Case Commentaries

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Canada opens initial consultations on new carbon pricing mechanism

On 5 August 2021, the Government of Canada announced its launch of an initial exploratory phase of consultations on border carbon adjustments ('BCAs'), along with the release of a discussion paper. These exploratory consultations will involve discussions with the provinces and territories, industry associations representing those sectors most impacted, as well as labour and environmental organisations and academics with expertise on BCAs. The broader Canadian public will be consulted through a second phase of consultation in the fall.

BCAs as a mechanism to combat carbon leakage and competitiveness

As Canada and other countries legislate and take actions to reduce their greenhouse gas emissions, among the policy tools they may use are mechanisms to price carbon pollution and impose these costs on emissions-intensive industries. BCAs are intended to level the playing field between domestic producers and foreign importers from countries with less robust policies that may not impose similar carbon costs on the private sector.

BCAs are most relevant for products that are at high risk of carbon leakage and competitiveness, namely those made by emissions-intensive and trade-exposed ('EITE') sectors including, for example, oil and gas, motor vehicle and parts, mining, smelting and chemical products.

BCAs may take different forms. The Canadian consultation focuses on two possible mechanisms:

- Import charges applied to goods from other countries with either lower or no carbon pricing which are comparable to the carbon costs that must be absorbed in the price of domestic goods.
- Export rebates provided to domestic producers so that their goods can be priced to better enable competition with goods from countries in foreign markets with limited or no carbon pricing policies.

The objectives of BCAs

The government refers to four primary interrelated objectives of BCAs.

1. Reducing the risk of carbon leakage

Carbon leakage occurs when production of goods is moved from countries that impose carbon costs on others with lower or no carbon costs. When entities face carbon costs, and they are unable to fully reflect them in their prices due to competition, profitability suffers. If production is moved elsewhere to avoid carbon costs, global emissions are not reduced, but merely 'leak' to the new location. If carbon costs are compensated through price adjustments applied to imports and exports, there would be less incentive to relocate production.

2. Maintaining the competitiveness of domestic industry

Where carbon pricing is imposed, BCAs may help maintain competitiveness of domestically produced goods through the application of comparable charges on similar imported products. This could be coupled with export rebates for domestic producers so that their products can be competitively priced in foreign markets.

3. Supporting greater domestic climate ambition

BCAs may level the playing field between imported and domestic goods and increase the effectiveness of climate policies by encouraging production to stay in countries (such as Canada) with regulations that promote the reduction of emissions.

4. Promoting international climate action

BCAs may encourage other countries to introduce stronger climate change policies and mechanisms with a view to avoiding exposing their exports to BCAs in foreign markets.

Relevant considerations regarding BCAs in Canada

In *References re Greenhouse Gas Pollution Pricing Act*, the Supreme Court of Canada's decision on the constitutionality of the Greenhouse Gas Pollution Pricing Act held that climate change is a threat to human life that necessitates collaborative global efforts to mitigate: 'no one province, territory or country can address the issue of climate change on its own. Addressing climate change requires collective national and international action'. The decision helps strengthen the legal and social policy foundation of any proposed BCA.

Environmental considerations

BCAs could support both domestic and international climate change policies. For example, countries might be motivated to take new or more ambitious measures to avoid a lack of competitiveness for their products. However, BCAs and other climate mechanisms may disproportionately affect emerging economies such that their respective decarbonisation efforts are impinged. Further, if a BCA results in raw materials becoming increasingly cumbersome to import, manufacturing may shift overseas thereby resulting in carbon leakage. Similarly, it is important to consider the potential for BCAs to cause new carbon leakage risks for downstream sectors.

Economic considerations

Applying BCAs in the form of import charges on foreign goods could result in an increase in the costs of similar goods produced in Canada. This is because domestic producers would be in a better position to pass through carbon costs on domestic goods to consumers and downstream manufacturers (that is, producers can increase prices while remaining competitive with foreign products). For some products, there is limited or no choice in terms of its country of export, meaning that the costs could still ultimately be borne by end consumers or Canadian-based industries that rely on imports.

International trade considerations

An effective border adjustment is a substantial undertaking, especially considering the complexity of most supply chains. Canada must ensure that any BCA measures applied to traded products are consistent with Canada's international trade obligations in the World Trade Organization (WTO) and its free trade agreements. For example, Canada must avoid measures that discriminate between domestic and foreign like products, as well as between like products from different countries. Identifying appropriate carbon pricing methodologies will be critical in this respect. Moreover, Canada must collaborate with key trading partners and like-minded countries to align proposed approaches to BCAs, assess risks to current trade relations and international trade law obligations, and discuss possible exemptions or flexibility for imports from certain developing countries.

Scope, design and administration considerations

A number of considerations arise in designing and selecting appropriate BCA measures, including which emissions and products will be subject to BCAs, whether BCAs will include both import charges and export rebates, as well as the basis for excluding countries from the application of BCAs. If pricing is not set at an appropriate level, BCAs may have the opposite effect to what they are meant to achieve. This underscores the importance of a careful scoping, assessment and verification process.

If BCAs are to address carbon leakage and competitiveness between domestic and imported products, it will be necessary to determine, among other things, how to establish carbon costs for imported goods, how to account for other countries' non-pricing climate measures, how to measure the impact of carbon cost savings on the pricing of imports, the legal framework and rules to be applied in establishing the calculation of quantum of import charges and whether there should be flexibility to apply different rates to different regions or sectors. Considerations related to the administration and enforcement of BCAs, along with reporting and verification requirements, will also need to be addressed.

Takeaways

There is an increasing global focus on BCAs amongst countries seeking to make meaningful climate contributions. Discussions are taking place in international organisations, including the WTO, where members are considering how to address carbon leakage and how to design BCAs that are consistent with their international trade obligations.

The European Union ('the EU') is amongst the most advanced in its BCA plans. In December 2019, the EU released the European Green Deal setting forth its plans to achieve net zero emissions. It followed with the release on 14 July 2021, of a proposed carbon border adjustment mechanism (CBAM) for certain industry sectors. CBAM acts as an extension of the EU's Emissions Trading System, with its phase-in expected to be coordinated with the phase-out of the current allocation of allowances to address the risk of carbon leakage due to carbon pricing.

Canada and the EU committed to work together on carbon pricing and WTO-compatible BCAs at the Canada-European Union Summit held in June 2021. Similar engagements are expected with the United States, the United Kingdom, Japan and Canada's other major EITE trade partners. Not all countries are in favour of BCAs, however. Australia and China, for example, have expressed apprehension about CBAM. They see it as a vehicle for protectionism and as undermining economic development.

Virtually all Canadian businesses will be impacted by the potential adoption of a BCA. Organisations should carefully assess such potential impacts and, to the extent possible, participate in the consultation process to inform the scope and design of the BCA.[1]

1 The Bennett Jones team has experience in all aspects of climate change, emissions trading and Canada's international trade obligations. This includes developing strategies for capitalising on the impending low-carbon economy and navigating the legal framework of similar import-based trade remedies. If you have any questions about the potential impact of BCAs and the Canadian consultation process on your business, contact one of the authors of this article or a member of the firm's ESG, Climate Change and Emissions Trading, Energy and International Trade & Investment groups.