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The Clean Fuel Regulation

WHO NEEDS IT?

Why Canada should reject a redundant and costly regulatory regime

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TRUE NORTH IN CANADIAN PUBLIC POLICY

TRUE NORTH IN CANADIAN PUBLIC POLICY


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Executive Summary

In December 2020, Environment and Climate Change Canada released a draft of the Clean Fuel Regulation (CFR).

The CFR is a regulatory regime that requires conventional liquid hydrocarbon fuels to be substituted with various alternatives in order to reduce the level of carbon emissions attributable to those hydrocarbons. For example, producers would be forced to add biodiesel, ethanol, or other renewable products to their fuels.

The CFR is intended to complement the federal carbon tax regime, which has been implemented to meet Canada's greenhouse gas reduction commitments under the Paris Agreement. But is the CFR needed at all given that carbon pricing is a superior way to meet the needs of decarbonization?

By its own design, the CFR imposes a *de facto* carbon price of $350/tonne for those who cannot achieve the required carbon intensity reductions compared to the $170/tonne benchmark for a carbon tax. However, there is no justification for emissions from certain liquid fuels to be taxed at a higher rate than other forms of emissions.

The CFR is unnecessary to achieve its stated goals. If biofuel development cannot occur in Canada within the context of a broader carbon pricing regime, then there is no case for providing it with a special mandate. And if biofuel can be produced at a lower cost than the carbon tax, then it will be done regardless since businesses will find it profitable to avoid the carbon tax.

The government states that small businesses will not be affected by the CFR since they would not need to comply with the policy. This is a surprising statement since heating and transportation costs will undoubtedly rise. Non-household (industry, commercial, and freight) demand for fuels is three-fifths of total fuel demand. While fuel producers will pass on their costs, the business sector will bear a significant share of those CFR costs.

The CFR will also increase transportation and heating costs among households, which will fall heaviest on the poor. In contrast, the carbon tax rebates help shield lower-income households from higher energy prices. The CFR provides no such relief. If anything, the government will lose fuel and carbon tax revenue with the imposition of the CFR while the primary gains will accrue to producers of biofuel and renewable energy who will benefit from the higher prices that households and businesses will pay.

> *A national carbon tax should be the government's primary economic instrument for mitigating greenhouse gas emissions.*

A national carbon tax should be the government's primary economic instrument for mitigating greenhouse gas emissions. No other policy offers more transparency with lower administrative costs or more reliance on market forces, all while achieving reduced consumption and creating the economic incentives for technological alternatives.

The federal government is proposing to make an enormous $20 billion economic bet based on what it calls the plausible outcome that the proposed, highly complex regulatory process of the CFR will achieve its objective. What is more plausible is that the CFR will materially increase costs for Canadians, result in unnecessary administrative expense, add enormously complex regulatory burdens that penalize Canadian competitiveness, and may be more costly than simply increasing the carbon tax as needed.

The CFR should be entirely scrapped.

Sommaire

En décembre 2020, Environnement et Changement climatique Canada a publié un projet de règlement sur les combustibles propres (RCP).

Le RCP est un régime de réglementation qui exige le remplacement des hydrocarbures liquides conventionnels par diverses solutions visant à réduire les émissions de carbone associées à ces composés. Ainsi, les producteurs devront notamment ajouter du biodiesel, de l'éthanol ou d'autres produits renouvelables dans leurs combustibles.

Le RCP a pour but de compléter le régime fédéral de taxe sur le carbone, qui a été mis en œuvre pour respecter les engagements canadiens de réduction des gaz à effet de serre pris en vertu de l'Accord de Paris. Or, comme la tarification du carbone peut mieux répondre aux besoins de décarbonisation, le RCP est-il une réelle nécessité?

Le RCP est conçu de manière à imposer, de fait, un prix du carbone de 350 $ la tonne, en comparaison avec les 170 $ exigés pour la taxe carbone, à ceux qui ne pourront pas réduire leur intensité carbonique tel que requis. Toutefois, rien ne justifie une taxation plus élevée pour les émissions de certains combustibles liquides que pour d'autres formes d'émissions.

Le RCP n'est pas nécessaire pour atteindre les objectifs qu'il fixe. S'il est impossible d'accroître les biocarburants dans le contexte d'un régime étendu de tarification du carbone au Canada, il n'y a pas lieu de leur donner un mandat spécial. De plus, si les biocarburants peuvent être produits à un coût inférieur à celui obtenu avec la taxe carbone, alors ils le seront de toute manière, puisque les entreprises trouveront rentable d'éviter la taxe carbone.

Le gouvernement affirme que les petites entreprises ne seront pas touchées

par le RCP puisqu'elles n'auront pas à se conformer à la politique. Il s'agit là d'une affirmation étonnante puisque, à n'en pas douter, les coûts de chauffage et de transport augmenteront. Le secteur non domestique (industrie, commerce et fret) explique les trois cinquièmes de la demande totale de combustibles. Les producteurs de combustibles refileront les frais aux entreprises, lesquelles devront absorber une partie importante des coûts du RCP.

Le RCP fera également augmenter les coûts de transport et de chauffage des ménages. Ces coûts pèseront plus lourdement sur les plus pauvres, alors que les remboursements de la taxe carbone, au contraire, contribuent à protéger les ménages à faible revenu des hausses de prix, allègement qui n'est pas offert par le RCP. Tout compte fait, le RCP privera le gouvernement de recettes en taxes sur les combustibles et le carbone. Ce sont les producteurs de biocarburants et d'énergie renouvelable qui tireront le plus de profit de ce Règlement par le biais des prix accrus payés par les ménages et les entreprises.

> *Le RCP n'est pas nécessaire pour atteindre les objectifs qu'il fixe.*

Le gouvernement devrait faire de la taxe carbone nationale son principal instrument économique pour réduire les émissions de gaz à effet de serre. Aucune autre politique n'apporte plus de transparence en offrant des coûts administratifs aussi avantageux ou autant de latitude aux forces concurrentielles du marché. Tout cela en permettant de réduire la consommation et de créer des incitatifs économiques pour des solutions de rechange technologiques.

Le gouvernement fédéral propose un énorme pari économique de 20 milliards de dollars sur la base des résultats dits « plausibles » qu'obtiendrait le processus réglementaire hautement complexe du RCP qu'il projette en vue de réaliser ses objectifs. Ce qui est plus plausible, c'est que, concrètement, le RCP augmentera considérablement les coûts pour les Canadiens, entraînera des dépenses administratives inutiles et imposera des fardeaux réglementaires d'une immense complexité, qui nuiront à la compétitivité canadienne. En somme, le RCP sera vraisemblablement plus onéreux que de simples hausses de la taxe carbone imposées en fonction du niveau des besoins.

Le RCP doit être rejeté en bloc.

Introduction

In December 2020, Environment and Climate Change Canada (ECCC) released a proposed draft of the Clean Fuel Regulation (CFR) regulations along with a Regulatory Impact Analysis Statement (Canada 2020a). The CFR is intended to complement the federal carbon tax regime, which has been implemented to meet Canada's greenhouse gas reduction commitments under the Paris Agreement. The CFR has been the subject of ongoing consultations and is open for public comment until March 3, 2021. Under the proposed regulations, the mandatory reductions would take effect in December 2022.

In this paper, we return to first principles and raise the critical question as to whether the CFR is needed at all given that carbon pricing is a superior way to meet the needs of decarbonization. We begin with an explanation of the CFR then argue that implementing the regulations is a costly and unnecessary duplication of the carbon pricing that is already in place and which is scheduled to increase the cost of carbon to $170 per tonne by 2030.

What is the Clean Fuel Regulation?

The CFR is a regulatory regime that requires that conventional liquid hydrocarbon fuels be substituted with various alternatives in order to reduce the level of carbon emissions attributable to those hydrocarbons.

The CFR is designed on an intensity basis (i.e., on emissions per unit of fuel consumed). Entities subject to it must reduce the carbon intensity of the liquid fuels that they produce or import – not emissions directly. For example, producers would be forced to pay the economic cost of reducing carbon content by introducing biodiesel, ethanol, or other renewable products in their fuels. In theory, elevated fuel prices would encourage consumers to substitute energy-intensive products with other alternatives. Producers can comply with the regulations by buying carbon credits at $350 per tonne or by investing in technologies that reduce carbon emissions.

Specifically, government notes that the proposed regulations, which include 170 sections and 19 schedules, are intended:

> to be a flexible, performance-based policy tool that reduces the CI [carbon intensity] of liquid fossil fuels supplied in Canada. Therefore, the proposed Regulations incorporate, but also improve upon the federal RFR [*Renewable Fuels Regulations*]. The proposed Regulations would also be complementary to carbon pricing as they would provide an additional incentive to reduce GHG [greenhouse gas] emissions by reducing the CI of liquid fuels, which are primarily used in the transportation sector, a major source of GHG emissions in Canada. (Canada 2020a, 4000-4001)

In its base case, the government predicts the CFR will reduce GHG emissions by 221 Mt between 2021 and 2040, costing $20.6 billion or $94 per tonne (the marginal cost of compliance credits will be $350 per tonne) (ibid., 3869-3870).

If ECCC's cost-benefit analysis calculations are correct, then the costs of compliance would be lower than the estimated current "social cost of carbon" (which ranges from $135 to $440 per tonne (ibid., 3914)) and would therefore yield a net benefit. However, these projections only allow ECCC to conclude that "it is plausible" that the monetized benefits of the proposed regulations would exceed their costs (ibid., 3870). The models, reflective of the economy in 2016, could incorporate a different characterization of endogenous growth, trade and capital flows, and trade for a small open economy, yielding much higher costs. Nonetheless, in the face of these material concerns, our argument below is not based on the predicted carbon costs but on the well-known principles of reducing emissions at the lowest cost possible.

If the pre-eminent objective of Canadian national climate policy is to achieve some prescribed level of carbon emission reductions, any regulatory regime that mandates reduced hydrocarbon consumption, whether directly or indirectly, would serve that objective. To date, the Trudeau government has dictated as an imperative that Canada should meet its commitments under the Paris Agreement. In that context, the CFR is a potential policy instrument. In reality, the question is whether the CFR can be justified as the most efficient policy.

The superiority of the carbon tax

Without debating the merits of Canada's decision to continue to define its national climate policy in terms of meeting its Paris targets, surely the only real policy question left to answer is what is the most efficient policy instrument to meet that goal? Environment and Climate Change Canada's regulatory impact analysis statement (Canada 2020 a) provides no analysis of other options that could achieve an equivalent reduction in emissions. Obviously, a key option to consider is whether it is more efficient to invoke the CFR or simply to increase the price of carbon. Assuming that the two policies achieve the same level of emission reduction, which one would have the lowest economic, administrative, and compliance costs? Here we argue in favour of a transparent, uniform national carbon tax, full stop.

A national carbon tax should be the government's primary economic incentive to achieve its desired policy outcomes. No other policy offers more transparency with lower administrative costs or more reliance on market forces, all while achieving reduced consumption and creating the economic incentives for technological alternatives. All emissions would be taxed at the same rate, reflecting the reality that all emissions have the same potential impact on global temperature. There would be no discrimination as to the source of the emission. In other words, the uniform tax would achieve accountability, efficiency, and fairness.

Specific levels of carbon tax would be determined over time by the federal government. While this process is ultimately political, the end result would produce a tradeoff between the desired emissions reductions and the national economy's capacity to absorb the attendant cost of such reductions. However, once defined, the process would determine the cost of carbon that the emitter could internalize, or avoid.

> *We argue in favour of a transparent, uniform national carbon tax, full stop.*

Ironically, there is presently a material though as yet undefined backdrop to the implementation of the Clean Fuel Regulation. The 2018 *Greenhouse Gas Pollution Pricing Act* (GGPPA) proposes charges for a broad range of fuels through an output-based performance system that would set payments for industrial facilities that exceed certain standards for national carbon pricing. It also proposes to impose the federal system on provinces that do not have equivalent legislation. It has been a central pillar of the federal Liberals' climate change agenda as, under the Paris Agreement, Canada has committed to reducing its GHG emissions by 30 percent below 2005 levels by 2030. More recently, the Government of Canada announced an intention to achieve net-zero emissions by 2050 (Canada 2020b).

However, the legislation is currently being challenged. Following hearings on the question of a national carbon tax, in September 2020 the Supreme Court of Canada adjourned without coming to a decision. The hearings combined three separate appeals all related to the constitutionality of the *Greenhouse Gas Pollution Pricing Act* and followed two 2019 appeal court rulings in Saskatchewan and Ontario, which held the federal carbon tax legislation to be constitutional, and a subsequent contrary decision in February 2020 by the Alberta Court of Appeal. Some legal experts have opined that the Supreme Court decision will be as nuanced as it is complex since it is unclear whether a carbon tax regime can be imposed federally, as the GGPPA seeks to do. After all, doing so could constitute an undue infringement on the provinces' jurisdiction over non-renewable natural resource development (Steyn 2020).

Assuming that the Supreme Court upholds the GGPPA one could assume that Canada will be in position to legislate a transparent and uniform tax on all national carbon emissions, sanctioned as to stringency by the political process, that leaves no place for any incremental regulatory regime to be selectively levied against specific sectors of the economy. Indeed, we argue that any other action would constitute an affront to economic efficiency and basic fairness. In sum, unlike a national carbon tax, a complimentary policy like the CFR would be neither efficient nor fair.

We further argue that once a national carbon tax rate is set, there is little need to impose any other regulatory interventions. In the case that a given carbon tax level is insufficient to realize some required level of carbon emission reductions, then emissions might increase. Further, if other considerations become more significant – such as the affordability of climate risk mitigation – then the costs of increased, or decreased, carbon taxes could be mitigated or deferred. However, the severity of the carbon tax would be validated by an explicit and transparent political process. Taxation policies for carbon would be based on stringency, not on the regulatory instruments available. In short, if the government were to rely on a uniform, national carbon tax, doing so would enable the economy to react to the tax's required stringency through market mechanisms that deploy a minimum of bureaucratic control, obscurity, and other rigid, long-term regulatory constraints.

Importantly, in mid-December 2020, the Trudeau government clarified its Canadian climate policy in *Healthy Economy Healthy Environment* (Environment and Climate Change Canada 2020). The document apparently intended to indicate how Canada could achieve its Paris carbon emission reduction targets. Although many legitimate issues about these policies persist, particularly related to Canadian competitiveness and the proportionality of the cost of emission abatement, it was heartening to learn from *Healthy Economy Healthy Environment* that the Trudeau government potentially recognized that its pre-eminent policy instrument was a reliance on carbon taxes of $170/tonne by 2030.

However, the federal government has continued to include a truncated version of the CFR in its policy, apparently as a vestigial regulatory adjunct that, while applicable only to Canadian liquid fuels consumption, is nonetheless both duplicative and unnecessary. Why is the federal government continuing with the CFR? If $170/tonne target is insufficient to meet the Canadian commitment to the Paris Agreement, then increase the tax rate. But why continue to include a complicated, selective, and fundamentally redundant regulatory scheme like the CFR? By its own design, the CFR imposes a *de facto* carbon price of $350/tonne for those who cannot achieve the required carbon intensity reductions. Is there some special reason that justifies that emissions from certain liquid fuels be taxed at a higher rate? Of course not.

> *Once a national carbon tax rate is set, there is little need to impose any other regulatory interventions.*

Furthermore, the CFR is unnecessary. Before 2012, many argued that the CFR would impose a higher *de facto* carbon tax on a smaller grouping of emissions, meaning that the majority of emissions priced at lower levels would lead to fewer adverse economic impacts. That would have been more understandable had Canadian carbon pricing remained at $50/tonne or lower over the decade. However, that is no longer the case. Significantly, the $170/tonne benchmark would become the highest explicit carbon tax applicable amongst Canada's major trading partners. If biofuel development cannot occur within Canada within the context of this pricing regime, we argue that there is no case for providing it with a special mandate. And, if biofuel can be produced at a lower cost than the carbon tax, then it will be done regardless since businesses will find it profitable to avoid the carbon tax. Even if carbon taxes within Canada are to be set with emission mitigation as a primary consideration, multiple carbon taxes in Canada, explicitly or implicitly, are unjustifiable.

The government admits that primary energy suppliers have already voiced concerns about the present lack of available low-carbon biofuel needed to meet the demand for blended fuels that the CFR would create. It further admits that required supplies of biofuels would be highly dependent on the development of possible, but as yet unavailable, biofuel technologies that would presumably have to be developed over the next decade. Moreover, the success of the plan would also be dependent on further incentives to create a shift in transportation from vehicles using gasoline and diesel toward vehicles and equipment using fuels with a lower carbon intensity (such as hydrogen, electric vehicles), as well as natural gas, renewable natural gas, or propane). The potential costs and success of such incentives and their implementation remain unclear.

Competitiveness

The government states that small businesses will not be affected by the CFR since they would not need to comply with the policy. This is a surprising statement since heating and transportation costs will undoubtedly rise. Non-household (industry, commercial, and freight) demand for fuels is three-fifths of total fuel demand. While fuel producers will pass on their costs, the business sector will bear a significant share of those CFR costs. Given that Canada is a small, open economy, businesses will not be able to shift these costs forward to export markets and still remain competitive. Businesses may be able to reallocate CFR costs onto Canadian consumers, but this would be mitigated by import competition. To the extent that costs are not passed along in the form of higher consumer prices, they will fall on Canadian producers who would presumably have to reduce labour and other costs to remain internationally competitive. By comparison, the impact on energy prices of the carbon tax would burden all businesses similarly.

Notably, the carbon tax would provide rebates to the average household to offer relief from higher transportation and heating costs. With the tax rebated to households, competitive pressures would be blunted to some extent since business consumers would absorb more of the cost. However, this will not be the case for the CFR.

Is the CFR fair?

The government estimates that the CFR will increase transportation costs by $100 per vehicle (central estimate) and result in heating costs of $136 dollars per household by 2030 (central estimate) a cost that will fall heaviest on the poor (Canada 2020a, 3988, 3986). This is quite different than the carbon tax. The carbon tax rebates help shield lower-income households from higher energy prices. To the contrary, the CFR provides no such relief.

If anything, the government will lose fuel and carbon tax revenue with the imposition of the CFR that will curtail consumption of liquid fuels to some extent. Since the CFR generates no tax revenues, who will gain from higher fuel prices? Clearly, the primary gains will accrue to producers of biofuel and renewable energy who will benefit from the higher prices that households and business will pay. On the other hand, a national carbon tax would benefit producers of alternative energy while ensuring that a significant portion of the benefits accrues to households through the rebate mechanism.

Conclusion

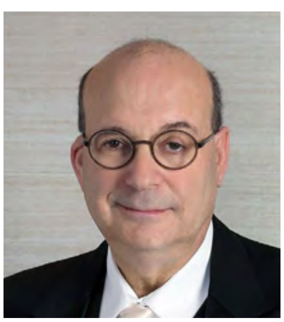
The ECCC estimates that incremental compliance costs for Canadians under the proposed CFR regulations would total $26.9 billion, with a net societal cost of $20.6 billion (Canada 2020 a, 3958, 3961). Their macroeconomic analysis done to evaluate the direct impact of the Regulations and the effect of relative price changes on Canadian economic activity and GHG emissions indicate an "overall GDP decrease of up to $6.4 billion (or up to 0.2% of total GDP)" in order to reduce up to 20.6 Mt of GHG. In effect, the federal government is proposing to make an enormous net societal economic bet of $20 billion, or more, based on what it calls the plausible outcome that the proposed, highly complex regulatory process of the CFR .

What is more plausible is that the CFR will materially increase costs for Canadians, add enormously complex, ongoing regulatory burdens that penalize Canadian competitiveness and that may be more costly than simply increasing the carbon tax. With the CFR, producers would be forced to pay an economic cost to reduce carbon by introducing biodiesel, ethanol, or other renewable products in fuels to reduce their carbon content. In theory, while higher fuel prices may encourage consumers to choose less energy-intensive products, it is far better to have uniform taxes with benefits that would accrue to households through rebate mechanisms.

We argue that ideally the CFR should be entirely scrapped. Assuming that the Supreme Court upholds the GGPPA, what should follow is a real debate on the stringency of, and targets for, the appropriate level of Canadian carbon taxes. This essential debate, rather than unneeded, extraordinarily complex, and costly legislation like the CFR, should be the focus for Canadian policy-makers and legislators.

About the authors

Dennis McConaghy is the former Executive Vice-President of Corporate Development at TransCanada Corporation. He has 30 years of experience in the Canadian energy industry in prominent commercial executive positions that included the commercial development of the Keystone XL pipeline systems within TransCanada Pipelines from its conception in 2006 to the finalization of commercial agreements in 2008. He is currently a visiting fellow at the public policy and energy studies schools at the Ivey Business School at the University of Western Ontario and an adjunct fellow at the Niskanen Center, a DC based think tank focused on carbon and energy policy. His book *Breakdown: The Pipeline Debate and the Threat to Canada's Future* (Dundurn Press) was awarded the 2019/2020 Donner Prize.



Jack Mintz is the President's Fellow at the University of Calgary's School of Public Policy and Distinguished Fellow, Macdonald-Laurier Institute. He also serves on the board of Imperial Oil Limited and is the National Policy Advisor for Ernst & Young. Dr. Mintz held the position of Professor of Business Economics at the Rotman School of Business from 1989-2007 and Department of Economics at Queen's University, Kingston, 1978-89. He was a Visiting Professor, New York University Law School, 2007; President and CEO of the C.D. Howe Institute from 1999-2006; Clifford Clark Visiting Economist at the Department of Finance, Ottawa; and Associate Dean (Academic) of the Faculty of Management, University of Toronto, 1993 – 1995. He became a member of the Order of Canada in 2015.

Ron Wallace is a former CEO who has served on federal, provincial and territorial energy and environmental regulators, including several governmental advisory boards, including the National Energy Board. Dr. Wallace is a Fellow of the Canadian Global Affairs Institute (formerly of the Canadian Defence and Foreign Affairs Institute), the University of Calgary, School of Public Policy. He is a Board member of the Canada West Foundation and was appointed to the Mackenzie Valley Environmental Impact Review Board. In addition to numerous research papers and texts he has recently authored Op Ed articles in the national press on strategic defence, Arctic policy matters and Canadian energy regulation.

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Endnotes

1 The Regulations would retain the minimum volumetric requirements (at least 5 percent low CI fuel content in gasoline and 2 percent low CI fuel content in diesel fuel and light fuel oil) currently set out in the federal *Renewable Fuels Regulations* (RFR). The RFR would be repealed.

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Paul Martin

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