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## Briefing Note

# The American Power Act

## An Analysis of the May 2010 Discussion Draft

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### At a Glance

On May 12, Senators John Kerry and Joe Lieberman published a draft piece of legislation called the American Power Act. This bill would set U.S. national greenhouse gas emission targets and establish an economy-wide cap-and-trade system.

Some of the most relevant provisions of the bill for Canada include:

- the treatment of transportation emissions
- approach to emissions-intensive, trade-exposed sectors
- border adjustment provisions and the assessment of “comparability”
- use of offset credits.

While Canada has set a 2020 target that matches the bill’s 2020 target, Canada has no plan in place to meet it. The Government of Canada has also failed to outline an approach to slow the growth in emissions from the oil sands sector, which is projected to account for the overwhelming majority of Canada’s projected business-as-usual growth in industrial (including power plant) emissions to 2020.

This briefing note provides a brief overview of the American Power Act (APA), a proposed piece of legislation released on May 12, 2010 by Senators John Kerry and Joe Lieberman, and describes some of the provisions of particular significance for Canada. These include the carbon pricing system, the provisions for border adjustments, the use of offset credits, and the treatment of energy-intensive and trade-exposed sectors. The federal government’s decision to wait for the United States before designing and implementing a Canadian carbon pricing system means that a detailed assessment of U.S. proposals has become important for any discussion of Canadian climate and energy policy.

### Process for adopting the American Power Act

The draft APA was presented as a discussion document, which could be updated in the coming weeks. Should this bill or a version thereof be approved by the Senate, it could then be merged and reconciled with the American Clean Energy and Security Act of 2009 (the Waxman-Markey bill) passed by the House of Representatives on June 26, 2009.<sup>1</sup>

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<sup>1</sup> H.R. 2454: American Clean Energy and Security Act of 2009, 111<sup>th</sup> Congress, June 26, 2009 online at <http://thomas.loc.gov/cgi-bin/query/z?c111:H.R.2454>

Once the bills are merged through a “conferencing” process, Congress as a whole must approve the merged legislation. While it is still possible the bill could be delayed or amended, its essential framework is expected to be a starting point for any future legislative debate.

## Key Elements of the APA

The proposed bill sets a declining cap on greenhouse gas (GHG) emissions from key sources that is set at the level of a 4.75% reduction below 2005 levels by 2013; 17% by 2020; 42% by 2030; and finally 83% by 2050.<sup>2</sup>

The bill regulates electric power generators, providers of refined fuels (petroleum, liquified natural gas, coal-based), industrial sources including those that emit more than 25,000 tonnes of GHG emissions, and natural gas local distribution companies.<sup>3</sup> Regulated entities must hold allowances to cover their emissions. By 2016, it is estimated the bill will apply to approximately 7,500 facilities in the United States.<sup>4</sup>

Beginning in 2013, the bill will cover emissions from power plants and transportation (by regulating the producers of refined petroleum products) that currently make up approximately 35% and 27% respectively of total GHG emissions in the

United States.<sup>5</sup> Emissions from transportation are included under the cap by requiring producers of refined fuels (petroleum, liquified natural gas, coal-based) to hold corresponding allowances.<sup>6</sup> The industrial sector, which makes up approximately 19% of domestic GHG emissions, will also be subject to the cap on emissions starting in 2016. Covered industrial facilities include those emitting 25,000 tonnes or more of GHGs annually, plus all stationary sources in certain sectors as specified by the bill (cement, petroleum refining, etc.).<sup>7</sup> Emissions from the extraction, processing and refining of oil and gas will be covered where facilities exceed the 25,000 tonne threshold.

By 2016, the APA’s cap-and-trade system would cover sectors responsible for 85% of all GHG emissions in the U.S., including electricity, transportation, buildings and industry.<sup>8</sup> The remaining sectors (most notably agriculture) do not fall under the cap, but may participate in emissions trading by choosing to produce offset credits, which can be sold to regulated sectors with compliance obligations under the cap.

The bill allows covered entities to use up to two billion tonnes of offset credits annually to meet their targets, with 75% of that total generated in the U.S. and the remainder from

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<sup>2</sup>The American Power Act Discussion Draft, May 12, 2010. Version available on Senator John Kerry’s website <http://kerry.senate.gov/americanpoweract/pdf/APAbill.pdf>

<sup>3</sup> According to Section 700(12)(J), this includes coverage of natural gas local distribution companies that deliver more than 460,000,000 cubic feet of gas per year to entities not already covered by the cap.

<sup>4</sup> Pew Center on Global Climate Change, “Summary of the American Power Act (Kerry-Lieberman),” fact sheet (Washington D.C., May 2010). <http://www.pewclimate.org/docUploads/Kerry-Lieberman-short-summary.pdf>

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<sup>5</sup> United Nations Framework Convention on Climate Change, *National Inventory Submissions 2010* (Bonn, Germany, 2010) under the United States NIR submissions, Figure ES-13: *Emissions Allocated to Economic Sectors Table ES-7: U.S. Greenhouse Gas Emissions Allocated to Economic Sectors*. [http://unfccc.int/national\\_reports/annex\\_i\\_ghg\\_inventories/national\\_inventories\\_submissions/items/5270.php](http://unfccc.int/national_reports/annex_i_ghg_inventories/national_inventories_submissions/items/5270.php)

<sup>6</sup> APA Discussion Draft, Section 722(a)(2)(B).

<sup>7</sup> APA Discussion Draft, Section 700 (12)(F).

<sup>8</sup> Environment Northeast. “American Power Act of 2010: Cap & Allocation Summary,” fact sheet (May 2010). <http://www.usclimatenetwork.org/resource-database/environment-northeast-the-american-power-act-of-2010-preliminary-cap-allocation-summary>

international initiatives.<sup>9</sup> Between 2013 and 2018, emitters can use either a domestic or an international offset credit to substitute for one allowance in covering their emissions. (However, there are limitations on emitters' use of offset credits in the bill, as described below in Section F). After 2018, 1.25 tonnes of international offsets must be submitted for every one emission allowance, while domestic offsets are still treated as being equal to one tonne.<sup>10</sup>

The Peterson Institute for International Economics estimates that with the adoption of this bill, the portion of total energy demand in the U.S. that is met through fossil fuel sources would shift from 84% in 2008 to 70% by 2030. Over the same time period, renewable and nuclear energy would grow from 8% of US energy supply in 2008 to 16% by 2030.<sup>11</sup> This would result from the combination of the cap-and-trade system and individual technology incentives.

Coupled with the successful passage of the American Clean Energy and Security Act of 2009 by the House of Representatives, the introduction of the APA marks a significant step toward comprehensive climate legislation in the United States. The APA received support from the U.S. Climate Action Partnership, an industry-NGO coalition whose membership includes Duke Energy, DuPont, Ford Motor Company, General

Electric, Shell, Honeywell and many other companies.<sup>12</sup> The Climate Action Partnership released a statement commending Senators Kerry and Lieberman for the draft bill, stating that "comprehensive action is needed to preserve and create American jobs, enhance our energy security and put the U.S. and the world on a path to lower greenhouse gas emissions."<sup>13</sup> Shortly after the release of the draft bill, 60 major U.S. companies and environmental organizations representing revenues over \$1.2 trillion and more than one million employees sent a letter to President Obama supporting the passage of the legislation.<sup>14</sup>

Particularly when coupled with the media coverage of the BP oil spill in the Gulf of Mexico, this kind of broad-based stakeholder support for the legislation is significant. As of today, the bill does not yet appear to have the full 60 votes required to overcome a filibuster and proceed into law. But while a final bill may not be adopted in 2010, it is likely some form of this legislation will re-emerge later in 2010 or in 2011. Furthermore, with a House bill already approved, it is already possible to discern some areas of agreement that are likely to form the basis for a final federal approach to GHG emission reductions and carbon pricing in the U.S.

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<sup>9</sup> APA Discussion Draft, Section 722(d)(1)(A)(ii).

<sup>10</sup> Environment Northeast, "Domestic Offsets and the Carbon Conservation Program in the American Power Act of 2010: Summary and Recommendations," (May 2010). <http://www.usclimatenetwork.org/resource-database/environment-northeast-domestic-offsets-and-the-carbon-conservation-program-in-the-american-power-act-of-2010>

<sup>11</sup> Houser et al., *Assessing the American Power Act: The Economic, Employment, Energy Security and Environmental Impact of Senator Kerry and Senator Lieberman's Discussion Draft*. (Peterson Institute for International Economics, Number PB10-12, May 2010). <http://www.iie.com/publications/pb/pb10-12.pdf>

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<sup>12</sup> For more information, go to U.S. Climate Action Partnership. <http://www.us-cap.org/>

<sup>13</sup> U.S. Climate Action Partnership, "Release of Draft Legislation By Sens. Kerry and Lieberman an Important Step, USCAP Says," statement, May 12, 2010. <http://www.us-cap.org/>

<sup>14</sup> Letter to the White House. May 27, 2010. <http://www.us-cap.org/PHPages/wp-content/uploads/2010/05/Leadership-Letter-5.27.2010.pdf>. Another letter representing over 80 U.S. companies calling for the passage of climate legislation was sent on January 2009. <http://wecanlead.org/newsroom/release0120.html>

## APA Provisions of Particular Significance to Canada

### A. The APA establishes national emission targets and an implementation plan from 2020 through 2050.

While the APA contains provisions on energy matters ranging from nuclear power to offshore oil and gas, the core climate provisions of the bill include language that sets national emission reduction targets for GHGs. Expressed as a percentage reduction from 2005 emissions, those targets are:<sup>15</sup>

2013: 4.75%

2020: 17%

2030: 42%

2050: 83%

**Implications for Canada:** While Canada has set an emissions target of 17% below the 2005 emission levels by 2020<sup>16</sup> (and inscribed that target in the Copenhagen Accord, which is non-binding),<sup>17</sup> the Government of Canada has not proposed its own cap-and-trade system (or other carbon pricing system) to help meet that target, nor has it produced a national plan (or enacted legislation) to meet its 2020 emissions goal. In contrast, the APA is a comprehensive effort: it includes both a target and many of the major policies and investments needed to help reach that target.

### B. The APA addresses the transportation sector through the establishment of a “linked fee,” or carbon tax. The sector will

be separate from (although linked to) the emissions trading system, but is covered under the cap and will be required to make emission reductions.

The APA specifies that the transportation sector will be covered under the cap from the outset in 2013, requiring refiners and importers of refined petroleum products to obtain emission allowances to cover the emissions from the combustion of fuels sold. These allowances will be obtained by paying a fee on those emissions.<sup>18,19</sup> The fee will be set based on the market price for auctioned GHG emissions on a quarterly basis (hence the name “linked fee”).<sup>20</sup> This approach differs from the American Clean Energy and Security Act bill passed in the House of Representatives, which would have included petroleum refiners and importers directly under its cap-and-trade system.<sup>21</sup>

**Implications for Canada:** Canada has not included transportation emissions in previous GHG emission trading proposals. Proposed federal emissions trading approaches in Canada (2005, 2007, 2008) covered only heavy industry, or just about half of Canada’s emissions. With the inclusion of a linked fee on the transportation sector, the APA achieves economy-wide or broad-based carbon pricing, covering 85% of U.S. emissions. There are no meaningful administrative or technical obstacles to broad-based carbon pricing in Canada (as B.C.’s economy-wide carbon tax demonstrates). “Harmonizing” with U.S. proposals, as the

<sup>15</sup> APA Discussion Draft, Section 702.

<sup>16</sup> Government of Canada. “Canada’s Action on Climate Change,” fact sheet.  
<http://climatechange.gc.ca/default.asp?lang=En&n=D43918F1-1>

<sup>17</sup> Canada’s submission is available from the UNFCCC’s table “Appendix 1: Quantified Economy-Wide Emissions Targets for 2020” at  
<http://unfccc.int/home/items/5264.php>

<sup>18</sup> The direct emissions from refineries are also covered in addition to obtaining allowances for the refined products.

<sup>19</sup> APA Discussion Draft, Section 729.

<sup>20</sup> APA Discussion Draft, Section 729.

<sup>21</sup> American Clean Energy and Security Act of 2009 (ACES).  
[http://energycommerce.house.gov/index.php?option=com\\_content&task=view&id=1560&Itemid=1](http://energycommerce.house.gov/index.php?option=com_content&task=view&id=1560&Itemid=1)

Canadian federal government has said it intends to do, would require moving to a broad-based proposal that includes transportation emissions under an emissions cap.

Furthermore, if the APA's linked fee proposal is adopted, harmonizing with the U.S. would require revoking the current government's opposition to carbon taxes.

**C. The APA aims to protect sectors deemed to be energy-intensive and trade-exposed (EITE) by providing some allowances free of charge.**

The APA contains provisions for certain manufacturing sub-sectors to be considered as energy-intensive and trade-exposed, including those sectors producing commodities such as steel, aluminum, cement and some chemicals. In total, the manufacturing sector emits 17% of U.S. GHG emissions.<sup>22</sup>

The decision to designate a sector as EITE will be made either by designation of a federal rule by the Environmental Protection Agency (EPA) or on the basis of meeting criteria established by the APA (discussed below). Once eligible, the EPA will designate the amount of the free emission allowances per unit of production that will be provided to each eligible sector.<sup>23</sup> Sectors will be designated by a variety of criteria which either individually or collectively enable that sector to receive emission allowances:

- The creation of a regulation by June 30, 2011 that defines eligible sectors (as discussed above).<sup>24</sup>

- Sector that is recognized by the North American Industrial Classification System (NAICS)<sup>25</sup>
- Energy or greenhouse gas intensity of at least five percent (defined in part by the cost of purchased electricity, fuel costs, value of shipments etc.)<sup>26</sup>
- Trade intensity as calculated in part by value of imports and exports of that sector.<sup>27</sup>

The EITE provisions are meant to avoid “carbon leakage,” which is defined as an “an increase ... in greenhouse gas emissions in countries other than the United States as a result of direct and indirect compliance costs incurred.”<sup>28</sup>

The APA would provide a number of free allowances that would decline over time to manufacturers that qualify as EITE.<sup>29</sup> The bill sets aside 15% of the total allowances for a transitional period to provide qualifying industries with free allowances. In addition, compliance obligations for these firms only begin in 2016 (while power plant and transportation emissions are covered starting in 2013). The rationale offered by the bill's sponsors is that these firms have limited ability to recoup their increased costs when they are competing with goods imported from countries that have not yet adopted “comparable” carbon limits.<sup>30</sup> Comparability is to be determined in part by an assessment of whether the country has adopted nationally enforceable and economy-wide GHG

<sup>22</sup> Environmental Protection Agency, *Inventory of U.S. Greenhouse Gas Emissions and Sinks: 1990–2007*, Table ES-7, 2009.

[http://www.epa.gov/climatechange/emissions/downloads10/US-GHG-Inventory-2010\\_ExecutiveSummary.pdf](http://www.epa.gov/climatechange/emissions/downloads10/US-GHG-Inventory-2010_ExecutiveSummary.pdf)

<sup>23</sup> APA Discussion Draft, Section 773(a)(1).

<sup>24</sup> APA Discussion Draft, Section 773(a)(1)

<sup>25</sup> APA Discussion Draft Section 773(B)(2).

<sup>26</sup> APA Discussion Draft Section 773(B)(2).

<sup>27</sup> APA Discussion Draft, Sections 773(b).

<sup>28</sup> APA Discussion Draft Section 772(1).

<sup>29</sup> APA Discussion Draft, Section 774.

<sup>30</sup> Senator John Kerry, “Addressing Manufacturing: American Power Act,” fact sheet (May 2010). <http://kerry.senate.gov/americanpoweract/pdf/manufacturing1page.pdf>

emission commitments.<sup>31</sup> For a fuller discussion of comparability, see Section D below.

**Implications for Canada:** How Canada defines and treats its EITE sectors will be relevant to the effectiveness and fairness of its climate policy and to any U.S. assessments of the comparability of Canada's approach.

To date, the Government of Canada has never proposed an emission trading system in which any emitters would have to pay for their allowances via an auction. Instead, all emissions trading systems proposed to date would have turned over the full value of emission rights to industry. Any system that harmonizes with the APA will require strengthening Canada's approach to include at least a partial auction from the outset, ramping up to a full auction. In keeping with the APA, any special rebates to EITE sectors would need to be phased out over time, so that all sectors purchase emission allowances from the government rather than receiving free allocations of allowances.

In a 2009 discussion paper, the International Institute for Sustainable Development (IISD) and the Pembina Institute examined the implications of applying the definition of EITE sectors described in the final House climate bill, the American Clean Energy and Security Act (ACES, Waxman-Markey), to Canada's industries.<sup>32</sup> The analysis concluded that:

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<sup>31</sup> APA Discussion Draft, Section 776.

<sup>32</sup> Using the metrics from ACES, and applying these against baseline 2005 Canadian industry, about 60% of industrial (including power plant) emissions are energy- or emissions-intensive *and* trade-exposed under ACES' definition. Most industrial emissions (97%) come from sectors that are either energy- or emissions-intensive. Twelve of the 21 industries are energy-intensive, with no sectors beyond these 12 being emissions-intensive. In fact, only two of the 21 sectors pass the emissions-intensive test, but these two have 40% of industrial emissions. All sectors are trade-exposed as defined by

- If Canada adopted the Waxman-Markey bill's definitions, sectors representing the vast majority (97%) of Canada's industrial emissions (including electricity generation) would meet the definitions of energy- or emissions-intensive. And all sectors except electricity would qualify as trade-exposed. About 60% of industrial (including power plant) emissions would be both energy- or emissions-intensive *and* trade-exposed.
- However, the stated rationale for special treatment of EITE sectors is to prevent carbon leakage. Even in a scenario where Canada's carbon price is double the level in the U.S. (\$60/tonne vs. \$30/tonne), the impact on Canada's trade surplus is small: a reduction of 0.19% in 2020. Thus, sectors in Canada face a very small risk of leakage even when carbon prices are not aligned.<sup>33</sup>

It is important to note that both the House and Senate bills specifically exempt the refining sector from being considered EITE, even if it would qualify under their definitions. (For more information on this exception, see the text box below.)

For this reason, any special provisions for EITE sectors in Canada should be based on a rigorous assessment of whether a sector is truly (and demonstrably) vulnerable to leakage.

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ACES, with the exception of electricity. The 20 trade-exposed sectors represent about 60% of total industrial emissions.

<sup>33</sup> Matthew Bramley, P.J. Partington and Dave Sawyer, *Linking National Cap-and-Trade Systems in North America* (Drayton Valley, AB: The Pembina Institute, 2009), 16–17 and 51. <http://climate.pembina.org/pub/1955>.

## Exempting Petroleum Refining from EITE Status

Because GHG emissions (and production) from Canada's oil sands sector are increasing so rapidly, the oil sands are effectively the litmus test for any effective Canadian cap-and-trade system. Oil and gas production accounted for 20% of Canada's emissions in 2006, with the oil sands accounting for 5% of Canada's total emissions.<sup>34</sup> However, a 2008 projection from Environment Canada concluded that the oil sands would be responsible for 95% of Canada's projected business-as-usual growth in industrial (including power plant) emissions from 2006 to 2020.<sup>35</sup>

Neither the House bill (American Clean Energy and Security Act of 2009) nor the proposed APA consider the petroleum refining sector to be eligible as an EITE category. In fact, petroleum refining was specifically exempted from EITE status in the APA, as the intent of the APA's EITE provisions is to assist the manufacturing sector.<sup>36</sup>

In a leaked draft document detailing the Canadian government's preferred approach to industrial GHG emission regulations from December 2009, the federal government categorized the oil and gas sector as an "emissions-intensive, trade-

exposed" (EITE) sector and proposed that this sector could be provided with preferential treatment of the kind described above for U.S. manufacturing sectors.<sup>37</sup>

Should Canada choose to treat its oil and gas sector as an EITE sector while the U.S. does not, this will surely draw scrutiny from U.S. legislators and regulators, as it could be deemed to offer Canada's oil producers an unfair advantage.

## D. The APA creates a "border adjustment" to protect EITE sectors with respect to the importation of certain goods to the U.S.

The border adjustment provision created by the draft APA to protect EITE sectors could be deemed to apply to Canada, depending on whether or not Canada adopts a comparable approach to climate regulation.

If they go into effect, the border adjustment provisions would require importers to buy emission allowances when importing commodities such as steel, aluminum or cement from countries that fail to adopt comparable GHG control programs.<sup>38</sup> If an adequate binding international multilateral agreement on GHG emissions is not reached by January 1, 2020, the President can effectively enact border measures in 2025 requiring importers to obtain allowances.<sup>39</sup> These provisions are designed to allow EITE businesses to compete against companies in countries that have not adopted similar policies.<sup>40</sup>

<sup>34</sup> The ecoENERGY Carbon Capture and Storage Task Force, Canada's Fossil Energy Future (Natural Resources Canada, 2008) <http://www.nrcan-rncan.gc.ca/com/resoress/publications/fosfos/fosfos-eng.php>.

<sup>35</sup> This is based on the Pembina Institute's assessment under business-as-usual conditions based on a 2008 projection from Environment Canada that occurred prior to the recession.

<sup>36</sup> Senator John Kerry, "Addressing Manufacturing: American Power Act."

<sup>37</sup> Climate Action Network, "Leaked Canadian Cabinet Documents," (December 15, 2009) <http://www.climateactionnetwork.ca/e/cop-15/documents/can-cabinet-docs-12-2009.pdf>

<sup>38</sup> APA Discussion Draft, Sections 775–78.

<sup>39</sup> APA Discussion Draft, Section 775.

<sup>40</sup> APA Discussion Draft, Section 776(b).

The determination of comparability will be made by the EPA based on several factors, including whether the country has binding targets that results in reductions; is a party to an international agreement to which the United States is a party as well; or has similarly equivalent provisions for monitoring, compliance, enforcement and restrictions on the use of offsets. The bill's language suggests strongly that the mere political adoption of targets will not satisfy this comparability measure. As one example, the U.S. will only designate a country's international climate change program as comparable if it has enforceable GHG emission reduction targets that are "at least as stringent as the greenhouse gas emission reductions levels established under this Act."<sup>41</sup>

**Implications for Canada:** While the primary purpose of the APA's border adjustment provisions is to protect the U.S. manufacturing sector, the broader result is to create an incentive for other countries to adopt like-minded climate strategies.

While this could certainly change between now and 2020, Canada's historical approach to emissions trading and climate policy would clearly fail the APA's comparability tests:

- Although Canada has adopted a national emission reduction target of 17% below the 2005 level for 2020, the government has not published a detailed plan to meet that target, nor has it proposed legislation or regulations capable of doing so.
- Canada is the only country to have accepted a target under the Kyoto Protocol and then chosen not to try to meet it. While the Government of Canada says it is a strong supporter of the 2009 Copenhagen Accord, this political

statement does not have the status of a binding treaty.

- The most recent federal proposal to regulate industrial emissions, the 2007 "Turning the Corner" plan (updated in 2008), had no limits of any kind on the use of domestic offset credits for compliance.

## **E. The APA establishes a "price collar" on emission allowances.**

The bill establishes a lower and upper boundary for the price of an emission allowance. The upper boundary starts at US\$25/tonne CO<sub>2</sub>e and rises by 5% per year, plus the rate of inflation. At the lower end, the price starts at US\$12/tonne and increases at 3% plus inflation.<sup>42</sup> The stated purpose of these provisions is to limit price volatility and uncertainty.

**Implications for Canada:** Under the Copenhagen Accord, the Government of Canada has adopted an emission reduction target for 2020 that is identical to the target included in the APA: 17% below the 2005 level. (The APA's 2050 target is more stringent than the Government of Canada's 2050 target of 60 to 70% below the 2006 level, as proposed in the "Turning the Corner" plan of 2007/2008. However, it is not clear whether this target is still current.)

For the purposes of this discussion, we assume that the federal government intends to meet its harmonized 2020 target. Independent economic analysis published by the Pembina Institute and IISD suggests that Canada needs a higher price on emissions than the U.S. to meet the same 2020 target, mainly because of the very rapid projected growth in Canada's oil sands sector. For example, modelling of a stylized Waxman-Markey type approach in the U.S. (aimed at achieving reductions of 17%

<sup>41</sup> APA Discussion Draft, Sec. 728(a)(2). See also Section 775(b) outlining the finding and statement of policy promoting international reductions in emissions.

<sup>42</sup> APA Discussion Draft, Section 726(b)(3).

below the 2006 level in 2020) and of a 'Turning the Corner-style system in Canada (with a target of 20% below the 2006 level, which was then the government's target) found that "the carbon prices that emerge in 2020 with no cross-border allowance trade are about \$60/tonne CO<sub>2</sub>e in Canada and \$30/tonne in the U.S."<sup>43</sup> Because of the higher price of reducing emissions north of the border, Canada will therefore likely require more than double the high end of the price collar outlined in the APA to achieve roughly the same target as the U.S. In other words, Canada cannot harmonize with the U.S. price if it hopes to hit the U.S. target.

As the Government of Canada has already decided to adopt the U.S. target, it must now adopt a carbon pricing system strong enough to meet that target — which will almost certainly mean adopting a higher price on emissions than the U.S. system produces.<sup>44</sup> Thus, a decision to harmonize Canada's price to the APA's price collar would mean either:

- Falling short of Canada's 2020 target; or
- Spending very significant amounts of public funds to acquire additional emission reductions outside of the cap-and-trade system.

#### **F. The APA creates a system of domestic and international offsets that limits individual firms' use of offset credits.**

The draft APA allows access to up to two billion tonnes of offset credits per year to help covered entities in the electricity and industrial sectors meet their compliance obligations. The bill sets a limit on individual firms' use of offsets as determined by the emissions from the individual firm compared to total emissions for all covered firms.<sup>45</sup> The bill also establishes criteria, to be administered by the EPA, to evaluate whether offset credits result in real and permanent reductions. The APA includes a long list of project types that are permitted to generate offsets, including methane collection at landfills, reforestation of acreage, carbon capture and sequestration, altered tillage practices, practices to eliminate or decrease the use of fertilizers, and management and restoration of peatlands or wetlands.<sup>46</sup>

Many environmental organizations are concerned about the high volume of offsets permitted by the draft APA. If firms take full advantage of the initial offset provisions, emissions in the capped sectors themselves could increase by up to 44%, as firms buy offset credits rather than reducing their own emissions.<sup>47</sup> Groups such as the Natural Resources Defense Council argue the list of presumptively allowed project types should be eliminated or shortened to include only the ones most likely to produce high quality

<sup>43</sup> Bramley et al., *Linking National Cap-and-Trade Systems in North America*.

<sup>44</sup> One exception to this statement would be a situation where the U.S. and Canada were part of a single cap-and-trade system, where emission allowances traded freely between the two countries. In that situation, the two countries would converge on a single carbon price that lies between the U.S. and Canadian prices (our analysis found a price of \$31/tonne). Canadian firms would be net buyers of U.S. emission reductions, leading to more innovation taking place in the U.S. However, the prospect of negotiating a single Canada-U.S. market seems, at present, quite distant.

<sup>45</sup> Skadden & Associates, "Senators Kerry and Lieberman Unveil the American Power Act," May 21, 2010.

<http://www.skadden.com/Index.cfm?contentID=51&itemID=2084>. Individual entities are limited in their use of offsets by a formula: (Total individual entity emissions/total of all covered entity emissions) \*2 billion.

<sup>46</sup> APA Discussion Draft, Section 734(b).

<sup>47</sup> Victor Flatt, "Kerry-Lieberman adds some certainty on offsets," Climate Progress blog, May 12, 2010. <http://climateprogress.org/2010/05/13/kerry-lieberman-climate-bill-offsets/>

emission reductions.<sup>48</sup> Other analysts acknowledge that there are many uncertainties regarding whether the offsets will actually result in real and additional emission reductions, but say that the draft APA takes verification of offset credits more seriously than previous bills did.<sup>49</sup>

**Implications for Canada:** While the APA allows very generous access to offset credits, it does include a limit on the use of both domestic and international offset credits. As discussed above, the APA places a prorated limit on the extent to which an individual emitter can rely on offset credits to satisfy its compliance obligation in a given year. The limit on individual firms' use of offsets is determined by its total emissions compared to total emissions for all covered firms.<sup>50</sup>

In contrast, the Government of Canada's "Turning the Corner" plan would have allowed firms unlimited access to domestic offset credits as one of several compliance options.<sup>51</sup> As noted above, limits on the use of offsets are one of the criteria that the APA includes in its definition of "comparable" systems when determining whether to impose a border adjustment. Although the federal government has since decided to scrap the "Turning the Corner" approach in favour of waiting for the U.S., we have seen no public

indications from the Government of Canada that it is now considering a limit on the use of domestic offset credits.

The "Turning the Corner" plan also gave firms access to a Technology Fund compliance mechanism, which would have allowed firms to meet 70% of their 2010 obligation by making payments into a fund (at a rate of \$15/tonne) rather than reducing their own emissions. There is no equivalent to this Technology Fund approach in the APA.

## Conclusion

While Canada has adopted a parallel target to the U.S. target of 17% below 2005 by 2020, the Government of Canada has not published a comprehensive plan, bill or regulations to meet that target.

Canada's Environment Minister Jim Prentice has stated that, in the federal government's view, "a key objective should be a common cap-and-trade system between Canada and the U.S. that would allay competitiveness concerns in both countries."<sup>52</sup>

The Pembina Institute's perspective is that waiting for the U.S. is not a responsible approach to climate policy for Canada, and is not in Canada's best interests. While we recognize that U.S. climate law and policy is an important consideration as Canada determines the policies and measures required to meet its targets to limit GHG emissions, there is no guarantee that an approach that works in the U.S. will be adequate to meet Canada's own 2020 target. In fact, economic analysis suggests that Canada will need a higher price on emissions to reach the same 2020 target (17% below the 2005 emission

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<sup>48</sup> Dan Lashof, "Solid at the Core: The Integrity of the Emissions Limits in the American Power Act," Natural Resources Defense Council switch board (May 13, 2010) bill.

[http://switchboard.nrdc.org/blogs/dlashof/solid\\_at\\_the\\_core\\_the\\_integrit.html](http://switchboard.nrdc.org/blogs/dlashof/solid_at_the_core_the_integrit.html)

<sup>49</sup> Flatt, "Kerry-Lieberman adds some certainty on offsets."

<sup>50</sup> See Skadden & Associates, "Senators Kerry and Lieberman Unveil the American Power Act."

<sup>51</sup> Environment Canada, *Turning the Corner: Regulatory Framework for Greenhouse Gas Emissions* (Ottawa, ON: Government of Canada, 2008).

[http://www.ec.gc.ca/doc/virage-corner/2008-03/pdf/COM-541\\_Framework.pdf](http://www.ec.gc.ca/doc/virage-corner/2008-03/pdf/COM-541_Framework.pdf)

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<sup>52</sup> Jim Prentice, speech to the Canadian Council of Chief Executives, January 20, 2009.

<http://www.ec.gc.ca/default.asp?lang=En&n=6F2DE1CA-1&news=E110AAE9-B810-4F07-ADEC-2A4C245D67D9>

level) as the U.S.<sup>53</sup> If Canada's government does intend to reach — or, even better, exceed — the level of emission reductions it committed to through the Copenhagen Accord, Canada's policymakers will need to implement policies aligned with that goal, even if that means moving more quickly than the U.S. Of course, any U.S. climate and energy bill will be designed with the U.S.'s particular situation in mind; that approach will certainly need to be adapted to suit Canada's specific economic, emissions and regional situation.

The APA builds on many of the provisions of the American Clean Energy and Security Act of 2009 (the Waxman-Markey bill), giving Canadian policymakers more than enough certainty about the outlines of an eventual U.S. carbon pricing system to proceed with the adoption of an effective carbon pricing system in Canada. Moreover, President Obama has been clear in recent statements that he will work to find the Senate support needed to enact a carbon pricing system in the U.S.<sup>54</sup> Even if that effort fails, the EPA has initiated a process to enforce emission performance standards for industrial facilities beginning in January 2011.<sup>55</sup>

In our view, the best way for Canada to cut its own emissions, and to increase its leverage and influence in Washington, is to move ahead with a strong federal carbon pricing initiative as soon as possible. As part of that, the Government of Canada needs to develop

a specific strategy to address its fastest growing source of GHG emissions, those from the oil sands sector.

Implementing a carbon pricing approach of demonstrably greater stringency than the U.S. approach is also surely the most effective way to protect Canadian industries from border adjustment policies.

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<sup>53</sup> See, for example, Bramley et al., *Linking National Cap-and-Trade Systems in North America*.

<sup>54</sup> Remarks by President Obama on the Economy at Carnegie Mellon University, Pittsburg, Pennsylvania, June 2, 2010. <http://www.whitehouse.gov/the-press-office/remarks-president-economy-carnegie-mellon-university>

<sup>55</sup> U.S. Environmental Protection Agency, *Prevention of Significant Deterioration and Title V Greenhouse Gas Tailoring Rule (Final Rule)*, May 13, 2010. <http://www.epa.gov/nsr/guidance.html>