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# Emissions Trading and Climate Change Update

SEPTEMBER 2009

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# Stikeman Elliott's Emissions Trading & Climate Change Practice Group



Recognizing that global climate change presents a complex and rapidly evolving business reality, Stikeman Elliott has established an Emissions Trading & Climate Change practice group that offers clients the multi-disciplinary skill set required to address the myriad of issues arising from this area of law.

The practice group draws from the expertise of some of Canada's leading lawyers in the areas of energy, corporate finance, derivatives and financial products, project finance and the environment. We have advised a variety of cutting-edge domestic and international businesses on the transition towards a carbon-constrained economy.

We work with a diverse range of clients to effectively manage risk, maximize opportunities, enter new markets and jurisdictions and enhance commitments to corporate social responsibility. Our experience includes working with clients on the funding, structuring and construction of "green" projects, carbon emissions trading, navigating environmental and energy regulation, compliance, government relations and the implementation of comprehensive trading platforms.

Further information on the group and a list of contacts are available at [www.stikeman.com](http://www.stikeman.com)

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Stikeman Elliott maintains offices in Toronto, Montréal, Ottawa, Calgary and Vancouver, as well as London, New York and Sydney.

# Canadian implications of U.S. climate change regulation

U.S. House passes *American Clean Energy and Security Act*

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While Canadian market participants are understandably focused on our own emerging climate-change regulatory framework, it is important to keep up to date on U.S. developments and their potential implications for our markets and industries. This short article provides a high-level overview of key features of current U.S. federal legislative initiatives and their possible effects north of the border.

## Key features of ACES

On June 26, 2009, the *American Clean Energy and Security Act* (H.R. 2454, the Bill or ACES) was narrowly passed by the U.S. House of Representatives. The passage of the Bill is the first major step in the U.S. towards the institution of federal climate change and greenhouse gas (GHG) reduction legislation. ACES' key policy objectives are set out in its four main titles:

- 1. Clean Energy.** Establishes a national renewable energy standard and promotes renewable energy, carbon capture and sequestration, and smart grid technology;
- 2. Energy Efficiency.** Increases energy-efficiency standards in household appliances and various industries and public institutions;
- 3. Reducing Global Warming Pollution.** Establishes a nationwide cap-and-trade program to reduce GHG emissions; and

## 4. Transitioning to a Clean Energy Economy.

Supports the transition to a low-carbon, energy-efficient economy for both industry and consumers.

Several features are worth particular mention. The Bill amends the U.S. *Clean Air Act* to bring GHG emissions from regulated sources to 97% of 2005 levels by 2012, 83% by 2020, 58% by 2030, and 17% by 2050. In connection with its framework for a carbon market, it provides for the trading, banking and borrowing, auctioning, holding and retiring of emissions allowances. The Bill also gives the Commodity Futures Trading Commission jurisdiction over the establishment, operations, and oversight of markets for regulated allowance derivatives.

In order to gain the support needed to pass the Bill in the House, several notable amendments were made:

**Credit allocations.** The cap-and-trade proposal in the Obama budget called for 100% of emission allowances to be auctioned. ACES falls well short of that target by initially allowing only 15% of allowances to be auctioned, while the other 85% are to be allocated for free to emitters. Refineries secured a larger allocation than was originally intended under the version of the Bill first introduced in the House. These changes are viewed as a necessary compromise designed to gain the support of congressional representatives of industrial and coal-burning states.

**Agriculture and forestry.** In last-minute negotiations during the drafting of final

amendments to ACES, major concessions were secured by the agriculture and forestry lobby. The final version of the Bill effectively excluded these industries from the definition of “capped sectors,” while leaving responsibility for developing a program for the generation of offsets in these sectors to the United States Department of Agriculture (USDA) rather than the Environmental Protection Agency (EPA). These changes are significant because it was originally intended that all sectors of the economy would be covered by the cap-and-trade regime, and many suspect that the USDA will be more permissive than the EPA in developing an offset program for agriculture and forestry.

### **Senate response to the bill**

Democratic Party leaders had set an end-of-summer deadline for bringing a climate-change bill to the floor for a vote, but because the Senate has been preoccupied with health care and other initiatives, that deadline has now been pushed back. According to a spokesman, Senate Majority Leader Harry Reid “fully expects the Senate to have ample time to consider this comprehensive clean energy and climate legislation before the end of the year.” Passage by the end of 2009 would be symbolically significant, as the United Nations is scheduled to hold a global summit in Copenhagen in December on the topic of the next steps on controlling GHG emissions after Kyoto expires in 2012.

Speculation is rampant as to whether the Democratic Party leadership in the Senate can muster the sixty votes needed to avoid a Republican-backed filibuster. With some moderate Democrats joining many Republicans in opposition to the current bill, Senate Environment and Public Works Committee Chairman Barbara Boxer and Senate Foreign Relations Committee Chairman John Kerry have indicated they need time to

work out mutually acceptable language. Among the concerns expressed by some senators who are considered swing votes is the prospect of price instability as experienced following the implementation of the European Union Emission Trading System. Senator Boxer is considering a price collar on emission allowance prices to provide greater cost certainty. Arkansas Democrat Blanche Lincoln has described ACES as “deeply flawed,” citing its adverse impacts on smaller oil refineries such as those in her state. Ten other Democrats, representing states with significant manufacturing industries, wrote to President Obama to communicate support for inclusion of a “longer-term border adjustment” in climate legislation to ensure that energy-intensive jobs and industries do not leave the U.S. for non-carbon-constrained countries.<sup>1</sup> The fact that many of the undecided senators come from coal and manufacturing states (or from Sunbelt states that would experience the sharpest increases in energy costs under the proposed legislation) is an indication of the difficulties that ACES may be facing.

### **Canadian business under ACES**

Canadian businesses will be affected by a U.S. climate-change regulatory regime, no matter what form it eventually takes. Until the Senate passes its own version of the Bill, the nature of its impact will not be understood with any certainty. However, based on the current form of the Bill, it is clear that Canadian businesses will be forced to consider the following issues:

#### **Trade**

As mentioned above, many senators are insisting that climate-change legislation include a broad carbon tariff that goes beyond ACES’ more limited tariff on “carbon-intensive” goods. A carbon tariff would prevent the occurrence of “carbon leakage” as U.S. industries lose competitiveness to jurisdictions that do not price carbon to the same standard. Similarly, the inclusion of subsidies in ACES to offset the cost increases associated with pricing carbon borne by U.S. companies may distort the dynamic of cross-border competition.

Canadian businesses, many of which are reliant on cross-border trade with the U.S., could stand to win or lose – depending on how the Senate crafts its final version of the Bill and how Canadian authorities choose to respond to its impact on trade.

If the Senate passes a version of ACES that does incorporate tariffs, subsidies or other trade barriers, those barriers would certainly be challenged in an international forum such as the World Trade Organization (WTO), the General Agreement on Tariffs and Trade (GATT) or the North American Free Trade Agreement (NAFTA). However, the U.S. could potentially assert a right to implement a tariff or subsidy through an exception under GATT or NAFTA. For example, pursuant to Article XX of GATT, WTO members are authorized to adopt measures that are (i) necessary to protect human, animal or plant life or health, (ii) relate to the conservation of exhaustible natural resources, or (iii) secure compliance with national law, so long as such measures are made effective in conjunction with restrictions on domestic production or consumption. These exceptions are subject to the requirement that such measures are not applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade. NAFTA also contains similar provisions that can potentially be used to justify a carbon tariff.

A possible response to an import tariff under U.S. federal cap-and-trade legislation by the Canadian government, apart from a WTO/NAFTA challenge in the short term, would be to implement its own equivalent regime to address climate change. In this event, the Canadian government would become the recipient of the tariff revenue (or equivalent) that would otherwise flow to the U.S. government.

## **Oil sands**

Canada has the second-largest proven oil reserves in the world. Many view the viability of the Alberta oil sands as a major determinant of overall Canadian prosperity. However, the extraction and refining of tar sands is an energy-intensive process that produces substantial amounts of GHGs, and any attempt to curb GHG production will inevitably have a dampening effect on the overall economic activity in the oil sands and Alberta as a whole.

Earlier versions of ACES threatened Alberta oil directly, reflecting sentiments expressed publicly by President Obama that the U.S. would seek to avoid fuels with large associated environmental impacts. Early drafts of ACES provided for a low-carbon fuel standard, similar to that created by Governor Schwarzenegger in California, requiring that annual average lifecycle GHG emissions from transportation fuel not exceed the annual average lifecycle GHG emissions from transportation fuel in 2005. While this proposal would have significantly reduced the viability of Alberta oil as a marketable fuel source in the U.S., it has since been dropped – although a less-targeted carbon tariff on Alberta oil could still emerge in the Senate bill.

## **Agriculture and forestry**

As GHG emissions in the U.S. agriculture and forestry sectors would not be regulated under ACES, there is obviously no significant concern that trade barriers would be erected by the U.S. to compensate for an ACES-related reduction in U.S. competitiveness. It also seems likely that any cap-and-trade regime instituted in Canada would follow the U.S. lead by not regulating these sectors. However, in the event that Canadian officials were to implement a cap-and-trade or other GHG reduction regime that *did* include agriculture and forestry, concerns over competitiveness would be felt domestically. This could lead Canada to impose its own version of an import tariff designed to prevent carbon leakage from Canada to the U.S. Such a move would undoubtedly subject Canada to attack through the WTO, NAFTA etc., as

discussed above, and could create grounds for the imposition of countervailing measures by Canada's trading partners. Canada's regulatory approach on this matter will therefore be critical to the prospects of the domestic agricultural and forestry sectors.

### **International offsets**

ACES would permit capped entities to hold an international emission allowance in lieu of a domestic emission allowance, subject to certain conditions. Were Canada to create a cap-and-trade regime, therefore, Canadian entities would be able to sell or transfer their unused allowances to U.S. entities, including their U.S. subsidiaries and parents. The transferability of allowances provided for in ACES would make Canada/U.S. carbon regulation a cross-border exercise.

The Senate version of the Bill currently provides for the differential treatment of international offsets as compared to offsets generated within the U.S. Each entity subject to an emissions cap may satisfy a percentage of the number of allowances required to be held by holding 1 domestic offset credit or 1.25 international offset credits in lieu of an emission allowance. This differential treatment takes effect in 2018. Until then, domestic and international offsets will be accepted at par.

Whether this is a step to protect the integrity of the cap-and-trade regime from non-compliant offsets or whether it is designed to protect and foster a domestic offset project market in the U.S. is not clear. In either case it is a key regulation that will materially affect the growth of the Canadian offset market. All else being equal, if passed by the Senate such a provision will make it likely that only short-term Canadian projects (i.e. five years or less) that can take advantage of the at-par treatment between 2012 and 2017 will be competitive with U.S. projects, if the offsets generated by them are to be marketed in the U.S.

### **Conclusion**

What should be apparent from the foregoing is that the climate change initiatives in the U.S. need to be carefully followed by the Canadian marketplace, as it is highly likely that U.S. legislation would have significant consequences for Canada.

Stikeman Elliott's Emissions Trading and Climate Change Group is watching the progress of the debate in the U.S. Senate closely in order to help our clients respond effectively to U.S. developments wherever it is advisable to do so.

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<sup>1</sup> Sens. Sherrod Brown (D-OH), Debbie Stabenow (D-MI), Russ Feingold (D-WI), Carl Levin (D-MI), Evan Bayh (D-IN), Bob Casey (D-PA), Robert Byrd (D-WV), Arlen Specter (D-PA), John Rockefeller (D-WV), and Al Franken (D-MN).

# On the road to Copenhagen, Canadian companies should stop to consider the impact of legislation requiring GHG-emissions reporting

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Focus continues to intensify on this December's climate change talks in Copenhagen. Regardless of what may transpire by year's end, climate-change considerations will remain a hot-button issue and will garner long-term political, legal and media attention. Towards Copenhagen and beyond, it seems safe to say that Canadian companies will continue to be faced with new legislative requirements enacted to address climate change issues. As an example, many Canadian companies are, or soon will be, required to report greenhouse-gas (GHG) emissions.

Against this backdrop, Canadian companies should consider whether they are adequately preparing themselves to report GHG emissions and/or to comply with other foreseeable climate change obligations. Additionally, Canadian reporting issuers should address whether they are giving adequate disclosure to investors about environmental matters that may have a material impact on them.

## **Canadian industrial emitters face deadline for emissions reporting**

The Department of the Environment has given notice that Canadian industrial emitters of GHGs have until June 1, 2010 to report their 2009 GHG emissions. The reporting deadline, which was established by Environment Canada, applies to facilities that emit over 50,000 tons of carbon dioxide

equivalent (CO<sub>2</sub>e) per year. Environment Minister Jim Prentice has indicated that more detailed regulations will be released prior to the Copenhagen talks.

## **The Western Climate Initiative releases essential requirements of mandatory reporting**

The partners of the Western Climate Initiative (WCI) are comprised of seven U.S. states and four Canadian provinces, namely British Columbia (B.C.), Manitoba, Ontario and Quebec. Other U.S. states and Canadian provinces (Saskatchewan and Nova Scotia) are currently WCI observers.

The WCI has recently released its final version of the first group of Essential Requirements for Mandatory Reporting (ERMR). The ERMR requires owners and operators that are subject to the mandatory reporting requirements to submit annual GHG emission reports by April 1 of each year for emissions in the previous calendar year. The initial reporting requirements will apply to the owner or operator of a facility that emits 10,000 metric tons of CO<sub>2</sub>e or more per year in combined emissions, from one or more of the listed source categories, in any calendar year starting in 2010. Accordingly, companies subject to the ERMR that commenced operations prior to

2010 will be required to report their 2010 GHG emissions by April 1, 2011.

Subsequent to the year 2010, the ERMR contemplates that the reporting requirements will also apply to: (1) all importers of electricity (both retail providers and marketers) that import electricity into the WCI region, (2) any supplier that within the WCI region distributes transportation fuels in quantities that when combusted would emit 10,000 metric tons of CO<sub>2e</sub> per year or more, in any calendar year starting in 2010, and (3) any supplier that distributes within the WCI region residential, commercial and industrial fuels in quantities that when combusted would emit 10,000 metric tons of CO<sub>2e</sub> per year or more, in any calendar year starting in 2010.

### **The impact of the ERMR regime**

In order to comply with the WCI-imposed obligations, the B.C., Manitoba, Ontario and Quebec provincial governments are each moving forward with legislation designed to implement the ERMR regime. For example, the B.C. government has announced its intention to introduce a mandatory GHG-emissions reporting regulation during the fall of 2009. The Ontario government has recently stated that its intention is to harmonize Ontario reporting requirements with those of the WCI (as well as with any U.S. federal trading system). Quebec has passed Bill 42 (*An Act to amend the Environment Quality Act and other legislative provisions in relation to climate change*), which establishes the reporting of GHG emissions by certain categories of emitters to be determined by regulation.

It should be noted that other Canadian provinces have also moved towards the adoption of legislation that will require companies to report GHG emissions. For example, in 2004, Alberta passed the *Specified Gas Reporting Regulation*, which continues to require industrial facilities that emit more than 100,000 tons of CO<sub>2e</sub> in a calendar year to submit annual emission

reports. Additionally, on August 14, 2009, the government of Nova Scotia released the *Greenhouse Gas Emission and Air Pollutant Regulation*. This regulation requires facilities located in Nova Scotia that emit more than 10,000 metric tons of CO<sub>2e</sub> in a calendar year to submit annual emission reports.

### **Measuring and reporting GHG emissions is a labour-intensive process**

In order to comply with the various provincial and/or federal legislation that may apply to them, companies will need to determine whether or not they emit the quantity of GHGs that triggers the various legislative reporting requirements. In order to do so, companies will need to measure their GHG emissions in accordance with the prescribed methods set out in the various legislation applicable to them. Measuring GHG emissions will be labour-intensive and will require that a detailed and mapped-out process be followed. Additionally, while governments have generally recognized the importance of standardized measuring methods (so as to help ensure the fair operation of multi-jurisdictional carbon cap-and-trade programs), there is no certainty that all legislation will contain common measuring techniques.

In the event a company is subject to GHG reporting requirements, the applicable legislation will also set out other obligations that the company will need to spend time considering. Typically, these obligations will include monitoring, record-keeping and retention requirements, as well as data-verification requirements. It can also be expected that GHG legislation will increasingly require emitters to reduce their GHG emissions towards established targets and/or to cover their GHG emissions with prescribed emission allowances, units or credits.

## Canadian reporting issuers and the impact of climate change

As was stated by the Canadian Institute of Chartered Accountants (CICA) in a Management's Discussion and Analysis (MD&A) disclosure guide published in November 2008 (the Guide), investors are increasingly seeking more detailed and nuanced information about how reporting issuers view the impact of climate change, in order to assess its effect on a company's current and future financial conditions, results of operations and cash flows. The CICA noted that the business impact of climate change will require reporting issuers – even those that do not directly produce GHG – to implement strategies, both to adapt to the effects of climate change on the reporting issuer's business and, in other cases, to take action to mitigate the extent of their GHG emissions. The CICA Guide outlines five types of information in MD&A that should address climate-change issues:

**Business strategy.** MD&A should present investors with an overview of the climate-change factors that the reporting issuer has factored into its business strategy.

**Risks.** MD&A should describe the risks presented by climate change on the reporting issuer, including physical risks (e.g. changes to weather patterns), regulatory risks (e.g. heightened regulatory oversight and scrutiny), reputational risks (e.g. negative customer perceptions of reporting issuers failing to address climate-change issues), litigation risks (e.g. lawsuits against heavy GHG emitters) and any other material risks.

**GHG emissions.** To the extent that it is material to evaluating the performance and future prospects of a reporting issuer, a reporting issuer's direct and indirect GHG emissions and related intensity data should be discussed in MD&A.

**Financial impacts.** The impact of climate change on financial operations, cash flows and the financial condition of the reporting

issuer should be discussed in MD&A, along with the future financial implications.

**Governance processes.** MD&A should describe the governance and organizational processes used by the reporting issuer in identifying and managing climate-change issues.

While Canadian securities regulators have not yet specifically mandated the disclosure of climate-change strategies in a reporting issuer's public disclosure record, the requirements of National Instrument 51-102 *Continuous Disclosure Obligations* (NI 51-102), including the requirements applicable to a reporting issuer's MD&A, are sufficiently broad so as to capture such issues.

A reporting issuer's MD&A, for example, is required to discuss the effect of "known trends, demands, commitments, events or uncertainties" on the reporting issuer's "financial condition, results of operations and cash flows." Moreover, a reporting issuer's annual information form (AIF) is required to disclose such things as the "financial and operational effects of environmental protection requirements" on its financial position, including capital expenditures. An AIF is also required to detail risk factors, such as environmental risks, and "regulatory constraints...and any other matter that would be most likely to influence an investor's decision to purchase" the securities of the reporting issuer. As climate-change concerns continue to escalate and, as a result, increasingly stringent legislation is enacted, regulatory authorities may in the future require Canadian reporting issuers to provide more prominent and expansive disclosure with respect to the impact that climate change will have on their business.

In February 2008, the Ontario Securities Commission (OSC) issued Staff Notice 51-716 - *Environmental Reporting*, outlining the results of a targeted review by OSC staff of the degree to which Canadian reporting issuers were adequately disclosing information about so-called "environmental

matters" in their annual financial statements, MD&A and AIFs. The OSC's written findings suggest that, at the time, the disclosure of certain Canadian reporting issuers with respect to potentially material environmental matters was inadequate and, in certain instances, consisted of insufficient, boilerplate disclosure.

Staff Notice 51-716 should continue to serve as a signal to Canadian reporting issuers

that, regardless of whether or not they are subject to specific GHG-emission or other environmental reporting requirements, it is necessary for them to seriously consider the effect of environmental matters and climate change on their business and to ensure that such matters are adequately disclosed to investors.

# The EU Emissions Trading Scheme and the UK *Climate Change Act*: a UK Perspective

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The European Union Emissions Trading Scheme (EU ETS), the largest emissions cap-and-trade scheme in the world, commenced on January 1, 2005. In addition, the United Kingdom's *Climate Change Act 2008* has established the world's first legally binding emissions-reduction target, which requires at least an 80% reduction on 1990 emissions levels in the United Kingdom by 2050. The following article gives a brief overview of the EU ETS and of some of the steps being taken to reach the 80% reduction target under the *Climate Change Act 2008*.

The EU ETS, entered into under the provisions of the European Union (EU) Emissions Trading Directive, represents one of the steps taken by the EU to meet its greenhouse-gas-emissions reduction target under the Kyoto Protocol. In accordance with the Kyoto Protocol, the EU is aiming to attain an 8% reduction on 1990 emissions levels during the Protocol's first "commitment period" (2008-2012), while the UK itself is seeking to achieve a 12.5% reduction in that period. The EU ETS is being rolled out in phases, the first of which ran from 2005 to 2007 and the second of which is running from 2008 until 2012. In preparation for the third phase, commencing in 2013, the EU is reviewing the Emissions Trading Directive.

In connection with the 80% reduction target under the *Climate Change Act 2008*, the United Kingdom government intends to publish, with the advice of the Committee on

Climate Change, a series of five-year "carbon budgets," the first of which covers the first Kyoto Protocol "commitment period" (2008-2012). The government has also produced the UK Low Carbon Transition Plan, describing how the United Kingdom will meet the cut in emissions set out in the budget, which requires a reduction of 34% on 1990 levels by 2020. A key objective of the United Kingdom's low-carbon industrial strategy is to try to ensure that British businesses and workers are equipped to maximise the economic opportunities and minimise the costs involved in moving to a low-carbon economy.

Currently, the EU ETS applies to four areas of industrial activity: energy activities (including, in particular, electricity generation); production and processing of ferrous metals; mineral industries; and pulp-and-paper industries. It is currently expected that aviation will be added to the list beginning in 2012. UK law requires all installations carrying out any of the above activities to hold a Greenhouse Gas Emissions Permit and to monitor and report emissions.

EU Member State governments are required to set emissions limits for all installations in their country covered by the scheme, and each installation is then allocated allowances equal to that cap for the phase in question. Under the current UK National Allocation Plan, the Government allocated most of the emissions allowances among the installations affected by the scheme

without charge, but 7% of the allowances – which would in the main have gone to large electricity producers - were auctioned. It is currently expected that the percentage of total emissions allowances to be auctioned will increase over time. Allowances in the EU ETS are held in electronically registered accounts , overseen by a central EU administrator.

As with other cap-and-trade schemes, the broad objective of the EU ETS is to provide an incentive-based system that will trigger investment in future energy efficiency and

cleaner technology. Under the scheme, installations can meet their cap either by reducing their emissions below the cap - in which case, they are then free to sell any surplus – or, to the extent their emissions exceed their cap, by buying emissions allowances from others (including certain carbon credits derived from certain international climate-change projects) to cover the difference. As a result, a secondary market in allowances has developed.

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For further information regarding any of the above articles, please contact your Stikeman Elliott representative, any author listed above or any member of our Emissions Trading and Climate Change Group listed at [www.stikeman.com](http://www.stikeman.com)

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