

## SUBMISSION

# The Federal Carbon Pricing Backstop: Comments and Recommendations

## INTRODUCTION

- Clean Energy Canada is a think tank based at the Centre for Dialogue at Simon Fraser University. We work to accelerate Canada's transition to a clean and renewable energy system.
- This submission contains comments and recommendations from Clean Energy Canada on Environment and Climate Change Canada's *Technical Paper on the Federal Carbon Pricing Backstop*.

## COMMENTS and RECOMMENDATIONS

- **Page 4, general comment:** We strongly support both the Pan-Canadian Framework as a whole and the federal commitment to establish a price on carbon across Canada in 2018.
- **Page 5, on using the backstop to “top up” a system:** It is important that a provincial or territorial carbon pricing system either adheres to, or exceeds, the federal backstop in each of its major components. Thus, we are supportive of using the backstop to ensure adequate coverage, price escalation and overall effectiveness of a given jurisdiction's price on carbon. However, “topping up” a system that is inadequate in several respects risks creating significant administrative complexity and, potentially, an incoherent system. Thus, to ensure adequate and internally-coherent pricing systems across Canada, the federal government should consider giving itself the ability to apply the backstop *as a whole* in a jurisdiction with an inadequate system, rather than merely “enhancing” various aspects of a system that does not meet the benchmark. This power could be included alongside the “top up” power in the upcoming federal carbon pricing legislation.
- **Page 5, on the use of revenues:** In any carbon pricing system, it is important to protect low-income or other vulnerable Canadians from cost increases they may not be able to afford.<sup>1</sup> This includes consideration of the unique circumstances of Indigenous communities across Canada. Thus, we recommend that the Government of Canada dedicate a portion of carbon pricing revenues to protecting low-income or other vulnerable Canadians from potential cost increases in any jurisdiction where the backstop goes into effect.

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<sup>1</sup> See, for example, Sustainable Prosperity, *Carbon Pricing and Fairness* (2011), <http://institute.smartprosperity.ca/sites/default/files/publications/files/Carbon Pricing and Fairness.pdf>

Potential mechanisms to help achieve this goal include rebates, refundable tax credits, and targeted investment programs. Such protection can, and should, be designed to preserve the signal to reduce carbon pollution that the price on emissions is intended to produce.

- **Page 8, on the application of the levy:** We support applying the carbon levy to all greenhouse gas emissions that can be accurately measured. Thus, we support the decision to apply the levy to venting and flaring emissions as well as to emissions from combustion.<sup>2</sup>
- **Page 12, exemption for gasoline and diesel fuels used in certain farming activities:** The Technical Paper does not provide a rationale for this exemption. While there may be valid reasons for such an exemption, in the absence of a convincing justification, we support the application of the carbon price to gasoline and diesel use on farms.
- **Page 13, exemption for biofuels:** We support an exemption for the combustion of biofuels, on the understanding that upstream emissions associated with biofuel production in a backstop jurisdiction would be subject to the carbon price. (We also recognize that the carbon emissions associated with biofuel production will be calculated under the forthcoming federal Clean Fuel Standard, which will create a complementary incentive for lower-carbon biofuels).
- **Page 15, inclusion of aviation emissions:** As the Technical Paper notes, an enhanced ability to price emissions associated with domestic aviation is an important benefit of adopting a price on carbon across Canada. We welcome the decision to apply a carbon price to aviation within Canada, and would encourage the Government of Canada to move quickly from pricing aviation emissions only in backstop jurisdictions to implementing a nation-wide system.
- **Page 17, threshold for inclusion in the output-based allocation system:** While we agree that output-based allocations will help reduce the potential for carbon leakage, this tool should be used sparingly, as the vast majority of Canada's economy is not at risk of such leakage.

According to 2015 analysis<sup>3</sup> from the Ecofiscal Commission, Alberta and Saskatchewan have the highest fraction of their provincial GDP exposed to the potential of carbon leakage, at 18 per cent each. Despite this, Alberta's output-based allocation approach will apply to those emitters that were regulated under the province's Specified Gas Emitters Regulation, a size threshold of 100 kilotonnes (kt)—which implies that Alberta did not see a need to offer output-based allocations to facilities emitting between 50 and 100 kt.<sup>4</sup>

Thus, we encourage the Government of Canada to consider including only those facilities emitting over 100 kt in its output-based allocation initiative, while allowing firms below that threshold to opt in (as is currently proposed for facilities under 50 kt in the federal backstop, and in Alberta for facilities under 100 kt).

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<sup>2</sup> We note that the exemption for fuels used as “a raw material, diluent or solvent in a manufacturing or petrochemical process in a manner that does not produce heat or energy” is presented as a blanket exemption on p. 8, but the same exemption is presented as applying only “in specified circumstances” on p. 12. We support the latter formulation and would encourage the Government of Canada to specify the relevant circumstances as further regulations are developed.

<sup>3</sup> Beale et al, Provincial Carbon Pricing and Competitiveness Pressures, 2015, <https://ecofiscal.ca/wp-content/uploads/2015/11/Ecofiscal-Commission-Carbon-Pricing-Competitiveness-Report-November-2015.pdf>, 14.

<sup>4</sup> We also acknowledge that some emitters of 25 kt and above are currently receiving free allowances in Ontario and Quebec's cap-and-trade systems.

- **Page 18, definition of “best-in-class performance”:** Setting an appropriate definition of “best-in-class” performance is a crucial element of an effective output-based allocation (OBA) approach under the federal backstop.

By design, the output-based allocation approach relies on a generous interpretation of competitiveness risk. Emitters are not required to demonstrate that they are both emissions-intensive and trade exposed; instead, all facilities over a given size threshold receive allocations. As a result, some facilities that are not facing a genuine risk of carbon leakage will almost certainly receive free allocations under the output-based allocation proposal—thus reducing those facilities’ incentive to reduce emissions, with no corresponding reduction in any genuine risk of carbon leakage.

The output-based allocation system also creates significant complexity for the regulator, as Alberta’s experience to date makes clear. Even in the context of a single province, there are facilities producing a large number of distinct products that each require a specific allocation approach, while other facilities are unique (or have very few peers), thus making comparison difficult. Emitters will nearly always push for special treatment for their specific circumstances, and regulators will nearly always have less information about operational details in a given facility than the regulated parties do.

To make the system as environmentally effective and economically efficient as possible, we recommend that the definition of “best-in-class performance” should **be rigorous from the start, become more stringent each year, be reviewed regularly, and be communicated as transparently as possible.** We provide further detail on these recommendations in the paragraphs below.

Alberta’s Climate Leadership Panel, chaired by Dr. Andrew Leach, recommended the top quartile of production as a floor for defining “best-in-class”. However, the panel also recommended setting best-in-class performance at the top decile of global performance in certain specific cases.<sup>5</sup>

We recommend that the Government of Canada begin consultations about specific allocations on the premise of top-decile Canadian performance. In cases where emitters can demonstrate a valid risk of carbon leakage, the standard could be set instead at top-quartile performance.

In proposing output-based allocations to manage competitiveness risks from carbon pricing in Alberta, Dr. Andrew Leach recommended that the allocation approach “would decrease over time at 1-2% per year, to reflect expected energy efficiency improvements.”<sup>6</sup> We recommend that the Government of Canada build in a similar annual rate of decrease in the available free allocations it offers to large emitters.

The allocations emitters receive need to be reviewed regularly to reflect:

- Changes in production processes, potentially leading to changes in best-in-class performance

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<sup>5</sup> Government of Alberta, *Climate Leadership Report to Minister*, 2015, <https://www.alberta.ca/documents/climate/climate-leadership-report-to-minister.pdf>, 67. The sub-sectors in question were refining and upgrading, and the rationale the panel offered was that the province lacks “a sufficient diversity of facilities in Alberta to establish an informative top provincial quartile.”

<sup>6</sup> *Ibid.*, 5.

- Policy changes in competitor jurisdictions, which could diminish (or increase) the risk of carbon leakage, and
- Increasing real-world evidence of the impacts of carbon pricing on heavy industry in Canada.

Signatory governments to the Pan-Canadian Framework have already committed to two reviews of carbon pricing: an interim (2020) review that includes an assessment of “best practices to address the competitiveness of emissions-intensive, trade-exposed sectors,” and a 2022 review of the “overall approach to pricing” (page 5). Because the output-based allocations will not come into effect before January 2019, we recommend the following approach to those reviews:

- During the 2020 interim review, compare the strengths and weaknesses of output-based allocations to other international best practices in addressing competitiveness, and make a recommendation as to whether to continue with OBAs or to adopt a different approach to managing competitiveness risk, if required, for the period after 2022.
- During the 2022 general review, assess specific allocations to all emitters to determine whether they remain appropriate. This will likely represent a four-year period (2019 to 2022) from initial allocation to detailed review, and any future allocations should be reviewed at least as frequently.

While there can be specific situations requiring confidentiality, the information used to determine best-in-class performance, and facilities’ ultimate allocations as a result, should be open by default and made readily available to the public.

- **Page 19, the use of offsets as a compliance mechanism:** The backstop proposal currently allows an emitter to meet its entire compliance obligation with “eligible offset credits,” a category that could include both domestic and international compliance units.

Ensuring strong environmental integrity for offset credits is never an easy task, particularly for the crucial question of whether or not an offset is additional to business as usual. We are pleased to see the list of proposed parameters for the creation of domestic offset credits<sup>7</sup> outlined in the Technical Paper, which represent an appropriate starting point for discussion about the creation of credible offset credits.

However, the relatively comprehensive nature of the Pan-Canadian Framework—an agreement that includes proposals to reduce emissions in all major economic sectors, including agriculture, forestry, waste, and government operations—means that there will be relatively few opportunities to create offsets that fit the proposed parameters. As a result, and to help ensure the environmental integrity of the carbon pricing backstop, the Government of Canada **should adopt a limit on heavy industry emitters’ access to domestic offset credits as a compliance mechanism**, a feature that is already part of cap-and-trade systems in effect in Canada.<sup>8</sup>

A limitation on the percentage of compliance that heavy industry can attain through the use of domestic offset credits is complementary to other proposed limitations on offset use listed on

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<sup>7</sup> i.e. that offset credits be created from voluntary activities that are “not subject to GHG emissions reduction regulations, that are not required by law, that have not been supported by government financing, and that go beyond ‘business as usual’ practices.”

<sup>8</sup> For example, Quebec’s system limits the use of offset credits to 8% of compliance, as described here: <http://www.mddelcc.gouv.qc.ca/changements/carbone/credits-compensatoires/index-en.htm>.

page 20 of the Technical Paper, including potential restrictions on offset banking and a requirement for replacement of emission reductions that are later reversed.

We would also recommend limits on emitters' access to international offset credits as a means of compliance, if those offsets are credits generated from voluntary activities outside of carbon pricing regulations (i.e. if international offset credits are analogous to domestic offset credits generated in Canada). As in Canada, assuring the environmental integrity of such credits is never an easy task, and thus limiting emitters' access to these credits helps to ensure a more robust carbon pricing system. However, the Technical Paper refers to "internationally transferred mitigation outcomes," a category that could potentially include cap-and-trade allowances generated in systems like California's and sold in joint auctions under linkage agreements with Canadian provinces. If this is what is meant by access to "foreign compliance units," we do not see a need to limit emitters' access to credits of that nature.

- **Page 20, administration of the output-based allocation:** The Technical Paper notes that industrial facilities that are subject to the output-based allocation approach will need to register with Environment and Climate Change Canada, which will administer the system. We note that because the system as currently proposed also offers access to offset credits, Environment and Climate Change Canada's responsibilities will extend beyond the regulated participants in the system to encompass administration of voluntary offset credit participants, a potentially significant increase in the regulatory workload associated with carbon pricing that the department will need to be prepared for.
- **Page 21, timing for the carbon levy:** The levy should come into effect as early in 2018 as possible. We support the proposal to have the full levy apply to industrial emitters while the output-based allocation approach is being developed.

Thank you for the opportunity to comment on this important proposal. Should you have questions about any of the comments or recommendations contained herein, we would be happy to provide further clarification.

We consent to the disclosure of this submission in its entirety.

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