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LOCAL GOVERNMENTS AND CARBON OFFSETS

DECEMBER 3, 2010

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I. INTRODUCTION

"Allowance units", "compliance units", "emission reduction units", "carbon neutrality", "carbon offsets".... What are these terms and concepts all about? Where do they come from? What mind came up with them? These are a few examples of the lingo evolving in the realm of carbon offsets trading and the movement to reduce global green house gas emissions (GHGs). The Province of British Columbia has been at the forefront in Canada in moving towards a carbon offset trading system. If fully in force and implemented through regulation, recent B.C. enactments will establish a comprehensive framework for the buying and selling of carbon offsets. Many B.C. local governments have also begun to take steps in this area, including by signing the Climate Action Charter and, in some cases, by buying and selling carbon offsets.

This paper summarizes the current legal regime in British Columbia and some of the legal issues surrounding the buying and selling of carbon offsets, with emphasis on the local government perspective. Some may still question the need for reducing greenhouse gas emissions. This paper does not examine the merits of such efforts but, rather, attempts to distil the legal context for buying and selling carbon offsets, from the vast amount of published material, newly enacted statutes and regulations and other arrangements.

The first part of the paper focuses on the nature of carbon offsets and examines the recent B.C. legislation. The second part examines carbon offsets in the context of B.C. local governments. The last part highlights some issues to be aware of when considering arrangements for the buying or selling of carbon offsets.

Be forewarned, you are entering a new world, with a new language unto its own…

II. CARBON OFFSETS GENERALLY

A. What is a Carbon Offset?

A carbon offset is not tangible. You cannot pick one up and put it in your pocket. Nor is it quite like a share, representing some interest in an asset. In a very basic sense, a carbon offset is a measurement or quantification of an environmental benefit. It is a recognition of value in an activity that has had a beneficial impact on GHG emissions.

The carbon offset concept is the result of a concerted effort to encourage GHG emission reduction by enabling those who achieve such reductions to sell the recognized benefit of such reductions to others, who would like to reduce their environmental impact, if only indirectly and notionally. In this context, it is not the GHG reduction itself that is marketable. Rather, what is sold are the benefits that flow from being credited with having caused that GHG reduction. However, in order for someone to be able to sell such an offset, there must be some

legal or other motivation for someone else to buy the offset. What are the benefits to being the owner of a carbon offset?

B. Why would anyone be interested in buying an Offset?

A person or business may, for a variety of reasons, be interested in reducing GHG emissions from their activities or operations. They may be able to do so by actually reducing those emissions, such as by installing energy saving devices. The concept of 'carbon offsets' provides an alternate avenue for a person to achieve GHG reduction goals. Rather than actually changing their own activities to reduce emissions, a person may be able to purchase an offset, being a marketable recognition of someone else's GHG reducing activities.

From the offset seller's perspective, the ability to sell a carbon offset provides an additional incentive to undertake GHG reducing action. Such a person may have little motivation (other than the 'global good', which may be insufficient for some), to install perhaps more expensive GHG reducing technology. That person may not have any legal reason (such as mandatory GHG emission targets) or other reason (improving public perception of their business) to proceed with such more expensive technology. The opportunity to sell the resulting GHG reduction may provide such motivation.

What then are the reasons that a person might be so interested in reducing GHG emissions that they would actually pay for the benefit of someone else's efforts by purchasing a carbon offset?

1. Public Demand (Self Interest?)

There may be a level of public 'demand' to see businesses and others become 'carbon neutral'. While this kind of demand may not create any legal obligation, it can provide other kinds of incentives. For instance, a business owner may see their business benefit if they are able to champion their climate record.

2. Government Regulation

In an ideal world, public demand and self interest would provide a sufficient, non-market motivation for people to reduce GHG emissions, including through the purchase of appropriate carbon offsets. However, governments may see the need for non-market methods to provide additional 'incentives' for people to reduce their GHG emissions. In this respect, the B.C. provincial government has taken steps to establish a framework for regulations aimed at reducing GHG emissions.

The provincial government has enacted various GHG oriented pieces of legislation, including the *Greenhouse Gas Reduction Targets Act* (the "Targets Act") and the *Greenhouse Gas Reduction (Cap and Trade) Act* (the "Cap & Trade Act").

(a) The Targets Act

The Targets Act establishes targets for the reduction of BC greenhouse gas emissions to be met beginning in 2020, as well as targets for the years 2012 and 2016 (the targets for these earlier years are set by regulation). These are targets for the entire Province and all activities within the Province. However, the Act does not actually impose any general obligation to reduce emissions.

The Targets Act does impose mandatory emission requirements on the Provincial government and certain "public sector organizations" that are reporting entities under the *Budget Transparency and Accountability Act*, including school boards, universities, health boards and government controlled corporations, but not local governments. More specifically, section 5 of the Act requires that each organization be "carbon neutral" for 2010 and subsequent years. To be "carbon neutral" the Act requires that a regulated body "pursue actions to minimize its PSO greenhouse gas emissions [a defined term] for the calendar year", determine GHG emissions for the year and, by June of the following year, apply emission offsets to net those emissions to zero. The targeted GHG emissions include direct and indirect emissions from the heating, air conditioning and lighting of buildings and the operation of machinery, appliances and equipment, as well as direct emissions from vehicles (but not from public transit buses or school buses) and office paper production. It is this requirement for carbon neutrality that sets the stage and motivation for these organizations to purchase carbon offsets.

The Emission Offsets Regulation establishes the framework for the approval and recognition of offsets for the purpose of meeting this carbon neutrality requirement. The Regulation contains a review and approval process for offsets (discussed in the last part of this paper). Under the regulation, a project reduction will be recognized as an emission offset for the purpose of the Targets Act if the reduction has been "verified" in accordance with the regulation and only if the offset is sold to the Pacific Carbon Trust and the related GHG reduction has not previously been recognized as an offset under the Targets Act or another emissions offset recognition scheme or greenhouse gas reduction program.

In short, the Targets Act imposes an obligation upon certain Provincial organizations to purchase carbon offsets, if necessary in order to meet their carbon neutrality obligations. As a result, the Act creates a market place for people to sell carbon credits, albeit to one entity only, the Pacific Carbon Trust.

It is worth noting that section 10 of the Targets Act provides each regulated organization with express statutory authority to "acquire, dispose of or otherwise deal with emissions offsets" for the purposes of the Act.

(b) The Cap & Trade Act

The Cap and Trade Act would go beyond provincial government organizations, and establish a framework for the imposition of a cap on GHG emissions on others. At this time the cap provisions of this Act are not yet in force. If Bill 18-2008, which contains the proposed Cap and Trade Act, is fully implemented, it will establish a cap on GHG emissions for "regulated operations" (to be set under regulation) that may create a significant demand for carbon offsets, depending on the level at which the cap is set and what operators are ultimately covered by the scheme. Certain GHG reporting requirements under the Act are currently in force, presumably to enable the Province to gather emission information to assist with eventual implementation of the cap and trade system. These reporting requirements apply to "reporting operations" under the Reporting Regulation (primarily heavy industry, such as mining, pulp and paper, manufacturing and energy). Under the Western Climate Initiative design, only facilities emitting more than 25, 000 tonnes of carbon dioxide equivalent would be subject to a cap. Apparently, the Province is planning to start the cap and trade system in 2012.

The proposed system would be based on an allocation of "allowance units" or BCAU's, each representing one tonne of emissions. The Lieutenant Governor in Council would set a maximum number of BCAUs to be made available to regulated operators for a "compliance period". The director under the Act would then make these BCAUs available to operators. While the Province is still consulting as to how this scheme would be implemented, apparently allowances will be allocated in part for free and in part by auction. For each compliance period, a regulated operator will be required to determine the amount of GHG emissions from their operations and then match that emission amount by retiring a combination of BCAUs and offsets acquired by the operator. The Act recognizes two kinds of offsets for this purpose. Firstly, project proponents will be able to acquire and then use or sell emission reduction units or BCERU's, which would be issued for projects that meet the reduction requirements under the Act. The Act contemplates an offset project approval process somewhat similar to that under the Targets Act Emissions Offsets Regulation. The Act also contemplates that compliance units from other systems may be recognized as "RCU"s by regulation. In a nutshell, a regulated operator will be limited in their ability to emit GHGs to the amount of allowance units allocated to them, except to the extent that they are able to acquire offsets issued or recognized under the Act. The Act also contemplates that there may be limits on the extent to which offsets may be used to meet the emission target. Importantly, the ownership and trading of BCAUs and BCERUs will be tracked through a compliance unit tracking system.

What might happen to someone who does not have a sufficient allocation of BCAUs and does acquire a sufficient number of BCERUs to offset their GHG emissions for a compliance period? The Act contains potentially significant penalties, if brought into force in the form set out in Bill 18. These include a scheme of "administrative penalties" that enable the imposition of monetary penalties, as well as the imposition of an obligation to retire additional compliance units. If, under this penalty scheme, a person is required to retire compliance units, but does

not do so, the government may acquire and retire the necessary compliance units and recover its costs from the person as a debt.

As noted, the Province is still going through public consultation with respect to how the Cap and Trade Act will eventually be implemented.

3. Contractual Obligation

It is also possible for someone to become motivated to achieve GHG emissions and perhaps purchase carbon offsets by entering into an agreement obligating them to meet GHG targets and permitting the purchase of offsets to do so. For instance, an international treaty might serve as the foundation for the creation of national cap and trade systems. Many British Columbia local governments have signed on to the Climate Action Charter, which includes a carbon neutrality target and is discussed further below.

III. LOCAL GOVERNMENTS & CARBON OFFSETS

A. Why would a Local Government be interested in buying an Offset?

1. Regulation?

Currently, there is no regulation in place setting emissions targets for local governments or obligating local governments to reduce emissions or become carbon neutral. The Cap & Trade Act may ultimately affect some local governments that engage in regulated activities, such as the generation or distribution of electricity. Perhaps that Act will eventually target other kinds of local government entities, such as office, machinery and vehicle emissions.

2. Obligation under Agreement?

Many local governments (178 according to the Climate Action Chart's website) have signed on to the B.C. Climate Action Charter (CAC) with the Province and the UBCM. The CAC contains various acknowledgements regarding the importance of reducing GHG emissions and as to the steps that have been taken to address the issue. Under subsection (5) of the CAC, signatory local governments "agree to develop strategies and take actions to [become] carbon neutral in respect of their operations by 2012, recognizing that solid waste facilities regulated under the *Environmental Management Act* are not included in operations for the purposes of this Charter". Importantly, subsection (9) of the CAC states, "This Charter is not intended to be legally binding or impose legal obligations on any Party and will have no legal effect".

The CAC is not contractually binding on signatory local governments. As a result, there would be no legal consequence to breaching an 'obligation' under the CAC. Rather, the CAC simply establishes 'political' promises. These non-binding commitments may nevertheless serve as a motivation for formal local government action and a motivation for purchasing carbon offsets. This will ultimately depend on the political and economic climate in coming years.

3. Political Reasons

As noted above, public demand and politics (that is, responding to community demands) may serve as a significant motivation for some local governments to achieve carbon neutrality and to buy offsets in order to do so.

B. Local Government Authority

In light of the current absence of mandatory emission requirements for local governments, how does the local government legal framework address the purchase of carbon offsets?

1. Statutory Enabling Provisions

Local governments are creatures of statute and have only those powers granted to them under statute. Accordingly, while a council or board may have an interest in purchasing offsets, it may only do so if it has the statutory authority to do so.

In this respect, neither the *Community Charter*, nor the *Local Government Act* contains any express power to purchase carbon offsets. Section 8(1) of the *Community Charter* provides that "a municipality has the capacity, rights, powers and privileges of a nature person of full capacity". The purposes of a municipality are set out in section 7 of the Charter and include, "fostering the economic, social and environmental well being of its community".

Regional districts do not have 'natural person powers'. However, section 176 of the *Local Government Act* sets out certain 'corporate powers', including the power "to make agreements respecting…the regional district's services" and "to acquire, hold, manage and dispose of land, improvements, personal property or other property, and any interest or right in or with respect to that property". Section 2 of the LGA includes similar purposes to those of municipalities, including as noted above.

Do these broad, but non-specific powers, enable local governments to purchase and sell carbon offsets in light of the stated purposes of local governments?

2. Policy (complying with the CAC)

It is likely that a council or board could establish a policy respecting local government operations aimed at reducing GHG emissions and achieving carbon neutrality. Such a policy is simply an aspect of conducting local government business and it is doubtful that any express statutory authority is required for such a policy. A local government may certainly choose to conduct its activities in a manner that is friendly to the environment.

For instance, in the context of such a policy, a local government might undertake some projects aimed directly at reducing GHG emissions. In proceeding with a typical local government

project, it might choose a project design with lower GHG emissions as compared to other design options.

Where a local government undertakes such a project and does not wish or need to 'retain' the GHG reduction for its own purposes, it may be in a position to generate revenue by selling the resulting carbon offset, such as to the Pacific Carbon Trust. The general powers noted above provide sufficient authority for such a sale.

3. Purchasing Offsets

What is less clear is whether a local government may purchase carbon offsets in order meet its carbon neutrality goals under such a policy or under the non-binding CAC.

(a) Valid Local Government Purposes?

Would a purchase of offsets achieved through emissions reductions made in another community, province or country be considered to be for a valid municipal purpose, such as, to foster the environmental well-being of the municipality, particularly where there is no prospect of environmental improvement to the community? Does such a purchase have a local benefit?

In *Shell Canada Products Ltd. v. Vancouver (City)*, (1994), the Supreme Court of Canada held that it was unlawful for the City of Vancouver council to pass a resolution refusing to do business with Shell Canada "until Royal Dutch Shell completely withdraws from South Africa". The majority of the Court held that such a decision was not within the scope of 'purposes' set out under the Vancouver Charter. The Court considered that the City "was seeking to use its powers to do business 'to affect matters in another part of the world', a purpose which is directed at matters outside the territorial limits of the City". The Court noted that, "No doubt Council can have regard for matters beyond its boundaries in exercising its powers but in so doing any action taken must have as its purpose benefit to the citizens of the City". It is worth noting that a 5 to 4 majority decided this case. The minority, in dissent, was much more supportive of an expansive view of the 'corporate' powers of a municipality and the ability of a council to consider and express community views on broader issues, such as by refusing to do business with those who perpetrate activities the community disapproves of. Under this broader approach, a local government would likely be permitted to exercise its powers with a view to achieving carbon neutrality, including by purchasing carbon offsets.

In light of *Shell*, there remains uncertainty about whether, in the absence of any express statutory power or a regulatory requirement to become carbon neutral, a Court might consider the purchase of carbon offsets generated outside of the local government's community to be outside the scope of a local government's powers. It may be that a Court would conclude that there is local benefit where the purchase is made under an arrangement whereby the local government and the jurisdiction in which the GHG reduction is generated are parties to a mutual GHG reduction arrangement (such as the CAC). In that case, it might be argued that the

purchase of offsets is part of an arrangement aimed at reducing GHG emissions within a common area and therefore locally.

(b) Unlawful Assistance to a Business?

Pursuant to section 25 of the *Community Charter* and section 182 of the *Local Government Act*, municipalities and regional districts are prohibited from providing 'assistance' to a business. Assistance is defined to include various things, including the provision of a 'grant', that is, the provision of money to someone, for nothing of equivalent value in return.

When someone purchases a carbon offset, what do they receive in return? This really depends on the motivation for the purchase. If the person is subject to regulation that requires them to become carbon neutral, with penalties in the event they fail to comply, then an offset may be of value if it assists the person to comply with that requirement.

When a local government is providing money to a business in exchange for an offset, what corresponding benefit does the local government receive? The local government has no present legal need for the offset, as it is under no legal obligation to reduce GHG emissions. As a result, there is some risk that if a local government is acquiring the offset to comply with a purely voluntary emissions target, it may be providing "assistance", in that the payment is essentially a grant or subsidy. For instance, if a municipality pays money to a mill operator in order to purchase the offsets arising from the installation of emission reducing technology at the mill, that payment might be seen as merely subsidizing the installation of such technology. If so, then the municipality may be providing assistance to a business, contrary to the *Community Charter*.

If there is a ready market for carbon offsets, then there may be some value to the purchased offset as an asset or investment. A local government might be able to defend an 'unlawful assistance' argument on the basis that the offset has a value, as there is a market for the offset and the local government can turn around and sell the offset. Over time, the market value of the offset might increase (or decrease) from the price the local government originally pays for the offset. However, to purchase an offset because of its marketability and the potential for gains would appear to be a mere investment of local government funds. Such an investment would not be authorized under section 183 of the Charter (which also applies to regional districts by virtue of section 814 of the LGA).

4. What is in store for the future?

What is also unclear is whether local governments will at some point be subject to regulatory requirements to meet GHG emission targets or become carbon neutral. Such an obligation would provide a clear legal foundation for the purchase of carbon offsets.

In this respect, it should be noted that section 877 of the LGA provides that "An official community plan must include targets for the reduction of greenhouse gas emissions in the area

covered by the plan, and policies and actions of the local government proposed with respect to achieving these targets". Is this requirement a pre-curser to a greater regulatory role for local governments in relation to controlling and regulating local GHG emissions?

IV. OFFSET BUY/SELL AGREEMENTS

The next part of the paper examines some basic issues related to the buying and selling of carbon offsets.

A. Buying Offsets

In considering the purchase of an offset, a key issue will be determining whether the offset is 'valid' for the local government's purposes. The importance of the integrity of the offset and how far a local government is obligated to go in this respect will depend on the local government's reasons for purchasing the offset. As local governments are not currently legally required to be carbon neutral and to acquire offsets approved or authorized under a particular regulatory scheme (such as under the proposed Cap and Trade Act scheme), there is no mandatory level of assurance required in acquiring an offset. That said, even if a local government is purchasing an offset to achieve entirely voluntary goals, it will still have a strong interest in ensuring it acquires valid offsets in order to avoid a waste of public funds.

In this regard, there are inherent risks with purchasing something as vague as an offset. How does one ensure that a purchased offset is reflective of a real emission reduction, from a legitimate project, and that the seller is the owner of the "offset"? Accordingly, a local government acquiring an offset may wish purchase an offset that has been approved under a program similar to that under the Targets Act or the proposed Cap and Trade Act scheme. Obviously, these programs are not a guarantee, however, they can give the purchasing local government a greater level of comfort.

B. Selling Offsets

The following outlines some basic issues and considerations for local governments embarking on projects with a view to selling emission reductions as offsets.

1. Process to Obtain Recognition of Offsets for Sale

The process required to enable the sale of an offset will depend on the legal regime under which the offsets are to be recognized and the sale is to be made. For instance, if the proposed sale will be to the Pacific Carbon Trust, the project will have to meet the requirements of the Emission Offsets Regulation. Under the Cap and Trade Act, the project would have to meet the requirements under that Act and related regulations in order for the local government to receive an ERU, which could then be marketed under that Act. The following is a very general outline of the process currently in place for sales to PCT under the Emission Offsets Regulation.

(a) Project Plan

A project proponent wishing to sell offsets to PCT must prepare a "Project Plan" outlining the nature of the project and describing the "baseline scenario", which is basically an estimate of the GHG emissions that would occur if the project is not carried out. The Plan must also contain various assertions about the project, including as to the estimated emission reductions and that the proponent has a "superior claim of ownership" to those reductions.

(b) Project Plan Validation

The project plan must be submitted for validation by a "validation body". A validation body is a team made up of one person authorized to act as an auditor under section 205 of the *Business Corporations Act* and at least one qualified professional or, alternatively, some other ISO accredited body. The validation body validates the plan, if the plan and its assertions are "fair and reasonable".

(c) Project Report

Following completion of the project, the proponent must prepare a project report, which contains various assertions, including, as to the level of emission reductions and that the project was completed in accordance with the validated project plan. The report must include an assertion that the proponent has a "superior claim of ownership" to the offsets and provide evidence supporting that assertion.

(d) Project Report Verification

The project report must be submitted to a "verification body". These bodies have the same make-up requirements as for a validation body. The verification body is to 'verify' the report if it is satisfied that the assertions in the report are "materially correct", "are a fair and reasonable representation of the project's greenhouse gas reduction" and that there have been no material changes to the project as compared to the validated project plan.

Once a project report is verified, the GHG reduction under the verified report is recognized under the Act as an emission offset, but only if title to the reduction is transferred to the PCT and the reduction has not previously been recognized under the Act or another recognition scheme, or for the purposes of a voluntary or mandatory reduction GHG reduction program.

Meeting the above recognition requirements will represent additional costs to a project. These include the costs of engaging someone knowledgeable in this area to prepare the required reports on behalf of the local government and of engaging qualified professional teams to review, validate and verify these reports.

2. Offset Ownership

In order to sell an offset, the local government will have to be able to prove that it is the rightful owner of the offset. Accordingly, if the local government has engaged other persons in connection with the construction and implementation of the emissions reducing project, the local government should ensure that it has written agreements in place with such organizations evidencing the local government ownership of any GHG reduction benefits, including offset rights. This should be dealt with upfront, in the contracts engaging such persons, so as to avoid the possibility of a later dispute as to ownership.

3. Risk & Liabilities

In any given arrangement, the following factors are likely to have a significant impact on the level of risk associated with entering into an agreement to sell carbon offsets:

(a) the volume of offset sales commitment

(b) the reliability of the emission reduction project in achieving the committed offset level

(c) the offset price

(d) the term of the commitment

The greater the risk, the greater the reward. A local government seeking a greater revenue commitment from an offset purchaser, will likely face a greater level of risk. For instance, a municipality that enters into a longer term arrangement to supply a high volume of offsets from a project may be attracted to the corresponding financial commitment from the buyer. However, the municipality may also have greater liability exposure. For instance, if the project fails to generate the promised offsets, the municipality's liability exposure for its failed commitments to the purchaser will be higher, given the greater commitment level and term. Depending on the terms of the contract, the municipality may have to compensate the purchaser for the purchaser's costs of acquiring the lost offsets elsewhere. If at that time the market price of offsets is considerably higher than the price under the arrangement with the municipality, then the compensation exposure will be greater. This risk will depend in part on the price level negotiated for the local government offset sale agreement, as well as on how the market moves after that price fluctuation. One would expect the market for offsets to be difficult to predict, and to depend to a large extent on the periodic 'cap' levels set by governments that have the effect of creating the demand for offsets. This makes the risk very difficult to gauge.

In this environment, risk averse local governments may wish to avoid longer-term offset commitments and accept a less certain revenue flow.

V. CONCLUSION

Local governments considering transactions to purchase or sell carbon offsets are entering an evolving and uncertain market. The legal regime surrounding the need and ability of local governments to purchase carbon offsets remains less than clear. While there may ultimately be some mandatory requirement for carbon neutrality, the current local government framework remains voluntary, which raises some questions about the extent to which a local government may purchase carbon offsets. At the same time, the potential to sell carbon offsets may be a significant revenue generating opportunity for some local governments. The extent of this opportunity will ultimately depend on the extent to which the Province implements the Cap & Trade Act and to which other governments do the same. This will also depend on the extent to which a local government is able to meet its own emission reduction goals or, perhaps in the future, mandatory reduction requirements.

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