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The Immediate Effects of the Kyoto Protocol and Project Green on Canadian Companies

By Isabelle Lamarre

On April 13, 2005, the government of Canada announced the first phase of Project Green "Moving Forward on Climate Change: A Plan for Honouring our Kyoto Commitment". Although there is no legislation in force in Canada which requires companies to reduce their greenhouse gas (GHG) emissions, emitting companies should begin preparing for this possibility. In some cases, they should even look at the advantages of immediately trading emission reduction credits.

On the other side of the Atlantic, the European Union has already passed legislation to enact the Kyoto Protocol. Closer to home, although the United States has said that it does not intend to ratify the Kyoto Protocol, several states have already passed legislation respecting the reduction of GHG emissions and GHG reduction credits are being traded on the Chicago Climate Exchange.

The Kyoto Protocol

The Kyoto Protocol was adopted in 1997 under the auspices of the United Nations Framework Convention on Climate Change. The main goal of the Kyoto Protocol is to reduce GHG emissions.

Canada ratified the Kyoto Protocol in December 2002 and it came into force on February 16, 2005, when it was ratified by Russia.

Under the Kyoto Protocol, there are no direct sanctions in the case of non-compliance. The sanctions would be found in laws and regulations adopted by the legislative authorities having jurisdiction in each state, province or country wishing to reduce GHG emissions.

Canada

On March 24, 2005, the Canadian government published Bill C-43[1], which amends the *Canadian Environmental Protection Act*, 1999 to add the concept of GHG emissions to the list of substances governed by that statute.

Project Green provides that large final emitters (LFE), which produce slightly less than 50% of Canadian GHG emissions, must play an active role in the reduction of GHG emissions. Certain sectors will be exempt from the requirement of reducing GHG emissions, including the automobile industry, which will have its own protocol.

Fixed process emissions (emissions which are driven purely by underlying chemical reactions and not by fuel combustion) can only be reduced by reducing the entire production. Thus, fixed process emissions receive a zero percent target. All other emissions receive a 15% target. However, the targeted reductions of these other emissions as a percentage of total emissions may not exceed 12% of all emissions.

LFE companies will have a number of options for compliance:

- investment in in-house reductions;
- the purchase of emission reductions from other LFE companies that have done better than their target;
- investment in domestic offset credits;
- the purchase of international credits;
- investment in the GHG Technology Investment Fund.

The federal government has also pledged that a GHG emission reduction credit will cost less than $15.00 per credit.

Until legislation is passed, Canadian companies have no obligation to reduce their emissions. However, it is also true that until legislation is passed, the price for each emission reduction credit will be lower.

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[1] An Act to implement certain provisions of the budget tabled in Parliament on February 23, 2005 .

You can contact any of the following members of the Climatic Changes Law group in relation with this bulletin.

Nicolas Gagnon
514 877-3046
Litigation

Isabelle Lamarre
514 877-2995
Business Law

Hélène Lauzon
514 877-2985
Environmental, Energy and Natural Resources Law

Mathieu Quenneville
514 877-3087
Environmental, Energy and Natural Resources Law

Any trading of GHG emission reduction credits prior to the adoption of legislation entails greater risk, as it will not be possible to determine the validity of the emission reductions until legislation is in force.

Among other things, until the reference year is determined by the federal government, the trading of emission reduction credits has the additional risk that the emission reduction will not be valid, as it may not be considered a “surplus” emission reduction after the reference date if the emission reduction took place before the said reference date.

Trading CO_2 Credits

The mechanism of trading emission reduction credits offers the possibility of reducing GHG emissions at a lower cost, as the purchaser which generates GHG having emission reduction options at a lower cost will purchase emission reductions from a vendor having emission reduction options at a lower cost.

The ability of companies to sell emission reductions encourages them to exceed their target.

The purchase of emission reduction credits has the effect of reducing the economic consequences of legislative and regulatory measures relating to the reduction of GHG emissions, as:

- the purchaser pays the vendor of emission reduction credits to reduce its emissions;
- the purchaser does not have to reduce its own emissions;
- the emission reduction price is set in advance;
- the purchaser pays the price;
- the vendor receives the money.

Purchase contracts create rights between the parties even in the absence of legislation. It is important in such contracts that:

- the method for measuring emission reductions be well defined (independent methodology, audit report, etc.);
- the legal characteristics of the credit be determined according to its origin (jurisdiction, ownership, free of charges);
- the time of the transfer of ownership be defined;
- ownership guarantees be provided;
- proof of the transfer and of the existence of rights (audit by a third party, documentation, “real, measurable, verifiable and surplus” character of emission reductions) be provided;
- the risks related to the transaction and borne by each party (possibility of insuring the risk) be clearly identified (approval of host country, nationalization); and
- the legal forum having jurisdiction to settle commercial disputes be identified.

The price per tonne of CO_2 varies according to the market and how the trade is structured (premium according to risk; solvency and experience of promoter; support of host country). On the Chicago Climate Exchange, 145,700 tonnes of CO_2 were traded in January 2005 at a price ranging from US$1.74 to US$1.96. The price of “Not for Kyoto Compliance ERs” is necessarily lower than for “Kyoto Compliance ERs”.

Recommendation

Companies which do not expect to be able to sufficiently reduce their emissions at a reasonable cost following adoption of the Canadian legislation should act proactively. Understanding of the rules governing CO_2 trading credits is sufficiently advanced to explore the possibility of entering into agreements with potential partners immediately.

For some companies, it may be more financially advantageous to sell credits immediately or purchase them at a lower cost.

Our practice groups specializing in climate change, business law and environmental law are available to assess your situation and advise you.

Isabelle Lamarre
514 877-2995
ilamarre@lavery.qc.ca

Montréal
Suite 4000
1 Place Ville Marie
Montréal, Quebec
H3B 4M4

Telephone:
514 871-1522
Fax:
514 871-8977

Québec City
Suite 500
925 chemin Saint-Louis
Québec City, Quebec
G1S 1C1

Telephone:
418 688-5000
Fax:
418 688-3458

Laval
Suite 500
3080 boul. Le Carrefour
Laval, Quebec
H7T 2R5

Telephone:
450 978-8100
Fax:
450 978-8111

Ottawa
Suite 1810
360 Albert Street
Ottawa, Ontario
K1R 7X7

Telephone:
613 594-4936
Fax:
613 594-783

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