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REGULATION RESPECTING A CAP-AND-TRADE SYSTEM FOR GREENHOUSE GAS EMISSION ALLOWANCES

BY OUR ENVIRONMENTAL LAW GROUP

January 2012 — On December 15, 2011, the Minister of Sustainable Development, Environment and Parks announced the adoption of the Regulation Respecting a Cap-and-trade System for Greenhouse Gas Emission Allowances (the "**Regulation**"). The Regulation has been in effect since January 1, 2012.

The Regulation imposes obligations for the reduction of greenhouse gas ("**GHG**") emissions upon a select group of companies beginning on January 1, 2013. To that end, the Regulation establishes a system known as cap-and-trade (the "**System**") such that targeted companies ("**Targeted Emitters**") can benefit from various options in order to comply with their reduction obligations. The establishment of the System will take place in 2012.

The Regulation relies on rules established by the Western Climate Initiative ("**WCI**"), which is a group currently consisting of five (5) members that aim to reduce their GHG emissions: four (4) Canadian provinces (Quebec, Ontario, Manitoba and British Columbia) and California. At the beginning of 2011, the WCI had eleven (11) members of which six (6) American states have recently withdrawn.

The main elements of the Regulation are presented below. By mid-January 2012, we will publish a more detailed bulletin on this Regulation (among other things, on the applicable conditions regarding the initial free allocation of emission units, the auction process and the sale by way of mutual agreement) as well as on the outcome of the United Nations international negotiations that took place in Durban from November 28 to December 11, 2011, and its impact on Quebec companies.

WHO ARE THE TARGETED EMITTERS?

The Regulation imposes the obligations to reduce GHG emissions by January 1, 2013, on any company that meets the following two criteria:

a) their industrial establishment(s) emit 25,000 tons of carbon dioxide equivalent (or CO_2 equivalent) or more per year; and

b) the company operates within one of the following activities: i) mining, quarrying and oil and natural gas extraction (NAICS code 21), ii) electric power generation, transmission and distribution (NAICS code 2211), iii) natural gas distribution (NAICS code 2212), iv) steam and air conditioning supply (NAICS code 22133), v) manufacturing (NAICS code 31, 32 or 33), and vi) pipeline transportation of natural gas (NAICS code 486210).

Additional industrial sectors will be subject to the Regulation beginning in 2015, such as Quebec importers and distributors of oil or fuel used in the transportation and building sectors.

Exceptions to the Targeted Emitters

There are certain exceptions to Targeted Emitters. For instance, the following are excluded: i) CO_2 emissions attributable to the combustion or fermentation of biomass and biomass fuels, ii) certain methane (CH_4) emissions attributable to coal storage, and iii) certain CO_2, methane (CH_4) and nitrous oxide (N_2O) emissions attributable to mobile equipment on the site of an establishment.

In addition, up until January 1, 2015 only, the following emissions are exempt from applying the Regulation: i) certain methane (CH_4) emissions attributable to the operations of a petroleum refinery, ii) certain methane (CH_4) and nitrous oxide (N_2O) emissions attributable to anaerobic wastewater treatment, and iii) certain CO_2, methane (CH_4) and nitrous oxide (N_2O) emissions attributable to the transportation and distribution of natural gas.

WHAT IS THE GHG EMISSIONS REDUCTION TARGET?

On November 18, 2009, decree 1187-2009 established the GHG emissions reduction target as 20% below 1990 levels, by 2020. The Regulation does not determine how this target will be divided amongst Targeted Emitters. Thus, the Quebec Government will soon have to determine whether the 20% target will be imposed equally on all Targeted Emitters or whether this 20% target will be unequally divided among various industrial sectors and, eventually, among various Targeted Emitters.

In order to help Targeted Emitters reach their GHG emissions reduction objectives, the Regulation establishes a free allocation of emission units to Targeted Emitters (with the exception of those Targeted Emitters active in the pipeline transportation of natural gas and natural gas distribution); it being understood that an emission unit is equivalent to a reduction of GHG emissions. The Regulation establishes the formula used to determine the free allocation, which formula is determined by various criteria including the allocation year and the activity sector.

We will provide further detail on this issue in our next bulletin.

WHAT WILL TARGETED EMITTERS BE ABLE TO TRADE IN THIS CARBON MARKET?

In the event that a Targeted Emitter cannot or does not want to reduce its GHG emissions by modifying its processes and/or by implementing new equipment, a Targeted Emitter will be allowed to submit to the Minister of Sustainable Development, Environment and Parks (the "**Minister**") the following four (4) types of emission allowances in order to comply with its reduction obligation: i) GHG emission unit, ii) offset credit, iii) early reduction credit, and iv) any other emission right determined by the Quebec Government.

Each of these categories of emission allowances will be detailed in our next bulletin. Note, however, that reductions in GHG emissions made during the eligibility period starting on January 1, 2008 and ending on December 31, 2011, are the only reductions eligible for early reduction credits. Early reduction credits must satisfy the criteria established in the Regulation.

Finally, the use of offset credits cannot exceed 8% of the Targeted Emitter's GHG emissions for the compliance period. The requirements applicable to offset credits will be determined by another regulatory instrument to be adopted by the Quebec Government.

WHEN WILL THE SYSTEM BE IMPLEMENTED?

The System will start in 2012 with a transition year, followed by three compliance periods.

The 2012 transition year: This transition year will allow Targeted Emitters and participants to familiarize themselves with the functioning of the System. Thus, no reduction of GHG emissions will be required in 2012. However, Targeted Emitters must register with the System between May 1 and September 1, 2012 in order to obtain an identification number, a general account and a compliance account such that they can participate in the auctions and trading of emission units. Additional milestones apply in certain conditions.

Any person other than a Targeted Emitter interested in purchasing emission allowances must register as a participant starting from May 1, 2012. A physical person may also register to the System.

Any request to obtain early reduction credits must be submitted to the Minister no later than December 31, 2012 with the prescribed information.

As of January 1, 2013: The Targeted Emitters will be required to reduce their GHG emissions as of 2013. The first compliance period will be of two years, from January 1, 2013 to December 31, 2014, and each of the two other compliance periods will be of three years (2015-2017 and 2018-2020).

As of January 1, 2015: Additional companies and GHG emissions will be subject to the obligation to reduce GHG emissions.

HOW WILL THE SYSTEM FUNCTION?

Compliance: No later than October 1, following the end of a compliance period, Targeted Emitters must determine their GHG emissions for each of their establishments subject to the Regulation and for the applicable period. They must send the Minister a report on the coverage of its GHG emissions with the prescribed information, including among other things, the number and type of emission allowances to be deducted from this Targeted Emitter's compliance account to cover the GHG emissions. Thus, the first report on the coverage of the Targeted Emitter's GHG emissions must be submitted to the Minister at the latest on October 1, 2015.

To be valid for the purpose of covering GHG emissions, the emission allowances:

a) must be an emission unit, an early reduction credit within the meaning of the Regulation, an offset credit issued by the Minister or any emission allowance issued by a government other than the Quebec Government for which an agreement has been entered into;

b) must not have been suspended, cancelled or extinguished or otherwise used for compliance purposes; and

c) must not have been issued for a year following the compliance period.

Transaction: Only emission allowances recorded in a Targeted Emitter's general account may be traded. To that end, within three business days of signing an agreement concerning a transaction of emission allowances, the Targeted Emitter or participant who wishes to trade emission allowances must send the Minister a transaction notice that includes the prescribed information.

The Minister's accounts: In order to ensure the functioning of the System, the Minister keeps the following four (4) accounts: i) an allocation account containing the emission units created as the basis for the cap, ii) an auction account containing the emission units to be sold at auction, iii) a reserve account, containing reserve emission units along with any other emission allowances that must be recorded in the account, and iv) a retirement account in which emission allowances deducted from the System are recorded.

We will also provide further detail on the functioning of the System in our next bulletin.

CONSEQUENCES FOR QUEBEC COMPANIES

With the adoption of the Regulation, Quebec becomes the third North American jurisdiction to impose an obligation to reduce GHG emissions to its Targeted Emitters, following Alberta and California. Current members of the WCI other than Quebec and California (meaning Ontario, Manitoba and British Columbia) have not yet defined and/or published their requirements on GHG emissions reduction.

Targeted Emitters shall now identify each alternative to reduce their GHG emissions at their covered establishments, estimate the cost of each alternative, and determine the most favourable short, medium and long term compliance strategy with respect to the Regulation, energy efficiency and economic productivity.

Despite constraints that Targeted Emitters face with these new obligations, the Regulation establishes a carbon market that could be linked to the Californian cap-and-trade system and eventually to the European emission trading system and the Kyoto Protocol if Quebec wishes it. With its choice of System partners and by adopting its offset credits requirements, Quebec will determine to which extent its carbon market will become an important economic instrument.

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