Comments on the regulatory proposal of Environment and Climate Change Canada for *The Output-Based Pricing System* regulations under the *Greenhouse Gas Pollution Pricing Act*

Carbon Market Watch (CMW) welcomes the opportunity to submit comments on the OBPS regulations under the GGPPA which entered into force on June 21, 2018, and would like to formulate comments as below.

1. **Carbon leakage and the calculation of the emissions limit**

We express strong concerns with the decision to revise the starting point of the output-based standard (OBS) from the initial benchmark of 70% of average emissions intensity of a given activity, to the three-phased approach proposed in this document (80%, 90%, and 95%).

This value is represented in the proposal as "**Factor$_{red}$**", on page 25. It sets the limit for which installations (or which portion of emissions of a given installation) will be covered by the mechanism. For example, the proposed value of 95% will mean that carbon pricing covers only installations which have an emissions intensity higher than 95% of the average intensity for the given activity. This is very close to saying that only installations with above average emissions intensity will have their emissions priced. **Combined with the award of surplus credits for emissions below the limit (see our comment in section 2 below), this will be a major loophole for the environmental integrity of the mechanism.** It is also a significant departure from the original plan of rewarding only the best performing installations[1].

We believe the values proposed for **Factor$_{red}$** on page 25 are too high and are not proportionate to any risk of carbon leakage. In the context of the proposed output-based measure, **we propose to revert to the initial 70% value for Factor$_{red}$**, as a maximum, and **apply it uniformly across industrial sectors**. We also recommend to **lower this factor by 20 percentage points annually** in order to progressively increase the share of priced emissions, until the factor reaches a value of 0%.

First, there is no substantive, empirical evidence to support the hypothesis of a large risk of carbon leakage from carbon pricing measures, especially when only part of an installation's emissions will be priced (those above the limit), as in the current proposal. Lacking sufficient empirical evidence, excessive protection of heavy industry weakens environmental objectives of the pricing mechanism. If undue competitiveness impacts were to materialize following the implementation of the measure, which we do not expect, this could be dampened through smart redistribution of the revenues from the measure to support industrial investments in clean

[1] See the original technical paper from Environment and Climate Change Canada which reads, on page 18: "The output-based standard will be set at a level that represents best-in-class performance ***(top quartile or better)*** in order to drive reduced emissions intensity." (emphasis added)

technologies, to create a more ambitious level playing field for global action instead of weakening domestic rules in a global race to the bottom.

Second, the unpriced carbon emissions, and the mechanism rewarding "clean" installations with free permits, **are very likely to lead to heavy industry making a windfall profit from the carbon pricing mechanism**, similarly to what happened in the European Union[2]. For example, the cement industry is identified in this proposal as a highly emissions intensive and trade exposed industry, yet empirical evidence has demonstrated that it is not[3].

Third, the OBPS measure will only price a small portion of emissions from the Canadian industry, which will significantly limit the effect of the measure to guide investments (as well as its environmental integrity). Adopting a **Factor$_{red}$** of 80% or higher will lead to only very small portions of industrial emissions to be covered by the pricing mechanism. This is not a sufficiently strong signal for investments or business decisions. Only the best performing installations should be rewarded for their efficiency, not installations which have an emissions intensity slightly lower than average.

Our view is that an output-based mechanism is not appropriate for tackling industrial emissions, and **we recommend the adoption of a mechanism setting an overall cap on absolute emissions** with an aim to achieve full pricing of all emissions.

2. Distribution of surplus credits

While we are in favor of supporting the most efficient and low-carbon installations, we believe the proposal for the distribution of credits to those installations which emit less than their allowed amount (described on page 31 of the proposal), excessively rewards installations which are only marginally less polluting than average. **The proposed system would lead to rewarding installations which *increase* their emissions** (both overall and relative to output), as long as they were already below the allowed limit at the launch of the mechanism. This is especially problematic when combined with the high values proposed for **Factor$_{red}$** (see above).

In addition, the mechanism is susceptible to generate significant windfall profits to industrial installations given that it could award credits to companies who have not done anything to reduce their emissions (e.g. because they were already below the ceiling of emissions intensity).

We recommend that surplus credits be awarded only to those installations which emit less than their allowed amounts, *and* have achieved a year-on-year absolute reduction in emissions. Indeed, reductions in emissions intensity do nothing to solve the climate crisis if absolute GHG emissions are allowed to increase. The current system could be

[2] See our 2016 report "*Mythbuster reload*" on industrial windfall profits in the EU ETS, here
[3] See for example Sandbag (2016): "*Cement exposed"*, here

counterproductive in rewarding installations even if their emissions intensity increases over time. For example, an installation which had an emission intensity at 60% of the average intensity at the start of the mechanism, and which, one year later, has an emissions intensity at 75% of the average intensity, would still be rewarded with surplus credits, even though it has increased its emissions per unit of output, let alone its absolute volume of emissions. This is a major loophole in the proposed regulation, undermining its potential climate benefit.

3. Do not incentivise further extraction of oil

We propose to delete the provision under item 15 (3) a) ii) of page 19, which suggests that emissions are not subject to the pricing mechanism if they are stored through CCS technologies, even if the CCS project consists of injecting the collected CO2 "in a depleted oil reservoir for the purpose of enhanced oil recovery". This sets an incentive for further extraction of fossil fuels (in this case oil), when science has demonstrated that reaching the Paris Agreement's objectives requires for 80% of existing oil reserves to be left in the ground[4]. In addition, some of the CO2 injected for the purpose of enhanced oil recovery can sometimes trickle back to the surface and the storage can therefore not be considered as "permanent", which is a requirement identified by the proposed regulations. Furthermore, the regulations should clearly establish that installations resorting to CCS remain liable for any emissions leaking from the chosen storage site.

4. Don't exclude the emissions from combustion of biomass

Combustion from biomass can have negative environmental and climate impacts depending on the type of biomass used. We therefore encourage ECCC to conduct further analysis into the exclusion criteria for emissions from biomass combustion and accurate lifecycle accounting of the carbon emissions, including emissions associated with the processing and transport of biomass to the combustion facility. Pricing of emissions should reflect accurate accounting of emissions from the land use, land use change and forestry (LULUCF) sector. If biomass is used to generate electricity for example, and plantations are maintained and harvested to that effect, it is not accurate to account for both reduced emissions in the LULUCF sector and for reduced emissions in the power sector. If emissions reductions in the LULUCF sector are taken into account by Canada in its national inventory, then the emissions from biomass combustion cannot be ignored, and therefore must be priced.

5. Limitation on use of compliance units and offsets

We support the provision to limit the use of compliance units (page 29), but we recommend the limit to be significantly lowered from the suggested 75% value, and to be applied from 2019 rather than 2021. We also believe it is very important that this limit applies to the use of offsets, as this contributes to the lock-in of installations into high-carbon technologies. Previous experiences with the use of offsets in carbon pricing mechanisms in the EU Emissions Trading System have led to a legislative revision banning entirely the use of such credits due to

[4] See for example https://gofossilfree.org/keep-it-in-the-ground-just-how-much-exactly/

concerns related to their environmental integrity as well as their adverse impact on prices and market balance.

CMW has extensive experience with offsetting mechanisms and their impact on carbon pricing systems, and we believe the criteria set out on pages 33 to 36 under “Criteria for recognizing units from other jurisdictions” are insufficient to ensure the environmental integrity of the scheme. This is especially problematic when coupled with the very high ceiling on the use of such units for compliance purposes.

On page 33, item 28(2), we believe an additional item should be added to the list, reading “be issued from a project located within the territory of Canada”, to avoid the use of international offsets. While cross-sector offsetting can have some benefits, relying on emissions reductions from other countries to comply with domestic targets is highly problematic. Past experience has shown the lack of environmental integrity of many international offsetting mechanisms, as well as their adverse impacts on local people and the environment. For example, the largest international offsetting scheme has failed to reduce emissions by generating most of its units from non-additional projects[5]. In addition, the Paris Agreement, and its article 6 which sets up new carbon markets for the post-2020 period, foresees ambitious climate action in all countries. This means that a serious risk of double counting emission reductions exists. While this risk can be mitigated within Canada (through the requirement to obtain a guarantee that emissions will not be double claimed, as explained in the proposed regulations), this is very difficult to achieve at an international level as it will be difficult to ensure that every offset project obtains a letter of authorization guaranteeing the avoidance of double claiming from the host country.

Furthermore, we strongly support the proposal to limit the use of offset credits to those issued from projects that started in 2017 or later, and to increase this date over time to ensure that only new emission reductions can be claimed through offsets.

In addition to this, the “criteria for eligible offset programs” on page 33 and following need to be further elaborated to include the following provisions:

- ensure that offsets come only from projects which carried out a local stakeholder consultation prior to implementation, do not infringe on Human Rights, and do not have adverse social and environmental impact
- The “dispute resolution mechanism” of item 28 (3) a) viii) (page 34) should be adequate to address disputes arising at a project level in order to protect local stakeholders and indigenous people[6].
- Item 28 (4) a) ii) (page 35), setting out objectives for eligible offset project activities, should include an item stating that an activity cannot 1) go against the transition to

[5] See our 2018 report: “The clean development mechanism: local impacts of a global system”, here
[6] For more information on the importance of social safeguards in carbon crediting mechanisms, see our note here

low-carbon societies, and 2) should not carry significant risks of adverse impacts on local communities and the environment. To this end, offsets coming from some project types such as coal projects or large hydropower projects should not be eligible for use under the canadian carbon pricing mechanism.

- Item 28 (4) b) iv) (page 35) on additionality, should be amended to read “proponents demonstrate how the project activity would not be economically feasible without carbon offset revenue“, i.e. delete the second part which suggests that a project can be additional if it faces significant non-financial barriers to implementation. Allowing a project to sell offsets does nothing to alleviate **non-financial** barriers, given that the support provided by offsets is **only financial**. If anything, offsetting mechanisms *increase* non-financial barriers for a project by increasing the administrative burden of Monitoring, Reporting and Verification (MRV). A project which is economically viable should not be deemed additional as a credit-issuing project simply on the grounds that it faces non-financial barriers.

6. Transparency and public access to information

The proposed regulation lacks clarity on public access to information, including when it comes to the tracking system (page 36), the information contained in which should be public, and the information mentioned in item 22 (2) (page 29) relating to the compensation provided by installations. Confidential information should not be kept private but instead made public in aggregate form which protects sensitive data, where necessary.

For further questions, please do not hesitate to get in touch with Sam Van den plas, Policy Director (sam.vandenplas@carbonmarketwatch.org), or Gilles Dufrasne, Policy Officer (gilles.dufrasne@carbonmarketwatch.org).