

Government of Canada releases framework for an oil and gas sector emissions cap

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The Government of Canada has published the long-awaited framework (the Framework) for an oil and gas sector emissions cap. If implemented, the proposed cap-and-trade system would limit 2030 emissions from covered sources in the sector to 20-23% below 2019 levels (or 35-38% below 2019 levels, without the use of compliance flexibility).

What you need to know

- **Coverage.** The cap-and-trade system would apply to emissions from certain oil and gas facilities, including liquified natural gas (LNG), conventional oil, offshore, oil sands, and natural gas production and processing facilities. Beginning in 2030, the cap would be in the range of 106 to 112 megatonnes (MT) of greenhouse gas (GHG) emissions (although the system would allow between 131 and 137 MT of emissions with the use of compliance flexibility). In contrast, 2019 emissions from covered sources were 171 MT.
- **Compliance flexibility.** The cap-and-trade system would give facilities flexibility to cover their emissions using various compliance instruments, subject to an upper limit. Those compliance instruments would include tradable allowances, federally-recognized offset credits and, potentially, decarbonization fund units and internationally transferred mitigation outcomes (ITMOs).
- **Remaining uncertainty.** The Framework is meant to solicit initial feedback and does not address several key design features of the proposed cap-and-trade system. In addition, the Province of Alberta has said it may challenge the cap if final regulations are issued.
- **Deadline for public comments.** The proposal is open for public comments until February 5, 2024.

Background

Prime Minister Trudeau promised an emissions cap for the oil and gas sector during the 2021 election campaign. Since then, the Government of Canada has taken several key steps in developing the Framework:

- February 7, 2022: The Standing Committee on Natural Resources launched a study on the proposal to cap GHG emissions from the oil and gas sector.

- March 29, 2022: The Government of Canada issued its 2030 Emission Reduction Plan, where it reiterated its commitment to cap and cut emissions from the oil and gas sector at a pace and scale required to reach net zero by 2050.
- April 6, 2022: The Government of Canada announced its plan to develop guidance that will require proponents of new oil and gas production projects subject to a federal impact assessment to demonstrate they will have “best-in-class” emissions performance.
- July 18, 2022: The Ministry of Environment and Climate Change and the Ministry of Energy and Natural Resources issued a discussion paper and launched consultations on two options: implementing a cap-and-trade system under the *Canadian Environmental Protection Act, 1999* or modifying the carbon benchmark requirements under the *Greenhouse Gas Pollution Pricing Act*.
- December 7, 2023: The Government of Canada released the Framework.

The Framework

The proposed cap would function, in many ways, like a typical cap-and-trade system: a cap would be set on emissions from the oil and gas sector and allowances (essentially, licences to emit a tonne of carbon dioxide equivalent, or CO₂e) equal to the cap would be allocated to covered facilities within the sector. Those allowances could be traded between covered facilities, which, in theory, incentivizes emissions reductions at facilities with the lowest marginal cost of abatement. Over the course of each compliance period, facilities would need to either retire allowances equal to their emissions during that period or “true up” any shortfall in allowances by purchasing and retiring other eligible compliance instruments, subject to certain limits.

In a typical cap-and-trade system, the cap would contract over time, making allowances scarcer and thereby increasing demand for allowances and other compliance instruments. This, in turn, would increase the cost of each tonne of CO₂e and incentivize investments in more costly abatement measures at covered facilities. The Framework does not outline how the size of the cap would change after 2030 and only mentions that the post-2030 period will need to balance regulatory certainty with the challenges associated with projecting future conditions.

According to the Framework, the cap-and-trade system would have the following design features.

Coverage

The cap would cover emissions from LNG and upstream oil and gas facilities, including conventional oil, offshore, oil sands, and natural gas production and processing facilities¹. Upstream facilities represented 85% of sector emissions in 2021, and new LNG facilities are projected to be a growing source of emissions.

The Framework does not specify an annual emissions threshold below which facilities in the covered sectors would be exempt from compliance. In contrast, the cap-and-trade systems of California and Québec, which are linked under the Western Climate Initiative (WCI), only require the participation of facilities with annual emissions above 25 kilotonnes (kt). Currently, Environment and Climate Change Canada only requires annual emissions reporting from facilities with emissions exceeding 10 kt per year of CO₂e. However, the Framework notes that the upstream oil and gas sector includes many smaller emitters with annual emissions below 10 kt per year. While these facilities are not major emitters on their own, collectively they are estimated to account for one-third of the sector’s total GHG emissions. Therefore, the Framework states that the government is examining provincial approaches to covering smaller emitters to support an efficient approach to covering them under the federal cap-and-trade system.

The proposed cap would cover direct GHG emissions from covered facilities. However, the cap-and-trade system would also take into account transfers of thermal energy, hydrogen carbon dioxide (CO₂), and electricity to and from these facilities. In particular, each covered facility would be required to report and quantify information related to the purchase and sale, production, use and import, and export from the facility of thermal energy, hydrogen and electricity, as well as CO₂ transfers for storage. According to the Framework, this accounting would help ensure a level playing field and minimize leakage risk—in particular, by minimizing the incentive for covered facilities to relocate

energy production (and any associated emissions) outside of the cap. That said, the Framework contains little detail on how this accounting would occur and how transfers of energy and CO₂ would impact facility emissions subject to the cap.

Cap

Beginning in 2030, the Government of Canada would issue allowances to covered facilities equal to the initial emissions cap. There would also be a separate ceiling on the emissions the entire sector would be allowed to emit in a year. That ceiling—what the Framework calls the “legal upper bound”—would be equal to the emission cap (i.e., the amount of allowances distributed in a year) plus the maximum allowable amount of other compliance instruments that could be used in such year. Based on current estimates, the initial 2030 emissions cap would be between 106 to 112 MT. There would also be about 25 MT in additional compliance flexibility, meaning that the legal upper bound would be around 131 to 137 MT. According to the Framework, the final emissions cap and legal upper bound would be set based on the best information available when the regulations are finalized. As mentioned above, the Framework does not outline how the cap or the legal upper bound will change in the post-2030 period. However, it does mention that the legal upper bound would decrease over time to ensure that the covered sources achieve net-zero GHG emissions by 2050.

Allowance allocation

Allowances would initially be allocated to covered facilities free of charge. However, the Framework suggests that allowance auctions may be considered for future compliance periods. Allowance auctions are a prominent feature in other cap-and-trade systems; for example, the WCI has held quarterly allowance auctions for years.

According to the Framework, in allocating allowances to covered sources, the Government would recognize better performers that are able to produce the same or similar products with a lower emission intensity. The Framework does not provide any details on how this emissions intensity-based allocation method would work in practice. Rather, the government is seeking feedback on the approach.

Compliance periods

The cap-and-trade system would use three-year compliance periods, thereby helping to smooth the impact of any emissions volatility at covered facilities. The multi-year compliance periods would have both an annual compliance requirement and a final true-up at the end of each compliance period. For example, in each of the first and second years of a compliance period, facilities would be required to remit compliance instruments covering up to 30% of their verified GHG emissions, less any GHG emissions permanently stored, for the year.

Compliance instruments

If a facility was not able to cover its emissions with the allowances allocated to it, it could buy and retire allowances from other facilities who have a surplus. A facility could also use certain other compliance instruments to cover its emissions, subject to certain limits:

- **Decarbonization funding program.** The Government is considering whether to include a decarbonization funding program as a compliance option. If this option is adopted, each covered facility could contribute to a decarbonization fund by purchasing fund units to cover up to 10% of its emissions. The price per fund unit would be set at the estimated allowance price needed for the sector to reduce GHG emissions in line with the legal upper bound. Modelling suggests that this price would be approximately \$50 tonne/CO₂e in 2030. Proceeds from the decarbonization fund would be used to support oil and gas sector decarbonization.

- **Offset credits.** The cap-and-trade system would allow covered facilities to retire certain offset credits (i.e., credits awarded to projects or activities that voluntarily reduce greenhouse gas emissions beyond a business-as-usual baseline in accordance with an approved protocol or methodology) to cover a portion of their emissions. Those offset credits would need to have been issued pursuant to Canada's GHG Offset Credit System or from provincial compliance offset systems recognized under the federal Output-Based Pricing System Regulations, like emissions offsets issued under Alberta's TIER program. The Framework proposes that facilities could retire offset credits to cover up to the percentage of GHG emissions between the cap and the legal upper bound (i.e., an amount expected to be up to approximately 20% of a facility's emissions), net of contributions to the decarbonization fund. The Government is also considering an offsets funding program, whereby facilities could make contributions to a fund in exchange for compliance units; the proceeds of this fund could be used by the Government to purchase domestic offset credits and possibly internationally traded mitigation outcomes (ITMOs).
- **Internationally traded mitigation outcomes.** The Government of Canada is considering whether to allow facilities to use ITMOs as a compliance option. ITMOs are internationally transferrable GHG mitigation outcomes created pursuant to the Paris Agreement. This compliance option would presumably depend on the progress of international discussions to implement the architecture for ITMO trading.

Banking

Facilities would be able to bank any unused allowances for up to two compliance periods (six years). This would apply to allowances allocated to the facility or purchased from another facility. The Government of Canada is considering whether there should be a limit on the total number of allowances that can be banked.

Remaining uncertainty

Given its purpose to solicit initial feedback on the proposed cap-and-trade system, the Framework, not surprisingly, leaves certain other issues unaddressed:

- **Overlapping compliance obligations.** The Framework states that, with the exception of certain federally-recognized compliance offsets, credits from other provincial and federal carbon pricing schemes could not be used by facilities to cover their emissions. However, the Framework does acknowledge that emissions reductions at covered facilities may be recognized under applicable federal and provincial schemes. As such, the Government of Canada is exploring options to allow an offset credit that is retired under the oil and gas cap-and-trade program to also be used by the same facility for compliance with a separately applicable carbon pricing system, provided it compensates for the same tonne of GHG emissions. This may require coordination with provincial schemes. For example, Alberta's TIER program was recently amended so that facilities earning offset credits for sequestering CO₂ emissions in accordance with the applicable TIER protocol can convert those credits to "sequestration credits" that may be used for stackable compliance with both TIER and the federal Clean Fuels Regulations.
- **Market intermediaries.** The Framework does not indicate whether market intermediaries will be allowed to participate in the trading of allowances or other compliance instruments. Cap-and-trade systems will sometimes allow the registration of market intermediaries to help improve liquidity.
- **Holding (and purchase) limits.** Cap-and-trade systems will sometimes include holding limits, restricting the volume of allowances that can be held by any covered facility or its affiliates, in an effort to limit market manipulation. For similar reasons, there can be limits on the volume of allowances that can be purchased at auction. It is unclear whether the cap-and-trade system will include any holding limits (or purchase limits if allowances are auctioned in future compliance periods).

- **Offset credit availability and demand.** Although the Framework would allow facilities to cover a portion of their emissions, through the use of federally-recognized offset credits, there is already significant demand for these credits under existing carbon pricing schemes. In addition, Environment and Climate Change Canada has, so far, published only two federal offset protocols, though more are under consideration. Therefore, the available supply of qualifying offset credits remains to be seen. The demand for these credits will also depend on their price; currently, the price of federally-recognized compliance credits tends to track, with a discount, the federal carbon backstop price, which is scheduled to be \$170/tonne in 2030.
- **Pricing: collars and safety valves.** Although, the Framework suggests that fund units may be priced around \$50/tonne, it does not otherwise specify any upper or lower bounds on the price of allowances or other compliance instruments. Such price collars are used in some cap-and-trade systems to create pricing certainty and limit market volatility. The Framework also does not contain any mechanism to act as an upper price limit on compliance instruments (i.e., a safety valve), which is sometimes used to help ensure the price of these instruments does not exceed a politically acceptable price or an amount that is necessary to achieve the program objectives.
- **Constitutional considerations.** The Government of Alberta has already indicated that it may bring a constitutional challenge to the oil and gas cap, should it be finalized, building on the recent challenge to the federal *Impact Assessment Act* (as discussed in our [bulletin](#) and [related video](#)) and the province's invocation of Alberta's *Sovereignty Act* in respect of the proposed federal [Clean Electricity Regulations](#).

Looking ahead

The Government of Canada plans to publish final regulations in 2025, with the first reporting obligations starting as early as 2026 and full system requirements phased in between 2026 and 2030.

The proposal is open for public comments until February 5, 2024, and the Government of Canada plans to publish draft regulations in mid-2024. Comments may be submitted to PlanPetrolieretGazier-OilandGasPlan@ec.gc.ca. As always, please feel free to contact members of Torys' Climate Change Practice regarding the Framework or any planned submissions on the proposed cap-and-trade system.

FOOTNOTES

To discuss these issues, please contact the author(s).

This publication is a general discussion of certain legal and related developments and should not be relied upon as legal advice. If you require legal advice, we would be pleased to discuss the issues in this publication with you, in the context of your particular circumstances.

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