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TABLE OF CONTENTS

New Federal Plan for Kyoto Commitment Implementation

The Kyoto Protocol became international law on February 16, 2005. On April 13, 2005, the federal government released "Moving Forward on Climate Change: A Plan for Honouring our Kyoto Commitment" (the "Plan"). The measures presented in the Plan are intended to reduce Canada's greenhouse gas ("GHG") emissions by 270 megatonnes per year in the 2008-2012 period. This is the federal government's current estimate of the "gap" between the 830 megatonnes of emissions expected in 2008-2012 in the absence of climate change action, and 560 megatonnes per year of GHG emissions, on average, which is Canada's Kyoto target for 2008-2012 of 6% below 1990 emission levels.

The Plan provides for:

- Establishment of the Climate Fund, which will purchase emission reductions on behalf of the federal government, and the Partnership Fund, which will support agreements with the provinces and territories through cost sharing and will invest in technologies and infrastructure development
- Enhanced renewable energy incentives and the EnerGuide for Houses Program
- Increased individual action to be addressed through an enhanced One-Tonne Challenge program
- A new emissions reduction plan for large emitters, including companies in the mining and manufacturing, oil and gas, and thermal electricity sectors (known as "Large Final Emitters" or "LFEs"), to achieve reductions from industry

Individuals and organizations that reduce or sequester emissions will be able to apply to a government body for offset credits. Emission reductions occur when emissions released into the atmosphere are decreased. Sequestration occurs when GHGs in the atmosphere are taken up by a sink (for example, when carbon dioxide is taken up by a forest).

The federal government and the automotive industry have reached an agreement on emission reductions that focuses on technological improvements in vehicle emissions, production of more alternative fuel and hybrid vehicles and the development and application of high fuel efficiency technologies.

Funding for many of the foregoing measures were included in the 2005 Budget Implementation Bill. According to the Plan, new funds will be added after a review in 2007 of existing programs (as noted above, existing programs include residential, commercial and institutional building energy efficiency incentive programs and cleaner alternative fuels).

Key components of the Plan as they may affect LFEs and other industry sectors are outlined below, although most of the implementation detail has been left to be defined in legislation and regulations. Industries and individual businesses will need to carefully review draft regulations when they are issued and participate fully in stakeholder processes to ensure their views are considered before government finalizes details for the new regulatory measures and implementation of the Plan. As noted above, parts of the Plan are proposed to be implemented through the 2005 Budget Implementation Bill.

At this time it is unknown whether the Bill will be passed. If there is an election shortly, the specific details of the Plan may change. Regardless, Canada's Kyoto commitment to reduce emissions will continue, and industry will need to respond accordingly.

Large Final Emitters Measures

The LFE sectors include about 700 companies that are estimated to emit just under 50% of total Canadian GHG emissions. The Plan does not include a new definition of LFEs, but NRCan currently defines large industrial emitters using the following two criteria: annual average emissions of 8 kt carbon dioxide equivalent (CO_2e) per establishment or more; and annual average emissions of 20 kg CO_2e per $1000 gross production or more.

In the 2002 Climate Change Plan, the government planned to negotiate covenant agreements with LFEs, as well as develop regulatory backstops. The current Plan indicates the government now intends to directly utilize regulations with limits on emissions and to implement rigorous monitoring and reporting requirements. Therefore, the previous potential for LFEs to obtain adjustments of targets through covenants will no longer be available.

The overall target of emission reductions for LFEs has been dropped from the 55 megatonnes set in the 2002 Climate Change Plan to 45 megatonnes per year in the current Plan. LFEs will have emission reduction targets, although details on how the targets will be established are not yet known. Sectoral LFE targets will be developed by activity on an emissions intensity basis and will be different for the following categories:

- Fixed process emissions - These emissions cannot be controlled by industry other than by lowering production. LFEs with fixed process emissions will receive a 0% emissions reduction target for the 2008-2012 period
- All other emissions - These emissions can be reduced by using available technologies without lowering overall production levels. The Plan states, "all other emissions receive a 15% target. However, the targeted reductions from these other emissions as a percentage of total emissions cannot exceed 12 percent of total emissions"
- New facilities and facilities undergoing major transformations - The targets for emissions will be based on "Best Available Technology Economically Achievable" performance standards

LFEs will have several options to reduce emissions:

- investment in in-house reductions (e.g. technology improvements to LFE facilities)
- purchase of emission reductions from other LFE companies reduce emissions below required levels (the latter may also be able to sell credits to the Climate Fund)
- investment in domestic offset credits, which are real emission reductions or carbon sequestration generated outside the LFE system (e.g. credits earned by the forestry industry)
- purchase of certified international emissions reduction credits
- investment in technologies for emission reductions, including in the government-established Greenhouse Gas Technology Investment Fund

Regulatory Initiatives

Under the Plan, an LFE regulation for targets, compliance monitoring and emissions trading is to be developed beginning in the Spring of 2005 in cooperation with provinces and territories, aboriginal peoples, industry and environmental groups. The Plan emphasizes that the federal government's preferred option for implementing the new regulation is the *Canadian Environmental Protection Act* ("CEPA"), since it is already in place, is currently used to regulate other emissions from LFEs and enables the federal government to facilitate equivalency agreements with provinces, territories, and aboriginal governments. The Plan states that GHGs must first be added to the List of Substances under Schedule 1 to CEPA and that GHGs meet the second criterion for listing, namely that they constitute a danger to the environment on which life depends. A draft protocol for the proposed regulation system, and later in 2005 a draft LFE Regulation, will be released for public review and comment.

Some of these regulatory measures were included in the 2005 Budget Implementation Bill as amendments to CEPA (see "Federal Government Budget Measures Regarding Kyoto Commitments", an April 2005 Lawson Lundell newsletter available at http://www.lawsonlundell.com/resources/Kyoto%20Newsflash.pdf). As noted above, the Bill has not yet been passed by Parliament.

Forestry Industry Measures

The Plan indicates the Climate Fund may provide incentives for an increase in carbon sinks through afforestation (the establishment of a tree crop on an area from which trees have always or long been absent), re-forestation (meaning the natural or artificial restocking with trees on forest land) and avoided deforestation. Forestry companies that engage in state-of-the-art forest management practices designed to substantially reduce or sequester emissions (e.g. accelerated regeneration programs) will be able to apply to a government offsets body to have their projects recognized as eligible for domestic offset credits.

Renewable Energy Incentives

The Plan describes the contribution that renewable energy makes towards reducing the emissions intensity of Canada's power sector. As part of the Plan, the 2005 Budget Implementation Bill also includes increased funding of the Wind Power Production Incentive ("WPPI"), which was established in 2001 and is intended to position Canada to be a leader in the wind energy industry. The Plan proposes to extend the 2001 WPPI allocation program from $260 million (which was to be provided on a per kilowatt-hour basis for eligible projects commissioned between March 31, 2002 and April 2007) to a total of $920 million over 15 years. An incentive payment of 1% per kilowatt-hour of production for the first 10 years will be made to eligible projects commissioned before 2010. In addition, the government introduced budgetary measures for the allocation of $886 million over 15 years to the Renewable Power Production Incentive ("RPPI") to support other renewable energy sources including small hydro, biomass and tidal power (details of the RPPI to be announced before April 1, 2006). Projects that receive WPPI or RPPI may also be eligible for the offset system.

Tax Incentives

The Plan sets out several generally applicable tax incentive initiatives. Many of these relate to an expansion of capital cost allowance.

- For businesses investing in energy efficient and renewable energy generation, capital cost allowance rates will be increased from 30% to 50% for highly efficient co-generation equipment and the renewable energy generation equipment currently included in Class 43.1 of the *Income Tax Act* (including wind turbines, hydro facilities with a maximum rated capacity of 50 MW, active solar heating equipment, photovoltaics and geothermal energy equipment.). Class 43.1 will also be extended to include heat distribution assets of energy systems such as pipelines, pumps and meters where the heat energy has been produced using cogeneration equipment that qualifies for Class 43.1 treatment.
- The same accelerated capital cost allowance will also be extended to include certain equipment used to produce biogas (largely methane) from anaerobic digestion of farm manure, where the biogas is used to generate electricity.
- Qualifying start-up expenses of projects using these additional technologies will be eligible for immediate write off as Canadian Renewable and Conservation Expenses. These expenses may also be flowed through to investors as part of a flow-through share subscription.

Key Legal Issues Arising from the Plan

- The Plan is short on implementation details, most of which are left to be addressed through regulations or other means.
- The Plan indicates that climate change covenants with LFEs will no longer be available. In their place, a new regulatory structure will be developed in cooperation with stakeholders.
- Companies that develop practices designed to substantially reduce or sequester emissions will be able to apply to an offsets body under the authority of the Minister of the Environment to have their projects recognized as eligible for domestic offset credits. An offset system provides domestic offset credits for project-based GHG reductions or removals that meet the requirements of the system. Once the emission reductions have occurred, this separate body will award credits for reductions. Companies planning such projects will want to ensure that they will result in credits that will count as credits against their required reductions.
- Companies that will not be able to meet their new targets through technological means will need to obtain emissions credits from other sources. It will be important to identify which domestic and international credits will be certified as valid. Careful attention will need to be paid to certification process requirements and all documentation.
- Those companies that will be below the new target emissions levels

may consider certifying their emissions reductions for sale as credit to other companies. Significant due diligence will be required to ensure the credits will be valid

- The 2002 Plan indicated companies would receive credit for early action, but it is not clear if and how the 2005 Plan will provide credit for early action.

How We Can Help

Lawson Lundell can assist clients in responding to the challenges presented by the 2005 Plan in many ways. Lawson Lundell has worked for members of every major industrial sector, including the energy, forestry, forest products manufacturing, mining, and other industries. Lawson Lundell has assisted in preparing submissions regarding the development of legislation that affect our clients. Other areas where we can assist include: drafting legislation and regulatory on behalf of industry associations; drafting agreements for the purchase and sale of carbon credits and for transactions involved in domestic or international projects yielding emission credits; advising on tax implications and tax planning in connection with such transactions; advising on certification processes and due diligence regarding the validity of credits resulting from projects.

Lawson Lundell has been actively monitoring climate change issues since the Kyoto Protocol was signed and has developed an international network of contacts in countries that are signatories to the Kyoto Protocol and who represent opportunities for developing international emission reduction projects.

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