-752 (Can.).

38. D. VANNIJNATTEN, INTERGOVERNMENTAL RELATIONS AND ENVIRONMENTAL POLICY MAKING: A CROSS-NATIONAL PERSPECTIVE 23 (P. Fafard and K. Harrison eds., 2000).

39. W. MacKay, *Legitimacy in a Federal System*, 1 FEDERAL GOVERNANCE 27 (2003).

40. *Order Adding GHGs*, *supra* note 35.

The Notice of Intent to Regulate emphasizes that this development will involve federal-provincial partnerships and includes stakeholder participation and other consultation.[41] Equivalency agreements are intended to ensure national consistency of the GHG emission targets. This is said to be necessary to protect competitiveness among Canadian industries by "avoiding a patchwork of different regulations being applied to the same industrial sectors and to ensure an effective emissions trading regime."[42]

"Drafting Instructions, Cross-Cutting Provisions for Large Final Emitters," posted on the CEPA Registry Web site, outlines regulations that will apply to industrial sectors to be included (thus, "cross-cutting"). These include a prohibition on emitting GHGs beyond limits determined by a prescribed formula, requirements to demonstrate compliance by remitting compliance units to the Minister of the Environment, and a provision for insurance of emission credits.[43]

b. GHG Emission Targets

Targets will be prescribed for the 2008-2012 period, in emission intensity terms, for activities in each sector. This means an allowed amount of GHGs expressed in CO_2-equivalency per unit of output, with output defined for each sector.[44]

The method[45] for existing facilities will begin with the 2010 BAU forecast and then determine percentage reductions. Fixed chemical reaction process emissions will receive a zero reduction target. All other included emissions will be assigned a 15% emission intensity target relative to the 2010 BAU projections,[46] but no sector will be burdened with more than 12% of total reductions. Early action is credited because all facilities within a sub-sector receive the same target, giving early investors in emissions reduction a competitive advantage.[47]

For new, modified, or expanded facilities, the formula is familiar—the best available technology economically achievable ("BATEA").[48] This does not mean

41. *LFE Notice of Intent*, *supra* note 1, at 2491.

42. *Id.* at 2492.

43. Environment Canada, *Drafting Instructions, Cross-Cutting Provisions, Large Final Emitters Regulations* (2005), http://www.ec.gc.ca/CEPARegistry/documents/part/LFE_drft_inst/LFE_drft_inst.cfm [hereinafter "*Drafting Instructions*"].

44. *LFE Notice of Intent*, *supra* note 1, at 2493; *Drafting Instructions.*

45. *Id.*

46. Letter from Federal National Resources Minister Herb Dhaliwal to the Canadian Association of Petroleum Producers ("CAPP") in December 2002, and letter from Prime Minister Jean Chrétien to CAPP in July 2003, which gave assurances that Canadian Oil and gas production will not be made uncompetitive and that the BAU base for emission targets will take future environmental regulations into account, http://www.capp.ca (last visited June 3, 2007) [hereinafter "*Dhaliwal Letter*" and "*Chrétien Letter*", respectively]. Both letters are referred to in the LFE Notice of Intent, Annex 1.

47. *LFE Notice of Intent*, *supra* note 1, at 2494.

48. *Id.*

a requirement to install specific technology. The broader context is international benchmarks, collaborative best practices, and the advice of a technical advisory board. Thresholds for application of the regulation to small emitters will be developed. The idea, according to the Notice of Intent, is to recognize the "environmental and economic benefits [of] a capital stock life-cycle approach. . . ."[49] All of this target development will be done in the context of any equivalency agreement negotiated with provinces and territories and in consultation with industry and NGOs.

c. Offsets System

This is not part of the proposed LFE regulations, though creation and purchase of offset credits, as one means of meeting targets, is likely to be of interest to LFEs. As of 2006, a proposal for an offsets system was still in a public consultation process.

Proposed is an offsets system[50] much broader than the carbon reductions and removals through land-use, land-use change, and forestry contemplated by Articles 3(3) and (4) of the Kyoto Protocol.[51] Included are activities such as electricity or gas utility demand-side management, landfill methane capture, reforestation, carbon sequestration through low-till agricultural practices, and geological sequestration of carbon. LFE activities that are outside LFE regulatory requirements are also included.

The offsets system is not a minor program, since it encompasses all reduction activities not included in the LFE system. It is intended that offsets will be purchased by the Climate Fund and retired to meet Canada's Kyoto Protocol obligation. The Fund will invest in both domestic emission-reduction projects and the Kyoto Protocol international Clean Development Mechanism and Joint Implementation projects.

2. System Design

The offset scheme involves four stages.[52] First, application is made to an Offset Program Authority for registration of a proposed GHG reduction or removal project as an offset project. Second, it must be confirmed that requirements for an offset project are met. These include specifications that

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49. *Id.*

50. Offset System for Greenhouse Gases, Papers for Consultation: Overview Paper and Technical Background Document (Gov't of Can., Ottawa), 2005, http://www.ieta.org/ieta/www/pages/getfile.Php ?docID=1096 (last visited June 3, 2007) [hereinafter "*Offset System Papers, Overview Paper*" and "*Offset System Papers, Technical Background Document*"].

51. U.N. Framework Convention of Climate Change, Marrakesh COP7 Report, Addendum, Part II: Action Taken by the Conference of the Parties, Vol. 1, ¶¶54-63 U.N. Doc. FCCP/CP2001/13/Add.1 (Jan. 21, 2001), *available at* http://unfccc.int/resource/docs/cop7/13a01.pdf.

52. *Offset System Papers, Overview Paper*, *supra* note 50, at 2.

reductions and removals be quantifiable and will achieve results within the registration period.[53] Projects must be real, involving a specific and identifiable GHG reduction or removal action.[54]. They must be outside the LFEs system and can be used only once in the national offsets regime.[55] Third, emissions reductions achieved by a project must be verified by the Authority.[56] The fourth stage is the issuance of the proper number of offset credits.

These credits will then be tradable in the domestic market and can be banked. Most important, they can be created or purchased by LFEs and used to comply with emission requirements, and they can be purchased by the Climate Fund.[57]

3. Ownership

Several legal issues for the offsets system are not yet resolved. One is ownership of emissions reductions and removals. The proposal merely specifies that a single person or entity must serve as project proponent.[58] In the case of agricultural soil sequestration projects, the project proponent bears the burden of clarifying ownership of soil sequestration potential and sequestered carbon. This means that project proponents may be aggregators or investors who do not own the land surface, even though it is likely that at common law, rights to sequestration potential and carbon sequestered in agricultural land are part of the fee simple absolute and thus normally vested in the surface owner; thus dispute potential is high.[59] Consequently, certainty and stability of expectations suggest the need for legislation to clearly specify the nature of ownership rights.[60] Another function of such legislation would be to establish templates for contractual instruments to support sequestration projects on private and public land.[61] These instruments should, for example, clarify responsibility for maintenance of the amount of sequestered carbon on which issuance of offset credits is based, and replacement of offset credits should there be a sequestration reversal.[62] Otherwise, each sequestration project incurs significant transaction costs related to the individualized design of contract instruments.[63]

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53. *Id.* at 6.

54. *Id.* at 7.

55. *Id.* at 8.

56. *Id.*; *Offset System Papers, Technical Background Document, supra* note 50, at 22.

57. *2005 Climate Change Plan, supra* note 2, at 21.

58. *Offset System Papers, Technical Background Document, supra* note 50, at 8.

59. S. Kennett et al., *Property Rights and the Legal Framework for Carbon Sequestration on Agricultural Land*, 37 OTTAWA L. REV. 171 (2006).

60. *Id.*

61. *Id.*

62. *See Offset System Papers, Technical Background Document, supra* note 50, at 28.

63. Kennett, *supra* note 59.

4. Dispute Resolution

A dispute resolution system tailored to the needs of the offsets system is not part of the proposal. Yet without such a system, decisions of the Program Authority, including ownership decisions and operating decisions on such matters as certification of offset reversals, are subject to judicial review. Judicial review leads to delay and uncertainty. There should be an internal review or appeal mechanism with a related consensual dispute-resolution process to minimize transaction costs, as well as promote system fairness and equity.[64]

a. Emissions Trading System

The proposed LFE regulations do not address the structure of an emissions-trading market. They merely specify the kind of emissions credits that can be remitted for compliance purposes. The domestic offsets system will establish the rules and conditions for creation and ownership of offset credits. The latter can also be traded and used to meet LFE targets. Thus, together the LFE and Offsets Systems create conditions for development of an emissions-trading system. In addition to LFEs, governments, and individuals, the Climate Fund is likely to be a major buyer. The market would operate through private-sector exchanges. However, the government plans to establish an electronic registry and tracking system.[65]

b. Compliance Options

The result will be that various elements of the overall climate change regime, including the LFE and Offsets Systems, the Technology Investment Fund, and the various Kyoto Protocol mechanisms, may be used by LFEs to meet their emissions targets. These options include the following:

- investment in direct emissions reduction
- domestic emissions credits purchased from other LFEs that have surplus credits after achieving their targets
- domestic offset system credits
- non-tradable technology investment units as described above
- International Kyoto units, including Emission Reduction Units ("ERU"), Removal Units ("RMU"), Certified Emission Reduction

64. *See* A. Lucas & W. Daudu, *Disputes and Dispute Resolution in the Offsets System*, Apr. 2006, BIOCAP Canada Research Integration Forum, http://www.biocap.ca; Tilleman, *Environmental Appeals Boards: A Comparative Look at the United States, Canada and England*, 21 COLUM. J. ENVT L. 1 (1996).

65. *LFE Notice of Intent*, *supra* note 1, at 2497; *Drafting Instructions*, *supra* note 40.

Units ("CER") and Assigned Amount Units ("AAU"). These units must be "greened."[66]

But for LFEs, the most important compliance instrument is a federal subsidy. This is the $15/ton cap on the cost of compliance to which the federal government committed in 2002.[67] This price assurance will be implemented in part through the Technology Investment Fund with its $15/ton investment units, but total annual compliance from this source will be limited to 9 Mt. If additional credits are required, options identified include special credits and direct subsidies for emissions credit costs in excess of $15.[68] Overall, the federal government intends to stand firm on its commitment to LFEs that emission intensity targets will not be more than 15% below projected BAU emission intensity levels in 2010.[69] The limit on LFE responsibility will be implemented through the target-setting process described above.

The LFE regulatory system necessarily involves prohibitions, including failure to meet targets and reporting obligations. However, penalties will not exceed $200/ton of emissions, and offenses are likely to include due diligence defenses.[70] Deliberate failure to comply will, however, be dealt with under existing CEPA provisions that include potentially greater penalties.

c. Constitutional Powers

Legislative competence of the federal and provincial governments is a major factor in the development of the LFE regime and the platform for emissions trading. Sections 91 and 92 of the Constitution Act of 1867,[71] divide legislative powers between the federal government and provinces in relation to listed subjects. In the event of conflicts between federal and provincial legislation, the federal law is paramount.[72] There is also a residual federal "peace, order and good government ('POGG')" power. This power includes reasonably distinct and indivisible matters of national concern that are not of a scale that unduly diminishes exclusive provincial powers.[73] No head of legislative power specifically mentions environment. Provinces own the natural resources within their boundaries.

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66. For example, where surplus permits are purchased from Russia and Eastern European Countries where economic decline has reduced emissions below Kyoto commitments, seller countries must agree to invest sale proceeds in emissions reduction projects.

67. *Dhaliwal Letter, supra* note 46.

68. *LFE Notice of Intent, supra* note 1, at 2498.

69. *Dhaliwal Letter, supra* note 46.

70. *LFE Notice of Intent, supra* note 1, at 2495.

71. Constitution Act, 1867, 30 & 31 Vict. ch.3 (U.K.) *as reprinted in* R.S.C., No. 5 (Appendix 1985).

72. *Bank of Montreal v. Hall*, [1990] 1 S.C.R. 121 (Can.); *Multiple Access v. McCutcheon*, [1982] 2 S.C.R. 161 (Can.).

73. *R. v. Crown Zellerbach Canada Ltd.*, [1988] 1 S.C.R. 401 (Can.).

The problem is that provincial legislative competence must be taken seriously in this "water-tight" compartment allocation of legislative power. Generally speaking, the environment is a subject of shared competence. Provincial property, civil rights, local works and undertakings, and public-lands and natural-resources powers are set against the federal powers in relation to fisheries, navigation, trade and commerce, federal public (including territorial) lands, coastal marine belts, and Aboriginal lands.[74] Because environment is an aggregate subject, potentially ranging from human and ecosystem health, to property, industrial operations and taxation, federal POGG power is by no means clear.[75] While there is little doubt that the federal power to raise money by "any mode or system of taxation"[76] would support a carefully crafted federal carbon tax, the federal government explicitly, but informally, assured Alberta that it will not levy a carbon tax.

Provincial climate change and emissions legislation establishing a regulatory regime (including emission targets based on government-industry covenants that form the basis for creation of tradable emission rights) is very likely constitutionally valid.[77] A similar federal regime is more problematic, particularly if emissions targets are the subject of regulation,. Federal competence for a scheme such as that proposed in the LFE notice of intent to regulate may plausibly be based on the POGG power. The judicially recognized significance of "provincial inability"[78] in assessing the "singleness or indivisibility" of a subject such as GHG emissions reduction strengthens arguments for federal competence. But the Supreme Court of Canada has pointedly told the federal government to use its enumerated competencies, such as the criminal law power, before attempting to resort to POGG.[79] In practice, even consideration by the federal government of exercise of these competencies would be regarded by Alberta and other provinces as a stinging political blow—a significant factor in a federation that relies extensively on cooperative federalism processes and institutions.[80] Such federal action would be vigorously opposed, both judicially and politically.

This explains the federal strategy of cooperation, using negotiated equivalency agreements under the CEPA. It is not so much a constitutional constraint as a political constraint. It also assists in explaining the federal "no carbon tax" guarantee, as well as the federal guarantees to the energy sector of $15/ton price assurance and 15% of total emissions limit. All are political accommodations that reflect historical jurisdictional battles, and current

74. PETER HOGG, CONSTITUTIONAL LAW OF CANADA 29-19 (4th ed. 2004).

75. *Crown Zellerbach Canada Ltd.*, 1 S.C.R. 401.

76. Constitution Act, 1867, s. 91(3).

77. Nigel D. Bankes & Alistair R. Lucas, *Kyoto, Constitutional Law and Alberta's Proposals*, 42 ALBERTA L. REV. 355, 377, 397 (2004).

78. *Crown Zellerbach Canada Ltd.*, 1 S.C.R. 428 at 35.

79. *R. v. Hydro-Quebec*, [1997] 3 S.C.R. 213 (Can.).

80. HOGG, *supra* note 74, at 5-43.

perceptions about provincial and regional political and economic strengths in light of the formal constitutional division of powers.

d. The Energy Imperative

In the 2005 Climate Change Plan, the Government of Canada acknowledges the factors—cold, distance, and a resource-based economy—that create an energy-intensive Canadian economy.[81] The significance of natural resources, particularly hydrocarbon energy resources, is implicit in the main features of the Plan.

The Large Final Emitters System, with LFEs predominantly from the energy sector, is a central component of the Plan. LFEs contribute a large percentage of total emissions and, as noted in the 2005 Plan, makes them critical to Canada's climate change effort.[82] Further, a regulatory approach will provide LFEs a platform to access both domestic and international emissions trading.[83]

It is in the elements of the LFE system that the importance of the energy sector emerges clearly. The system features a number of financial supports. First, there is the 15% of total emissions responsibility commitment, which caps LFE financial responsibility for the first Kyoto commitment period. The government's $15/ton emissions allowance price limit provides a more specific financial assurance.[84] Second, the 2003 letter from Prime Minister Chrétien gave the industry competitiveness support and removed a concern about potential double-counting of emissions obligations, should more stringent federal environmental regulations come into effect.[85] The Greenhouse Gas Technology Investment Fund, which creates opportunities for economic payoff through innovation that energy sector firms are well-positioned to take advantage of, limits the investor unit price to $15 per ton of GHGs. Third, there is opportunity, particularly for the oil and gas sector, to lever provincial assistance through federal-provincial cost-sharing programs supported by the federal Partnership Fund.

These features of the federal plan implement the emissions quantity and price assurances that were given to the oil and gas sector in the period of national controversy surrounding Canadian ratification of the Kyoto Protocol in 2002. They also recognize and support the oil and gas industry development that is now underway, particularly in the Alberta oil sands.

The economic implications of the oil sands are enormous for Canada. The oil sands' reserve of 175 billion barrels of proven oil equivalent[86] place Canada in

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81. *2005 Climate Change Plan, supra* note 2, at Annex 3.

82. *Id.* at 17 ("... that there be certainty about the emissions reductions that will result from the LFE system.").

83. *Id.* At 16-17.

84. *Dhaliwal Letter, supra* note 46.

85. *Chrétien Letter, supra* note 46.

86. OIL AND GAS JOURNAL, Dec. 2004; ALBERTA ENERGY AND UTILITIES BOARD, July 2003.

the same league as Saudi Arabia. A frenzy of oil sands development, driven largely by United States market demand and the relative security of North American land-based pipeline delivery, is in progress. Projects either underway or planned over the next two decades are valued at more than $100 billion (Can.).[87] Canadian Natural Resources Limited's recently commenced Horizon mine and an upgrader project alone is projected to cost $10.8 billion (Can.).[88] Oil sands projects are now, and are likely to remain, Canada's most rapidly increasing source of GHG emissions.[89]

e. The Limits of Government-Industry Cooperation

Another factor evident in the development of Canadian climate change policy over the last decade is the weakening and ultimate removal of voluntary compliance initiatives as a central element of the federal climate change plan. The government- and industry-supported Voluntary Challenge and Registry ("VCR" Inc.)[90] became a major element of the national strategy and action program for GHG reduction under the UN Framework Convention on Climate Change and the Kyoto Protocol.

But VCR was not among the instruments proposed in the 2002 National Climate Change Plan. It was merely mentioned under "actions underway"[91] by LFEs. Under this plan, voluntary covenants, one component of the VCR scheme, were to be used (with a "regulatory backstop") by LFEs to establish emissions targets.[92] By late 2003, however, federal working papers did not mention VCR, and covenants were to be used only to "vary" regulatory obligations for companies likely to be competitively disadvantaged.[93] In the 2005 Plan, even the covenants were dropped as adding "considerable complexity to the system."[94]

The reasons for the shift from voluntary to regulatory are simple: time and money.[95] First, as shown above, the size of the "Kyoto Gap" was seriously underestimated. It became apparent that with the first Kyoto commitment period looming, larger emissions reductions were required than experience with VCR

87. Gordon Page, *An Oil SandsPrimer* and *Oil Sands Project,* CALGARY HERALD, Oct. 21, 2005 at A-20.

88. *Id.*

89. *Third National Report, supra* note 3, at 85.

90. VCR's background and organization is available at http://www.csa.ca/climatechange/services/carbon/Default.asp?language=english (last visited June 3, 2007).

91. *2002 Climate Change Plan, supra* note 17, at 29.

92. *Id.* at 30.

93. Natural Resources Canada, *Large Final Emitters Group Discussion Paper: Overview of Legislation,* 2004. This problem is recognized in the *LFE Notice of Intent, supra* note 1, at 2494. The BATEA-based emissions targets are intended to be responsive.

94. *2005 Climate Change Plan, supra* note 2, at 15.

95. A. LUCAS & V. POTES, REGULATING ENERGY AND NATURAL RESOURCES 317 (B. Barton et al. eds., 2006).

suggested it could deliver. Both industry and government tacitly acknowledged[96] that regulation is the only viable instrument. A related factor is that the expectation of industry, particularly the energy sector, changed as soon as it was perceived that significant expenditures beyond BAU expenditures would be required. At this point, the expectation was that if financially onerous requirements were to be imposed, it must be done through formal regulations.

5. Prospects for the National Regime

What are the prospects for the federal-provincial partnership approach to GHG emissions reduction? First, the CEPA equivalency agreement approach is a viable means of removing constitutional uncertainty.[97] But it requires, if not the agreement of all the provinces, at least the agreement of the major energy-producing and manufacturing provinces—British Columbia, Alberta, Ontario, and Quebec.

Agreements in principle have been reached with Ontario and Quebec.[98] The latter recognizes, in the emissions target to be developed for Quebec, the province's reliance on low-emission hydro-electric power. But federal negotiations with Alberta have proven difficult. After initial signs of progress, Alberta made threats of constitutional litigation.[99] In 2006, while negotiations continue, Alberta officials have made it clear that their priority is development of their own GHG emissions regulations under Alberta's Climate Change and Emissions Management Act.[100] The major objective is protection of the pro-vince's energy sector, which is pumping massive royalty revenues into Alberta's public accounts.[101]

Even assuming federal-provincial agreement, it seems likely that establishment of LFE emissions targets under the scheme for new facilities will involve a series of difficult negotiations. Like the regulations themselves, these BATEA targets are to be developed "in partnership with provinces and territories and in consultation with the industry . . . ."[102]

Another potential problem is that emissions trading may be slow to develop. LFEs have the $15/ton price assurance and the availability at $15/ton (at least for 9 Mt. annually) of Greenhouse Gas Technology Investment Fund credits. With this comfort and the likelihood of room for initial cost-effective direct emissions

96. Important notice concerning the transition of VCRs programs over the course of 2004 is available at http://www.csa.ca/climatechange/services/carbon/Default.asp?language=english (last visited June 3, 2007).

97. Bankes & Lucas, *supra* note 77, at 398.

98. R. Séguin, *Quebec buries Kyoto hatchet with Ottawa*, GLOBE AND MAIL, Nov. 24, 2005, at A15.

99. D. Bueckert, *Alberta is poised to battle Ottawa over Kyoto Treaty Plan*, GLOBE AND MAIL, Nov. 2, 2005, at A18.

100. R. D'Aliesio, *Alberta Renews Kyoto Battle*, CALGARY HERALD, Nov. 23, 2005, at A1.

101. Producing multibillion-dollar budget surpluses that support programs such as the $400 "prosperity bonus" for every Alberta resident: Alberta Resource Rebate Statute Amendment Act, Bill 43, 2005.

102. *LFE Notice of Intent*, *supra* note 1, at 2495.

reduction, as well as initial uncertainty concerning international emissions credits, it seems likely that LFEs will not rush into the market. In the early market, the Climate Fund is likely to be the major, and perhaps the only, purchaser of domestic offset credits and surplus LFE emission credits.

6. Potential NAFTA Constraints

The establishment and operation of a domestic GHG emissions trading regime raises potential issues under the North American Free Trade Agreement ("NAFTA") and the wider World Trade Organization ("WTO") regime. For example, allocation of emissions credits that favors domestic over non-domestic firms in ways that create competitive advantages may be infringements of NAFTA and WTO national treatment and most-favored-nation provisions.[103] The Framework Convention on Climate Change and Kyoto Protocol are not among the multilateral environmental agreements specifically given priority in the event of inconsistency by NAFTA's Article 104. NAFTA's Chapter 11 investment provisions create special investor discrimination rights that must be respected. These include rights to compensation for loss resulting from government measures that are "tantamount to . . . expropriation" of investments. Chapter 11 may encompass rights of U.S. and Mexican firms to enter and actively participate in a Canadian emissions trading system.

Detailed analysis of these and other potential trade law issues created by Canada's proposed Kyoto Protocol implementation regime is beyond the scope of this paper.[104] However, the Canadian federal LFE and Offsets System proposals do not contemplate selective allocation of emissions credits through establishment of emissions targets. No distinction will be made among Canadian firms, Canadian subsidiaries of U.S. firms, and any other non-Canadian firms in either LFE target-setting, credit allocation and trading, or in offset credit creation and trading. Though international Kyoto credits will be recognized in the trading system, non-Kyoto party credits have no place. Potentially, failure to recognize credits generated in non-Kyoto states, such as U.S. credits, is trade-restrictive. However, it has been argued[105] that even if this were accepted, there is a problem, because acceptance of non-Kyoto credits by Kyoto states would not be in accord with the Protocol.

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103. *See* Z. Zhang, *Open Trade With the United States Without Compromising Canada's Ability to Comply With its Kyoto Target*, 38 J. WORLD TRADE 155 (2004).

104. *See* H. Mann and K. von Moltke, *Protecting Investor Rights and the Public Good: Assessing NAFTA's Chapter 11*, Background Paper to the ILSD Tri-National Policy Workshops, IISD (2002), *available at* http://www.iisd.org/publications/pub.aspx?id=641 (last visited June 3, 2007)..

105. D. Bodansky, *Linking US and International Climate Change Strategies*, Arlington: Pew Centre on Global Climate Change (2002), *available at* http://www.iisd.ca/climate/cop11 (last visited June 3, 2007).

VI. CONCLUSION

Canada's climate change plan will deliver emissions reductions through technology investment and federal-provincial partnership subsidy programs. But regulating the LFEs to anchor an emission trading system is more problematic. Notwithstanding the lift resulting from the success of the 11th Conference of the Parties to the Framework Convention on Climate Change and First Conference of the Parties Serving as the Meeting of the Parties to the Kyoto Protocol, held in late 2005 in Montreal and chaired by Canada's Environment Minister, Stéphane Dion,[106] obstacles remain to implementing Canada's own GHG emissions-reduction regime.

There is serious risk that equivalency agreements cannot be negotiated with all provinces, particularly Alberta. Without this federal-provincial cooperation, unilateral federal regulation would be required, and this would be constitutionally uncertain. In the larger picture, the challenge for Canada is to achieve the necessary emissions reductions while continuing to support development of a high-emission oil sands-based energy sector.

A. *Postscript: Policy Signals from the New Minority Conservative Government*

The climate change policy of Prime Minister Stephen Harper's minority Conservative government, formed following the January 2006 general election, remains unclear. Environment Minister Rona Ambrose and other federal officials have said repeatedly that Canada will not withdraw from the Kyoto Protocol, but will develop a new national approach that involves provincial collaboration[107] and does not rely on purchase of international Kyoto emissions credits.[108] A number of the 2005 Climate Change Plan subsidy programs have been cut.[109] There has also been speculation about Canadian involvement in the Asia-Pacific Partnership on Clean Development and Climate, an agreement that includes the United States and a number of Asia-Pacific region countries.[110]

Meanwhile, Ms. Ambrose has assumed the presidency of the Conference of the Parties that is faced with the task of negotiating the next greenhouse gas emission reduction commitment with the Kyoto Protocol countries. As of May 2007, the new national climate change plan remains under development.

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106. IISSD, EARTH NEGOTIATIONS BULLETIN, Vol. 12, No. 291, Dec. 12, 2005 (stating agreement was reached that negotiations on future actions beyond 2012 should proceed both under the Kyoto Protocol and the Framework Convention on Climate Change).

107. Rhéal Séguin, *Pact With Provinces Needed on Kyoto, Tories Say*, GLOBE AND MAIL, Mar. 2, 2006, at A6.

108. Allan Woods, *Clean Air, Not Kyoto Will Guide Minister*, CALGARY HERALD, Feb. 18, 2006, at A14; Renata D'Aliesio, *Made in Canada greenhouse plan draws fire*, CALGARY HERALD, May 3, 2006, at A5.

109. Martin Mittelstaedt & Michael den Tandt, *Ottawa Hacks Green Programs*, GLOBE AND MAIL, Apr. 13, 2006, at A1.

110. Bill Curry, *Ottawa Considers Joining Rival to Kyoto Protocol*, GLOBE AND MAIL, Apr. 25, 2006, at A1.

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