

**DEVELOPING CREDIBLE AND EFFECTIVE COVENANTS FOR THE  
MANAGEMENT OF GREENHOUSE GAS EMISSIONS**

**A Project Conducted Under the Auspices of the**

***NEW DIRECTIONS GROUP***

**([www.newdirectionsgroup.org](http://www.newdirectionsgroup.org))**

July 31, 2001



## **Acknowledgements and Participants**

### **New Directions Group (NDG) Project Team**

The following individuals participated in the development of this document.

**Dale Austin**, Natural Resources Canada  
**Robert Flemington**, VCR Inc.  
**Daniel Gagnier** and **Ron Nielsen**, Alcan  
**Robert Hornung**, Pembina Institute  
**Murray Jones**, Shell Canada  
**Brent Lakeman**, Alberta Environment  
**Gord Lambert**, Suncor  
**Jim Leslie**, International Institute for Sustainable Development  
**Ingrid Liepa**, TransAlta  
**Ken Ogilvie**, Pollution Probe  
**David Rodier** and **Len Surges**, Noranda  
**Sarah Wade**, Environmental Defense  
**Paul Griss**, NDG Coordinator

### **Project Sponsors**

The NDG would like to acknowledge the financial contributions of the following project sponsors.

Alberta Environment  
Alcan  
British Columbia Ministry of Energy and Mines  
Natural Resources Canada (Sections #1 and #2)  
Noranda  
Shell  
Suncor  
TransAlta

### **External Reviewers**

The NDG appreciates the support of the following individuals who critiqued a final draft of this document.

Daniel Cayen, Ontario Ministry of Environment  
Jan Clark, Pan-Canadian Petroleum  
Dan Green, BC Ministry of Energy and Mines  
Richard C. Hill, DuPont Canada  
Dianne Humphries, Suncor  
Anne Mitchell, Canadian Institute for Environmental Law and Policy  
David Oulton, Climate Change Secretariat

### **Contact Information**

**Paul Griss**  
NDG Coordinator  
(T) 403-678-9956  
(F) 403-678-9414  
(E) [info@newdirectionsgroup.org](mailto:info@newdirectionsgroup.org)

## **Preface**

In September 2000, the New Directions Group (NDG) convened a project team comprising leading individuals on climate change and voluntary initiatives to address the challenges associated with establishing credible and effective climate change covenants. This report summarizes their thinking to provide guidance in the application, design and implementation of such covenants nationally. While there is general consensus among the project team on the content of this document, members have not been asked to endorse the final product.

This project is a follow-up to the NDG's *Criteria and Principles for the Use of Voluntary or Non-regulatory Initiatives to Achieve Environmental Policy Objectives* (Appendix II) released in November 1997. The criteria and principles apply specifically to those voluntary initiatives that complement or replace regulation, i.e. those in which there is government sanction for - if not participation in - the voluntary initiative. Application of the criteria and principles can also enhance the credibility and effectiveness of other voluntary initiatives, although the rigour of their interpretation and application may vary in the absence of government participation and thus a lessened public policy component.

When the NDG embarked on the development of the criteria and principles, its intention was to first develop generic rules governing the establishment of voluntary initiatives and then to apply those rules in a particular area. This report addresses the second goal, identifying the key elements of an agreement that is negotiated voluntarily between government and one or more entities respecting the management of greenhouse gas emissions and is binding on the parties (i.e., a "covenant"). As with the NDG's criteria and principles, the elements of credible and effective covenants identified in this report may also be applied to other forms of negotiated agreements, albeit in a perhaps less rigorous manner.

It is important to also note that while this report focuses on covenants for the management of greenhouse gas emissions, its findings are equally applicable to the use of covenants to address a wide range of environmental issues. Indeed, as many of the incentives available to government can stimulate performance on multiple environmental issues a stronger business case may be made for developing a coordinated strategy to achieve a number of environmental policy objectives through a single covenant. The NDG project team recognizes this but has chosen to focus this report on the management of greenhouse gas emissions as several governments in Canada have expressed an explicit interest in pursuing covenants for this purpose.

# NEW DIRECTIONS GROUP

## Developing Credible and Effective Covenants for the Management of Greenhouse Gas Emissions

### Executive Summary

The New Directions Group (NDG) has brought together leading individuals on climate change and voluntary initiatives to address the credibility and effectiveness of covenants for the management of greenhouse gas (GHG) emissions by identifying:

- principles governing the application, design, negotiation and content of a covenant; and
- the relationship between the incentives available for GHG emissions reductions and the performance possible under a covenant.

In embarking on this project, the NDG wished to ensure that covenants developed to address the management of greenhouse gas emissions in Canada benefited from a standard set of requirements that would:

- describe the circumstances in which covenants could contribute to significant cumulative reductions in GHG emissions in Canada;
- ensure consistency in the application of this type of policy instrument nationally; and
- enhance the credibility and effectiveness of each individual covenant.

In this report, the term “covenant” is intended to refer to any agreement that is negotiated voluntarily between government and one or more entities respecting the management of greenhouse gas emissions and is binding on the parties. As suggested above, for covenants governing the management of GHG emissions in Canada to be credible instruments of policy, they should adhere to a standard set of requirements to ensure consistency in their application nationally and to enhance the integrity of each individual covenant. For covenants to be effective instruments of climate change policy, they should result in voluntary commitments by industry and government leaders to implement the potential emission reduction opportunities identified through the National Climate Change Process. This implies a high degree of rigour to the application, design and content of covenants and demands the provision of incentives commensurate with performance expectations. This is not the only role for covenants as governments and industry can employ them as exploratory mechanisms to investigate opportunities to produce additional greenhouse gas emission reductions through facilitation of industry investments in GHG offsets and research and development of new technologies as well as in securing life-cycle emission reductions associated with improved product stewardship, enhanced product application and reducing indirect emissions.

Three issues are critical to ensuring credible and effective covenants: *context*, *content* and *incentives*.

### Context

An understanding of the context in which covenants will be applied helps to create realistic expectations of their contribution to Canada’s GHG emissions reduction target and to identify ways in which covenants can lead to creative and innovative approaches to GHG emissions management. For example, the performance possible under a covenant may be influenced by the requirements for parties to also address other environmental priorities and to comply with a wide range of domestic and international policy and regulatory requirements any of which might diminish best efforts to reduce GHG emissions. The business case for parties to join and to perform within the covenant also needs to be established, which will require incentives appropriate to the level of performance expected. The costs of negotiating and managing multiple covenants requires consideration and should be compared to the transaction costs of other policy instruments. And favouring the partnerships inherent in covenants over regulation and enforcement presents new challenges to the traditional roles and capacities of all parties.

A fundamental issue is that the policy and regulatory infrastructure in which climate change covenants will be placed is evolving slowly at the federal and provincial levels in Canada. While the negotiation of covenants will contribute to the evolution of that infrastructure the policy and regulatory support necessary for credible and effective covenants is not in place. This can be seen as an impediment to success but it also affords an opportunity to employ covenants to experiment with new approaches to GHG emissions management.

## **Content**

To be credible and effective, covenants for the management of GHG emissions must be applied and designed with three essential attributes: *performance*, *transparency* and *accountability*.

*Performance:* Performance targets will generally be negotiated among parties with the input of non-parties. Targets may be expressed as absolute levels of emissions over the life of the covenant or parties to a covenant may determine a more appropriate method of setting performance targets depending on the circumstances in which the covenant is being applied. In some cases the commitment may be to a specific level of emissions while in others it might be a commitment to invest in certain technologies or offsets. Performance targets for existing facilities or equipment may be different than those possible for new facilities or equipment. Performance targets may also be different at different stages in the life of a covenant. In all cases, performance targets and the manner in which they are set must take into account the issues of increases and decreases in output due to expansions, contractions, acquisitions, divestures and shutdowns and they must be clearly related to the available incentives.

*Transparency:* As there is both a significant public interest and a public policy component to using covenants for the reduction and management of greenhouse gas emissions, the negotiation and implementation of covenants must be open and transparent. This could include such actions as engaging NGOs, communities and other groups that may have an interest in the covenant in its development and/or implementation, public consultation, public reporting and reporting emissions through an independent registry.

*Accountability:* While entering into a covenant is a voluntary act, the commitments made therein, including performance targets, are binding upon parties and parties must be held accountable. This can be partially achieved through the transparency provisions described above but it also requires a commitment to ongoing evaluation and review of performance, a reconciliation of performance against objectives and against the incentives received, and the application of penalties in the event that a party reneges on its commitments.

## **Incentives**

There is a *quid pro quo* relationship between performance expectations and the incentives available in any covenant. The attractiveness of particular incentives will depend on the circumstances faced by the parties to a covenant and the commitments that they are making.

If industry is expected to make enhanced commitments in a covenant to implement existing technologies to reduce internal greenhouse gas emissions that go beyond “business as usual”, incentives are required that allow corporations to make a business case for the new expenditures and actions that can produce those emission reductions. The single most important incentive that governments can offer in this area is the creation of increased policy certainty for parties to a covenant. This could include a full or partial time-limited exemption for parties from future policy or regulatory requirements relating to the covenant. An example could be an exemption from, or provision of a reduced rate for, any future tax on carbon emissions (at least during the time period of the covenant). The costs of securing reductions in greenhouse gas emissions could also be alleviated through the provision of a range of financial incentives, such as formally recognized greenhouse gas emission reduction credits that could be sold to other emitters.

Incentives are also required to enable corporations to make more significant commitments to reduce greenhouse gas emissions. Governments could allow parties to purchase defined amounts of greenhouse gas emission reductions outside their own operations for application against the commitments made in the covenant (eg., through the purchase of GHG offsets) helping to stimulate investments in greenhouse gas emission reductions in other sectors. To encourage investments in the research, development, demonstration and commercialization of new technologies that could produce internal emission reductions,

governments could provide parties with related incentives in exchange for stronger emission reduction commitments. Finally, decreasing life-cycle greenhouse gas emissions through actions related to improved product stewardship, enhanced product application and reducing indirect emissions may be compromised by the existence of policy barriers that prevent the more widespread adoption of products and technologies that would help to reduce Canada's greenhouse gas emissions. In these cases, the application of incentives or complementary policies that are linked to the specific product or technology (or a performance standard that could be met by several products or technologies) may be required to stimulate progress.

Based on the foregoing, the New Directions Group project team believes that the negotiation of climate change covenants offers a range of opportunities to Canada in meeting its greenhouse gas emissions reduction targets. For covenants to be credible and effective, though, they require policy and regulatory support and the provision of incentives commensurate with their performance expectations. In the absence of those drivers, covenants - individually and cumulatively - are unlikely to make a significant contribution to reducing greenhouse gas emissions.

Given the range of factors that affect the credibility and effectiveness of covenants for the management of GHG emissions, they need to be pursued cautiously. Experience with these instruments is relatively new and is limited. Thus, it is appropriate to consider covenants initially as experiments designed to engage leaders and to determine which approaches and incentives work under which circumstances. Tolerance for failure must be built in to the application of this policy instrument recognizing that covenants will improve over time as Canada gains experience with this approach to reducing its GHG emissions.



## **Developing Credible and Effective Covenants for the Management of Greenhouse Gas Emissions**

### **Objective**

The New Directions Group (NDG) has brought together leading individuals on climate change and voluntary initiatives to address the credibility and effectiveness of covenants (see Box #1) for the management of greenhouse gas (GHG) emissions by identifying:

- principles governing the application, design, negotiation and content of a covenant; and
- the relationship between the incentives available for GHG emissions reductions and the performance possible under a covenant.

### **Introduction**

For covenants governing the management of GHG emissions in Canada to be credible instruments of policy, they should adhere to a standard set of requirements to ensure consistency in their application nationally and to enhance the integrity of each individual covenant. For covenants to be effective instruments of climate change policy, they should result in voluntary commitments by industry and government leaders to implement the potential emission reduction opportunities identified through the National Climate Change Process. This implies a high degree of rigour to the application, design and content of covenants and demands the provision of incentives commensurate with performance expectations. This is not the only role for covenants as governments and industry can employ them as exploratory mechanisms to investigate opportunities to produce additional greenhouse gas emission reductions through facilitation of industry investments in GHG offsets and research and development of new technologies as well as in securing life-cycle emission reductions associated with improved product stewardship, enhanced product application and reduced indirect emissions.

This report has been developed in consultation with companies representing the following industrial sectors: electricity generation; petroleum production; aluminum; and mining / smelting. Most of these companies have identified some potential opportunities to implement measures that would produce the internal reductions in GHG emissions identified by the Analysis and Modeling Group of the National Climate Change Process. Importantly, many of these measures will not be implemented in a “business as usual” scenario as policy and/or economic barriers prevent their implementation. Covenants can help facilitate such reductions by providing incentives and supporting policy changes that can allow these barriers to be overcome. In addition, some companies have also identified opportunities for more significant emission reductions associated with either expanded use of their products (relative to more greenhouse gas intensive products) or through the utilization of potential new technologies that require additional research and development support.

In many cases, there are economic and/or policy barriers to the achievement of emission reductions. Based on the operating realities of participating companies and the experiences with covenants elsewhere, this report considers three key determinants of success if covenants are to generate significant levels of GHG emission reductions in the absence of a direct carbon charge (either a tax or a requirement to purchase emission permits) on the industrial sector. Section 1 considers the policy context within which the development of covenants to address climate change takes place and discusses how that context can influence the potential level of GHG emission reductions that can be achieved. Section 2 describes the specific contextual issues that must be addressed in the negotiation of a covenant and identifies the characteristics and content requirements of a credible and effective covenant. Consideration is also given to how these issues are reflected in sectoral framework agreements and other forms of negotiated agreements (see Box #1) addressing the management of GHG emissions. Section 3 assesses existing policy, financial and regulatory barriers to action and examines how the provision of different types of incentives can influence the potential levels of GHG emission reductions that can be achieved through covenants.

**Box #1: Types of Negotiated Agreements**

The New Directions Group recognizes that there is a wide range of terms used to identify negotiated agreements in the area of environmental protection. In an attempt to facilitate understanding and interpretation of this report, three broad categorizations are employed.

**a) Covenants**

The thrust of this report is to identify the contextual issues, characteristics and essential content relating to credible and effective covenants. The NDG project team interprets covenants to be any negotiated agreement in which a government agency (or agencies) is either a sponsor of or a party to the agreement. These would, for the most part, be agreements entered into or sanctioned by governments to complement or replace regulation or to serve as a bridging mechanism while a policy and regulatory regime for the management of GHG emissions evolves. As there is a significant public interest involved in the employment of covenants, and the provision of public incentives, the credibility and effectiveness of covenants is paramount.

Covenants can generally take the following forms:

- *Initiative-based* - the emphasis of the agreement is on specific initiatives/actions/projects. The merit of an initiative-based agreement is that it potentially enables more creative thinking about opportunities than might occur with an outcome based agreement. It is also of benefit when *quid pro quo* commitments are not possible or are constrained due to policy uncertainty or other circumstances.
- *Outcome-based* - the agreement emphasizes the outcome to be achieved and is relatively non-prescriptive on the means by which that is to happen. This type of agreement can be easier to administer and the obligations of the parties are clearly defined.
- *Hybrid of Initiative and Outcome-based* - where specific initiatives are identified and cooperative actions are documented but this is complemented by a stipulation of the overall outcome to be achieved by the agreement.

**b) Sectoral Framework Agreements**

The development and implementation of covenants or other forms of negotiated agreements may be facilitated by establishing an overall framework for such agreements for companies within a particular sector. While these frameworks are likely to be enabling, and thus not as rigorous as the covenants negotiated under them, they must be sufficiently reflective of the contextual and content requirements identified in this report to ensure that the covenants they spawn are credible and effective (see Section 2.4).

**c) Other Negotiated Agreements**

It is possible for agreements for the management of GHG emissions to be negotiated without direct government involvement, especially in the absence of a robust policy and regulatory framework. Agreements of this nature could include those negotiated between: an emitter and VCR Inc. (eg., Champions in Action); between an emitter and an NGO (eg., Partners in Climate Action); or between an emitter and companies within its supply chain (see Section 2.4).

## **1. The Importance of Context**

The Federal Government's Action Plan 2000 on Climate Change makes it clear that covenants are a policy tool that will be pursued to generate GHG emission reductions in electricity generation and other industrial sectors. Other provincial governments, such as British Columbia, have made similar commitments in their climate change strategies.

What can covenants to reduce greenhouse gas emissions in industry achieve? For example, the Analysis and Modeling Group has concluded that even if carbon dioxide was priced in the market at \$300/tonne, industrial greenhouse gas emissions in Canada would not fall to six percent below 1990 levels by 2010. If this conclusion proves correct, covenants clearly will not be the "silver bullet" in Canada's climate change response strategy; nonetheless, the NDG project team believes that if covenants are pursued seriously as a policy tool they will be able to capture many (if not most) of the emission reduction opportunities identified through the National Climate Change Process and they can be used to explore opportunities to generate additional emission reductions, including offsets, research and development of new technologies and product lifecycle approaches.

A fundamental issue is that the policy and regulatory infrastructure in which climate change covenants will be placed is evolving slowly at the federal and provincial levels in Canada. While the negotiation of covenants will contribute to the evolution of that infrastructure the policy and regulatory support necessary for credible and effective covenants is not in place. This can be seen as an impediment to success but it also affords an opportunity to employ covenants to experiment with new approaches to GHG emissions management.

An understanding of the context in which covenants will be applied helps to create realistic expectations of their contribution to Canada's GHG emissions reduction target and to identify ways in which covenants can lead to creative and innovative approaches to GHG emissions management. The following are some of the key contextual issues affecting the application of covenants. Many of these are addressed in further detail in Section #2 and Section #3.

### ***1.1 An Embryonic GHG Policy and Regulatory Environment***

One of the principal benefits of covenants in reducing or managing Canada's greenhouse gas emissions is that they may be able to be deployed more rapidly and cost-effectively than other policy or regulatory options. Each covenant entered into by government also becomes part of and informs the policy and regulatory architecture for securing greenhouse gas emissions reductions. This architecture is evolving slowly at the federal and provincial levels across Canada and in that context there is a considerable amount of risk that may be assumed by parties to a covenant. The terms of a covenant may turn out to be too rigorous, placing participating companies at a disadvantage compared to other companies in their sector or they may be too favourable perhaps giving participating companies an unfair advantage and placing government in a difficult position when employing different instruments to secure reductions from competitors. Similarly, as the markets for trading in carbon evolve, performance incentives within a covenant may turn out to be too generous or not sufficient in relation to the targets to be achieved. Nevertheless, parties to a covenant need to be assured that their leadership will be recognized and that those GHG emitters not making similar commitments will not be treated more favourably through other approaches. Covenants must reflect the current policy uncertainty by being robust to the evolving climate change policy and regulatory frameworks in Canada. Indeed, enhanced policy certainty is one of the major incentives sought by industry in pursuing covenants (see Section #3).

### ***1.2 The Benefits of Policy Alignment***

Many companies are being challenged to address a broad range of environmental issues in addition to climate change, for example:

- electricity producers are also being challenged to control emissions of NO<sub>x</sub>, SO<sub>2</sub>, and mercury;
- petroleum refiners are being challenged to produce cleaner transportation fuels; and
- mining / smelting companies are being challenged to minimize emissions of particulate matter, metal emissions, SO<sub>2</sub> and mercury.

In addition, no company is governed by the climate change objectives of one government alone. Many companies find the range of possible actions they can take to address climate change is influenced by other regulatory frameworks, for example:

- electricity producers in jurisdictions undergoing regulatory reform often face significant policy uncertainty or regulatory decisions that limit or expand their options to reduce GHG emissions; and
- mining / smelting companies find their options limited by regulatory frameworks governing the recycling of metals.

In addition, multinational organizations face a variety of different domestic policy frameworks and requirements to address climate change and other issues.

Discussions of the potential for GHG emission reductions achievable through covenants must thus consider the broader policy and regulatory frameworks within which a company operates. In several cases, it may be difficult to address all issues with limited capital and priorities need to be established. In addition, action to address other environmental issues could sometimes require solutions that are more energy intensive and therefore could produce more GHG emissions. Some of these competing environmental pressures may also have internal as opposed to external drivers (for example, a company seeking to improve sustainability may develop an action plan that identifies different internal priorities for capital allocation than external pressures would dictate).

Any discussion of the scope of a covenant and the GHG emission targets to be achieved within it must actively consider the need to ensure efficient and coordinated action to achieve multiple environmental performance objectives and the associated tradeoffs. Increasing the range of issues to be addressed by a covenant may require the engagement of a greater number of agencies in its negotiation and may increase the complexity of implementation and reporting but it may also result in a more comprehensive and attractive package of performance incentives as many of the incentives to reduce GHG emissions can also be deployed to achieve other environmental objectives.

### **1.3 *Establishing a “Business Case” for Action***

All companies being challenged to reduce their GHG emissions must develop a business case for taking the requested action. A consideration of the business context within which the covenant will be placed will include the company’s emissions outlook, the evaluation of a variety of future business scenarios, the knowledge and learning to be obtained through the covenant and the identification of opportunities related to enhanced technology, operational efficiencies, new business ventures and offsets. The costs of action will be weighed against the costs of inaction, not only in terms of the company’s adherence to the regulatory and policy requirements of government (for example, a retrofit to comply with a future regulation that may have been avoided by early voluntary action) but also against the actions of competitors as marketplace advantages for reducing GHG emissions emerge. A key factor in improving the business case for action is the provision of incentives to reward the achievement of agreed upon levels of performance (see Section #3).

### **1.4 *Assessing the Transaction Costs of Covenants***

The costs of negotiating and managing multiple covenants must be assessed in making a determination of whether or not to employ this policy instrument. Even facilitated by sectoral framework agreements (see Box #1), the penetration of covenants throughout all industrial sectors could entail the negotiation and administration of hundreds of agreements. The so-called “transaction costs” of managing this many agreements will obviously be substantial and should be contrasted with the ability of other policy or regulatory instruments to achieve similar objectives. Covenants can be a valuable tool in engaging leaders on the climate change issue and thus in helping to establish the policy and regulatory context for action but it should be evident that reliance on this instrument may not be the most cost-effective method of securing comparable performance from all companies.

### **1.5 *Developing the Capacity to Negotiate and Manage Covenants***

Agreements negotiated voluntarily, such as covenants, present new challenges to government, industry and NGOs who are accustomed to working within a regulatory context. As covenants represent a form of partnership between government and industry and perhaps other organizations (such as NGOs), the negotiation and implementation of covenants demands appropriate skill sets. NGOs, for example, may evolve from critic to participant challenging their orientation and skill sets. The flexibility and innovation inherent in covenants requires industry to develop solutions to the greenhouse gas emissions challenge rather than simply complying with a stipulated requirement. And the emphasis on incentives over enforcement challenges the traditional orientation of government. As voluntary agreements to address climate change and other environmental issues become an increasing part of the policy and regulatory framework, government, industry and NGOs will need to develop the capacity to ensure their constructive participation in such initiatives. The relative capacities of parties needs to be considered in the determination of whether to proceed with a covenant. Mechanisms for enhancing capacity should be included in any agreement.

### **1.6 *Summary***

From the preceding, it should be evident that while covenants have the potential to make a significant contribution to Canada's ability to reduce its greenhouse gas emissions, they can only do so if there is the supportive policy, regulatory and business context necessary to enable them to succeed. While covenants may be deployed more rapidly than other policy or regulatory instruments, they should not be viewed as the only option for progress. The performance possible under a covenant may be influenced by the requirements for parties to address other environmental priorities and to comply with a wide range of domestic and international policy and regulatory requirements any of which might diminish best efforts to reduce GHG emissions. The business case for parties to join and perform within the covenant needs to be established, which will require incentives. And the costs of negotiation and management of multiple covenants should be compared to the transaction costs of other policy instruments. Further, relying on the partnerships inherent in covenants presents new challenges to the traditional roles and skills of potential parties and participants. These issues need to be addressed directly if Canada is to derive the maximum benefit from covenants in reducing and managing its greenhouse gas emissions.

## **2. Developing Covenants for the Management of Greenhouse Gas Emissions**

This section identifies key considerations in determining when to apply covenants, their general design characteristics and their required content all of which will facilitate the consistency and comparability of covenants. It is recognized that a “one size fits all” model is not appropriate due to the diversity of Canadian industry and the variety of operating circumstances that will be encountered. Thus, the issues described below should be addressed in the development of any covenant but their relative importance and the rigour with which they are interpreted may vary according to the circumstances in which the covenant is being applied.

The principal goal of the NDG project team is to ensure that covenants are both credible and effective. There are three key aspects relating to credibility and effectiveness which are reflected and implicit throughout the requirements laid out in this section. These are *performance*, *transparency* and *accountability*.

### **a) Performance**

Performance targets will generally be negotiated among parties with the input of non-parties. Targets may be expressed as absolute levels of emissions over the life of the covenant or parties to a covenant may determine a more appropriate method of setting performance targets depending on the circumstances in which the covenant is being applied (see Box #1). In some cases the commitment may be a specific level of emissions while in others it might be a commitment to invest in certain technologies or offsets. Performance targets for existing facilities or equipment may be different than those possible for new facilities or equipment. Performance targets may also be different at different stages in the life of a covenant. In all cases, performance targets and the manner in which they are set must take into account the issues of increases and decreases in output due to expansions, contractions, acquisitions, divestures and shutdowns and they must be clearly related to the available incentives.

### **b) Transparency**

As there is both a significant public interest and a public policy component to using covenants for the reduction and management of greenhouse gas emissions, the negotiation and implementation of covenants must be open and transparent. This could include such actions as engaging NGOs, communities and other groups that may have an interest in the covenant in its development and/or implementation, public consultation, public reporting and reporting emissions through an independent registry.

### **c) Accountability**

While entering into a covenant is a voluntary act, the commitments made therein, including performance targets, are binding upon parties and parties must be held accountable. This can be partially achieved through the transparency provisions described above but it also requires a commitment to ongoing evaluation and review of performance, a reconciliation of performance against objectives and against the incentives received, and the application of penalties in the event that a party reneges on its commitments. In the absence of a policy framework which provides a clear fallback (those in non-compliance become subject to

#### **Box #2: Key Considerations in the Application and Design of Covenants for the Management of GHG Emissions**

##### Application

Policy and Regulatory Support  
Establishing the Business Case  
Acceptability  
Potential Penetration  
Equitable Negotiation

##### Characteristics

Transparency  
Flexible and Innovative  
Provision for Continual Improvement  
Cost-effective

##### Content

Purpose  
Parties  
Principles  
Duration  
Roles and Responsibilities  
Engagement  
Eligible Sources  
Baseline  
Performance Targets  
Incentives  
Emissions Measurement  
Reporting  
Verification  
Reconciliation  
Capacity-building  
Banking  
Trading and Investment  
Review Mechanisms  
Early Termination

other instruments such as a full carbon tax), the consequence of non-compliance with a covenant is the risk of loss of the agreement and its benefits (eg., incentives for companies or corporate undertakings for governments) and the public embarrassment that might ensue.

The following sections discuss the application, characteristics and content of covenants. Each requirement is italicized and in some cases is followed by bullet points intended to clarify the requirement. Where appropriate, requirements are referenced to the New Directions Group *Criteria and Principles for the Use of Voluntary or Non-regulatory Initiatives to Achieve Environmental Policy Objectives* (eg., NDG C.a = NDG Criterion A and NDG P3 = NDG Principle #3) which are found in Appendix II.

## **2.1 Application of Covenants**

As described in Section #1, the policy, regulatory and business contexts within which a covenant will be placed have a profound influence on its potential scope and effectiveness. Here, those general considerations are considered in an applied manner to ensure that covenants addressing the management of GHG emissions appropriately reflect the external factors that influence their success.

*Before negotiation of a covenant begins, sponsors and potential parties should have sufficient understanding of the context in which it will be applied and of the operating realities faced by each party to ensure that a covenant is the most appropriate method of securing desired GHG emissions reductions.*

The following are issues that need to be taken into account in making that determination.

### **2.1.1 Policy and Regulatory Support**

*Covenants should be clearly linked to the relevant federal and/or provincial regulatory and policy requirements under which they are governed (NDG C.a)*

- participating governments should specify how the covenant's provisions interact with other policy mechanisms, e.g., eligibility of emissions trading among parties or with non-parties.
- as parties to a covenant are demonstrating leadership on climate change issues, governments should, to the extent possible, adopt a flexible approach to the imposition of new policy or regulatory requirements relating to the covenant on parties during the life of the covenant (see Section #3). One incentive that governments can make available is to link full, partial and time-limited exemptions from existing or future policy or regulatory requirements to the performance of parties under a covenant.
- provision should be made for parties to renegotiate, or withdraw from, a covenant should the evolving policy and regulatory environment disadvantage any party to the covenant (corporate or government) or should a more comprehensive regulatory instrument (eg., emissions trading) be introduced (see 2.3.19).

### **2.1.2 Establishing the Business Case**

*Parties, both corporate and government, need to ensure that there is a compelling business case for making the commitments required in developing and implementing a covenant*

Establishing the business case requires consideration of the scope of the covenant as well as the direct and indirect costs and benefits of participation, and will include such issues as:

- whether the covenant is intended to apply only to GHG emissions reductions or whether a multipollutant approach is preferable (the greater the scope, the greater the potential incentives);
- the congruence of performance expectations of all potential parties;
- the correlation between the available incentives and performance expectations;
- the transaction costs entailed in developing and implementing the covenant(s) - recruiting, managing and monitoring - and how they will be shared; and
- whether the parties (government, industry and other) have the internal capacity to fulfill their commitments under a covenant and the costs of developing that capacity.

### 2.1.3 Acceptability

*Covenants should only be used in circumstances in which sponsors, potential parties and other interested or affected organizations agree that they are an acceptable instrument (NDG C.b)*

- sponsors and potential parties to a covenant should demonstrate their commitment to this approach at an early stage in negotiations.
- early consultation should take place with interested and affected organizations (see Box #3) to determine whether a covenant is an acceptable instrument prior to the commencement of negotiations.
- as covenants for the management of GHG emissions are intended to contribute to the resolution of a significant environmental policy issue, early consultations with leading NGOs are particularly warranted.

### 2.1.4 Potential Penetration

*Where covenants are being negotiated, there should be a reasonable expectation of the eventual establishment of sufficient covenants within the sector to warrant the effort (NDG C.c)*

- one of the principal advantages of covenants is that they can engage leaders and stimulate action on climate change while the policy and regulatory framework evolves. For covenants to be a viable approach to securing GHG emissions reductions there needs to be an expectation that the application of covenants will contribute to significant cumulative reductions in GHG emissions which is not possible if covenants are applied in an isolated or sporadic manner. Consideration should be given to the potential for a covenant with a particular company to spawn other covenants or to generate comparable reductions throughout the sector.
- as voluntary initiatives take time to mature, it is appropriate to design a covenant for industry leaders and provide for expansion over time – the number of covenants is less important than their quality and their impact.
- covenants should not be designed so rigorously as to discourage potential parties but they should also not sacrifice quality in order to engage more parties.

### 2.1.5 Equitable Negotiation

*As covenants are both voluntary agreements and partnerships, they should be negotiated with the consent of potential parties and specific terms of the covenant should not be imposed by any one organization (NDG P1)*

- those negotiating a covenant should be able to demonstrate the consent of those on whose behalf they are acting.
- consideration should be given to the role of non-parties (see Box #3) in negotiating the terms of the covenant. Such involvement can significantly enhance the transparency and credibility of the resulting agreement.
- depending on the nature of the covenant and the circumstances in which it is applied, NGOs may be consulted in the development of the covenant, engaged directly in negotiating the covenant, parties to the covenant itself, or they may be participants in its implementation.

#### **Box #3: Interested or Affected Organizations**

In this document, the following terms are used to refer to the involvement of interested and affected organizations in a covenant.

**Sponsor** - refers to the entity that initiates the development of a covenant. This could be a government agency, industry association or a company.

**Party** - refers to those organizations (government, industry, NGO) who actually sign on to the covenant, committing themselves to its implementation.

**Non-Party** - refers to an organization that may have sufficient interest in the covenant to become engaged in its negotiation or implementation but who would not actually be a signatory. This could include other government agencies, NGOs and even competitors to those companies entering into the covenant.

**Participant** - some covenants may contain provision for non-parties to be active participants in their implementation, perhaps through a public advisory committee or by involvement in a third party monitoring process.

## **2.2 Characteristics of Covenants**

The following are generic principles that characterize a credible and effective covenant.

### **2.2.1 Transparency**

*As covenants are a voluntary mechanism to achieve an environmental policy objective, they need to be transparent in their design and operation to ensure credibility (NDG P2)*

- interested or affected organizations, such as NGOs or affected communities, should be consulted throughout the negotiation of a covenant, recognizing issues such as confidentiality and disclosure (see Box #3).
- consideration should be given to the participation of key interested or affected organizations who are not parties to the covenant in its implementation, such as the establishment of a public advisory committee or the inclusion of representatives of these organizations in monitoring and verification processes.
- covenants should contain a provision for public reporting of performance on at least an annual basis (see 2.3.10).
- governments should establish, or support the establishment of, independent registries for recording performance under covenants.

### **2.2.2 Flexible and Innovative**

*Covenants should emphasize what is to be achieved over how those achievements are to be made to encourage flexibility and innovation (NDG P5)*

- the manner in which performance targets are to be achieved should not be stipulated in the covenant itself; however, all parties to the covenant should table an action plan that describes how they will meet the terms of the covenant and which can serve as a basis for monitoring and evaluating performance.

### **2.2.3 Provision for Continual Improvement**

*Covenants should provide for cumulative increases in performance through a process of continual improvement (NDG P8)*

- covenants should contain provisions for periodic review of the covenant itself, its performance targets and the experience of participants in attempting to meet those targets - the longer the life of the covenant the greater the need for a review process.
- continual improvement is facilitated in covenants which strive for cumulative improvements in performance over the long term.

### **2.2.4 Cost-effective**

*Covenants should be competitive with other mechanisms for achieving climate change policy objectives and the costs of developing and administering a covenant should be allocated fairly.*

- cost-effectiveness is a function of performance expectations, incentives and flexibility and should be considered in all aspects of a covenant.

## **2.3 Content of Covenants**

The following can be considered as an annotated Table of Contents for a credible and effective covenant governing greenhouse gas emissions management.

### **2.3.1 Purpose**

- the expectations of the parties to the agreement should be stated to indicate why they are entering into the agreement.
- the range of activities (from greenhouse gas emissions to multipollutant reductions) to be addressed through a covenant should be clear, specific, manageable and agreed to by all potential parties.
- covenants should stipulate that the methods employed to secure greenhouse gas emissions reductions must not result in other social, economic or environmental problems.

### **2.3.2 Parties to the Covenant**

- covenants should list all parties to the agreement including contact personnel and coordinates.

### **2.3.3 Guiding Principles**

- to facilitate understanding and cooperation, covenants may contain a set of guiding principles that govern the implementation of the agreement and the manner in which the parties will relate to each other and to non-parties.

### **2.3.4 Duration of a Covenant**

- the duration of a covenant should be specified.

### **2.3.5 Roles and Responsibilities (NDG C.d)**

- the roles and responsibilities of all parties should be clearly stipulated.

### **2.3.6 Engagement**

- where non-parties, such as NGOs and communities, are to be involved in the implementation of the covenant, the process by which their input will be secured should be described.

### **2.3.7 Eligible Sources**

- sources of GHG emissions that are to be addressed through the covenant should be specified.

### **2.3.8 Baseline**

- a clear baseline against which performance can be compared and a methodology for its determination should be identified.
- depending on the operating circumstances of participating companies, the baseline may be set for the life of the covenant or it may be adjusted on an annual basis to reflect performance and/or changes in the operating environment.

### **2.3.9 Performance Targets (NDG P3)**

It bears emphasizing that while entering into a covenant is a voluntary act, the provisions of the covenant - including performance targets - become binding once the covenant has been signed.

- covenants should contain a clear statement of the performance expectations of parties including timelines and interim targets.
- the nature of the performance commitment will vary according to the participants in the covenant but in all cases it must be backed up by clear objectives and milestones.

### **2.3.10 Incentives** (NDG P4)

Section #3 provides a more in-depth discussion of the relationship between incentives and performance targets.

- the type of performance incentives and the circumstances in which they are to be awarded should be clearly specified.
- the selection of incentives should be related to the demonstrated ability of those incentives to contribute to an enhanced business case for achieving performance targets in excess of those possible through a “business as usual” scenario.

### **2.3.11 Emissions Measurement** (NDG P6)

- the responsibility for monitoring the performance of parties must be clear in the covenant.
- monitoring protocols should be included in the covenant - these must be consistent with an accepted methodology for calculating GHG emissions.

### **2.3.12 Reporting** (NDG P6)

- reporting protocols must be included in the covenant.
- parties to a covenant should report their emissions at least on an annual basis through an emissions registry (see 2.1.6).
- in addition to reporting to each other, parties to the covenant should publicly report their progress at least annually (see 2.2.1).

### **2.3.13 Verification** (NDG P7)

- the type and level of verification of baselines and performance should be clearly specified in the covenant.
- the type and level of verification should become more rigorous as performance expectations and the provision of incentives increase.
- an accepted methodology for determining verified emissions reductions, including those obtained through offsets, should also be included particularly where participants anticipate banking or trading.

### **2.3.14 Reconciliation**

- parties should regularly reconcile performance against the incentives received taking action to either enhance performance, bank excess reductions, or adjust incentives as appropriate.
- in circumstances in which a party has reneged on its commitments or has failed to apply best efforts, the application of penalties or sanctions should be clear.
- to protect parties in the event of unforeseen circumstances that compromise their best efforts to achieve performance targets, mechanisms such as an insurance pool may be built into the design of a covenant.

### **2.3.15 Capacity-building** (NDG C.e)

- covenants should contain provisions for facilitating the learning of all parties and be robust to the changes that may be suggested through experience as a contributor to continual improvement (see 2.2.3).
- provisions should be made for the enhancement of government capacity to administer or participate in the covenant to ensure that the covenant remains relevant and resilient to the evolving policy and regulatory framework.

### **2.3.16 Banking**

- where a party to a covenant exceeds its performance targets within a specified period, the eligibility of banking any excess emissions reductions for credit at a later date in the life of the covenant or for trading (see 2.3.17) should be clearly defined.

### **2.3.17 Trading and Investment**

- the eligibility of emissions trading activities under the covenant should be clearly established (see 2.1.1),
- identification and ownership of “credits” resulting from performance under a covenant should be clearly specified.
- where appropriate, covenants should specify the eligibility of offsets and sequestration investments in calculating emissions reduction performance including the extent to which parties can purchase external credits toward their performance targets and the ability to sell any credits arising from banking (see 2.3.16).

### **2.3.18 Review Mechanisms**

- covenants should contain provisions for the ongoing review of their relevance and performance with the frequency of review dependent on the duration of the covenant.

### **2.3.19 Early Termination**

- in exceptional circumstances, such as the non-performance of parties (including government) or the introduction of a more comprehensive policy or regulatory instrument, the early termination of a covenant should be possible.
- early termination clauses should address the provision or recapture of incentives and any sanctions that may be applied depending on the reasons for which a party withdraws from the covenant.

## **2.4. Application of Recommendations**

### **2.4.1 Covenants**

In embarking on this project, the New Directions Group wished to ensure that covenants developed to address the management of greenhouse gas emissions in Canada benefited from a standard set of requirements that would:

- describe the circumstances in which covenants could contribute to significant cumulative reductions in GHG emissions in Canada;
- ensure consistency in the application of this type of policy instrument nationally; and
- enhance the credibility and effectiveness of each individual covenant.

The preceding parts of Section #2, as indicated, are intended to refer to the application and design of covenants and all of these requirements are thus mandatory. As stated earlier, it is recognized that there is no single model that can create a credible and effective covenant in all situations but the resultant variation will be as a result of the interpretation of each of the above requirements according to the circumstances faced by sponsors and potential parties. These should be explained, particularly in cases in which any of the requirements are given a low priority or are excluded from negotiations.

## 2.4.2 Sectoral Framework Agreements

To facilitate the development of covenants, companies within a sector, usually through a sectoral association, may express a collective interest in negotiating covenants with government. In these circumstances, the sectoral association becomes a partner with government in developing and implementing covenants and assumes a share of the responsibility for ensuring the success of these agreements. It should be recognized, though, that sectoral associations have far fewer tools at their disposal to assume this role than do governments.

To ensure that covenants within a sector contribute to a common goal, a *sectoral framework agreement* may be developed that lays out the overarching principles governing covenants within the sector. As the resulting covenants must still be consistent with the requirements of Sections 2.1 - 2.3, a sectoral framework agreement should also meet these requirements, although the language of the sectoral framework agreement is likely to be more enabling than that which would be found in a covenant.

As the sectoral association shares some of the roles and responsibilities of government in negotiating and managing the resulting covenants, there are some key areas in which sectoral framework agreements may differ from the covenants they spawn.

### 2.1.3 Acceptability of a Sectoral Framework Agreement

- a sectoral association should be able to demonstrate agreement among its member companies that covenants are an appropriate approach to the management of GHG emissions within the sector (see also 2.1.4, 2.1.5); however, this does not imply a need for consensus among the membership of the sectoral association.

### 2.1.4 Potential Penetration

- the sectoral association must be able to demonstrate that it can both marshal and manage participants (see also 2.1.3, 2.1.5).
- if a framework agreement is binding upon a sectoral association then the association should consider the establishment of a covenant as a requirement of membership in the association.
- if the foregoing is not possible, sectoral associations should stipulate a target level of participation, the mechanisms to be used to encourage their members (and in some cases non-members) to enter into covenants, and the timeframe over which this will take place.

### 2.1.5 Equitable Negotiations

- in developing sectoral framework agreements, representatives of small or medium sized companies within the sector should be included in negotiations.

### 2.3.5 Roles and Responsibilities

- the role and responsibilities of the sectoral association in developing and managing covenants within the sector should be clearly stated in the sectoral framework agreement.
- in negotiating roles and responsibilities, consideration must be given to the provision of adequate resources to ensure the implementation of the framework agreement.

### 2.3.9 Performance Targets

- sectoral framework agreements may contain a collective performance target although performance targets may differ among resulting covenants; however the performance targets of each covenant negotiated under the framework should be consistent with the requirements of 2.3.9 and 2.3.10.

### 2.3.12 Reporting

- sectoral framework agreements should contain a rolling list of covenants and participating companies (see also 2.3.2).
- sectoral associations should regularly report publicly the collective progress in developing and implementing covenants under the sectoral framework agreement (see also 2.2.1).

#### 2.3.14 Reconciliation

- periodically, the performance of the sectoral framework agreement needs to be evaluated in light of the performance achieved within the sector against expectations and the incentives provided.

#### 2.3.15 Capacity Building Mechanisms

- as it is likely that companies within a sector will possess differing capacities for achieving the performance targets identified in their covenants, sectoral framework agreements and their resulting covenants should include provisions to encourage the capacity building and continual improvement of parties through the life of the agreement.
- the methods should be stipulated by which the capacity of all participating companies in the sector to contribute to sectoral targets will be enhanced, including capturing and communicating best practices among parties.

#### 2.3.17 Trading and Investment

- provision may be made for participating companies to purchase or trade credits resulting from emissions reductions among themselves or externally as a means of contributing to sectoral targets.

### **2.4.3 Other Negotiated Agreements**

Covenants with government, either inside or external to a sectoral framework agreement, are not the only voluntary agreements that can be employed to manage greenhouse gas emissions. In the absence of policy or regulatory certainty, an increasing array of mechanisms independent of government is available to attempt to assist those companies that wish to take a pro-active approach to GHG emissions management. These may serve to register plans and emissions, provide for the exchange of learning and best practices among companies, or provide a framework for activities such as emissions trading.

Certainly, all of these potential mechanisms in its own way contributes to the development of a policy and regulatory framework for the management of GHG emissions and it is to the benefit of all involved if these approaches are evolving in tandem. Consequently, the development of voluntary negotiated agreements governing participation of companies in these initiatives ought to be congruent with the requirements for developing a covenant with government. As there is no direct government involvement in these types of agreements, and thus less of a public policy component, their rigour may be less in certain areas but it is to the advantage of sponsors to adhere to the requirements for covenants as closely as is practicable in order to both enhance the credibility and effectiveness of these agreements and to allow them to potentially evolve into covenants as the policy and regulatory framework becomes better defined. One of the benefits of these types of agreements, then, is their ability to serve as a preparatory mechanism or a bridge until circumstances provide for a more substantive form of voluntary agreement.

As might be expected, the requirements for these forms of negotiated agreements should not differ substantially from covenants and it is advisable for the sponsors of such initiatives to begin with the requirements for a covenant and work backwards, eliminating or reducing any of the requirements that are deemed to be not essential or less important according to circumstances. For example, the Champions in Action program of VCR Inc. has determined that all of the requirements of Section #2 are mandatory for any agreements within that program with the exception of “banking”, “incentives”, “capacity building” and “reconciliation”, which are deemed to be optional.

The key differences between these agreements and covenants will likely be in the rigour with which each of the requirements is applied, particularly in those areas that are most associated with government participation in a covenant. These include:

#### 2.1.1 Policy and Regulatory Support

- negotiated agreements should reference the regulatory and policy requirements to which they are intended to contribute and should be designed in such a way as to allow them to evolve into more rigorous forms of agreements, such as covenants.

### 2.1.2 Establishing the Business Case

- it is less likely that significant performance incentives will be available through an agreement to which government is not a party therefore the business case must rely largely on internal factors and the market value of carbon which may impinge on performance targets.

### 2.1.3 Acceptability

- the consent of potential parties to the agreement is important; however, where there are no public policy implications the need to consult widely with a range of interested and affected organizations (see Box #3), while still advisable, may be lessened.
- the need to engage non-parties in negotiations may also be lessened where there are no public policy implications (although this can still contribute to transparency and credibility).

### 2.2.1 Transparency

- as with Acceptability, the need for transparency may not be as great as for a covenant; however, the more transparent the agreement the greater its credibility is likely to be.

### 2.3.10 Incentives

- in the absence of government involvement, the potential for significant incentives is lessened which has an impact both on performance expectations and on the procedures for monitoring and verifying performance

### **3. Incentives To Accompany Covenants To Reduce Greenhouse Gas Emissions**

If corporations are to adopt greenhouse gas emission reduction commitments that go beyond “business as usual” under a covenant, incentives are required that allow corporations to make a business case for new expenditures and actions that can produce those emission reductions.

The following discussion of incentives is divided into two parts. First, this section considers the incentives that would be required to enable industry to make enhanced commitments to put in place existing technologies to reduce internal greenhouse gas emissions. At issue is the extent to which governments will negotiate such covenants with industry relative to the extent to which those covenants result in commitments to implement actions that would produce the emission reductions identified through the National Climate Change Process. As noted earlier, the Analysis and Modelling Group believes such emission reductions will not reduce greenhouse gas emissions from the industrial sector to six percent below 1990 levels by 2010.

Second, this section discusses what types of incentives would allow corporations to make more significant commitments to reduce greenhouse gas emissions. Where would these additional greenhouse gas emission reductions come from? The section will briefly examine three possibilities:

- industry investments in greenhouse gas emission reductions in other sectors (through the purchase of GHG offsets, GHG emission reduction credits or GHG emission permits);
- industry investments in the research, development, demonstration and commercialization of new technologies that could produce internal emission reductions; and
- industry initiatives to decrease life-cycle greenhouse gas emissions through actions related to improved product stewardship, enhanced product application and reduced indirect emissions.

While many different types of incentives can be offered as part of a covenant, all incentives are not created equal. In general, the more effective the incentive is at removing barriers to action to reduce greenhouse gas emissions, the more aggressive the emission reduction targets corporations could commit to under a covenant. This is a quid pro quo relationship: the stronger the incentive provided, the stronger the commitment required (and vice versa).

#### ***3.1 Incentives to Reduce Internal Greenhouse Gas Emissions with Existing Technologies***

##### **3.1.1 The Fundamental Importance of Incentives that Reduce Domestic Policy Uncertainty**

The biggest obstacle to enhanced corporate voluntary action to reduce greenhouse gas emissions is domestic policy uncertainty. If the policy rules of the emission reduction game are unclear, any decisions by corporations to invest internally in emission reductions that go beyond “business as usual” involve an added element of risk. Will voluntary action taken now be rewarded or penalized under a future domestic policy framework? Will assumptions about future government policy choices (will an emissions trading system be established, how will growth be treated, etc.) prove to be correct? Will government policy require similar actions from all industry or will there be differential treatment?

As a result, the single most important thing any government could do to facilitate the adoption of covenants by corporations would be to provide a clearly defined policy framework and an explicit definition of the links between the covenant and the application of other major policy instruments. Under this scenario, the most effective incentive governments could provide to parties to a covenant would be an exemption from all or part of other major policy instruments to address climate change.

For example, if governments were to put in place a tax on greenhouse gas emissions, parties to a covenant could be exempted from the tax or could pay a reduced rate. If an emissions trading system were established, on the other hand, government could exempt parties from a mandatory requirement to hold emission permits, or it could allow parties to sell emission reduction credits into the system. Once again, the stronger the incentive (e.g., exemption), the stronger the commitment required under a covenant.

There are precedents for this type of incentive in many European countries where covenants have been implemented. For example, parties to covenants to reduce greenhouse gas emissions in the United Kingdom

are charged a reduced rate under the climate change levy. In the Netherlands, government has made a commitment that it will impose no additional measures relevant to the commitments in the covenant on participating companies.

The provision of a clear policy framework will also make it easier to specify the non-compliance provisions of a covenant. After all, if a corporation fails to meet its obligations under a covenant, governments will need to use other tools to generate emissions reductions from that company. A clear policy framework would make it evident to all participants in covenants what the alternative would be. In the absence of such a policy framework, penalties for non-compliance are limited to loss or recapture of incentives and potentially the agreement itself along with the negative publicity that would be associated with these penalties.

The Canadian situation is complicated by the fact that Canada has not yet made a commitment to implement any major regulatory or economic instruments to address climate change. Until governments reduce uncertainty by making such policy decisions, any incentives tied to such instruments will be somewhat “speculative”. Nonetheless, it is clear that Canada will have to put in place a major economic instrument that puts a price on carbon if it is to make significant reductions in greenhouse gas emissions. As a result, even on a “speculative” basis, these incentives represent the strongest form of incentive governments can provide to produce voluntary commitments to reduce internal greenhouse gas emissions in Canada’s industry sector.

While covenants, in their design and application, can help inform future policy development, there is a clear need to define the major policy instruments that could or will be used to reduce greenhouse gas emissions in Canada. The relationship of covenants to such instruments needs to be defined and a timeframe established within which such a relationship would hold.

### **3.1.2 The Role of Incentives that Reduce the Cost of Emission Reducing Investments**

The work of the National Climate Change Process Industry Table clearly identified a number of specific actions that could be taken by industry with existing technologies to reduce internal greenhouse gas emissions below business as usual. Some of the major examples suggested by members of the New Directions Group project team include:

- implementation of new technologies (e.g., advanced monitoring, Point Breaker Feeders, Centre Work Prebaked Smelting) that would reduce greenhouse gas emissions from aluminum production;
- new energy efficiency technologies that would reduce greenhouse gas emissions from petroleum refineries; and
- new technologies that would modernize and reduce greenhouse gas emissions from metal smelters.

While the creation of domestic policy certainty is vitally important to moving these projects forward, there are other barriers to implementation that covenants can take steps to overcome. In most cases, including those cited above, the most significant barriers to implementation are economic. For example, the emission reducing investment may provide an inadequate rate of return when compared to company hurdle rates and/or other investment opportunities. It may also be the case that the initial capital costs required to make the investment are too costly to cover from either internal or external sources.

Providing incentives that reduce these economic barriers can help allow these investments to proceed. While the provision of such incentives alone are not likely to secure the same level of emission reductions as they would in a more clearly defined policy context, they can make a difference. Fortunately, governments have at their disposal a broad range of incentives that could potentially reduce the costs associated with such emission reducing investments. These include:

- improved capital cost allowance treatment;
- equity partnerships;
- investment tax credits;
- low-interest / no-interest loans;
- exemption from sales taxes; and
- formally recognized greenhouse gas emission reduction credits that could be sold to other emitters.

Provincial governments may also be able to offer regulatory flexibility and a range of incentives related to permitting and reporting that could reduce costs.

Different types of companies and different types of projects might require different types of incentives. For example, companies with projects where the initial capital investment is the major problem may be more interested in equity partnerships and low-interest loans. On the other hand, companies primarily concerned about improving the rate of return on a project might be most interested in improved capital cost allowance treatment or investment tax credits.

Moreover, different levels of incentives may be required at different times. Is the emission reduction project a retrofit of an existing facility or a design change at a facility to be constructed? In most cases, the retrofit will be more expensive. What is the expected remaining lifetime of the facility being considered for retrofit? Should a facility near the end of its life be treated in the same way as a facility that only opened five years ago?

In addition, different types of projects will use vastly different types of technologies to produce greenhouse gas emission reductions. As a result, it may well be difficult to design generic incentives in those cases where incentives have traditionally been defined on the basis of technologies (e.g., capital cost allowance). Such incentives may well need to be negotiated on a sector by sector or company by company basis. Indeed, the only incentives that could probably be easily applied on a generic basis would be performance based (eg., greenhouse gas emission reduction credits).

While such economic incentives can play a useful role (particularly on an interim basis until there is greater domestic policy certainty), there is no guarantee that such incentives will result in the implementation of an initiative-based covenant unless specific projects are included in the covenant. After all, while the economics of a project can be improved through such incentives, that project will still be required to compete with other investment opportunities within the company. Nonetheless, an initiative-based covenant should still require the company to live up to its commitments in return for the provision of incentives.

When designing such incentives, it is important that they not be perceived as a subsidy that could be subject to countervailing duties by Canada's trading partners.

### **3.2 *Incentives to Generate Additional Greenhouse Gas Emission Reductions***

While there are limits on the amount of greenhouse gas emission reductions industry can produce internally through the use of existing technologies, it may be possible for covenants to incent actions by industry that would produce emission reductions in other ways. This paper will only briefly explore these possibilities, but governments should consider their possible integration into covenants in an effort to obtain more significant greenhouse gas emissions reductions in Canada

#### **3.2.1 Providing Access to Greenhouse Gas Offsets, Emission Reduction Credits, or Permits**

Governments could provide parties to covenants with the ability to purchase a defined amount of greenhouse gas emission reductions outside their own operations and then apply them against the commitments made in the covenant. For industry to make such investments on any meaningful level, however, there will need to be a clear understanding of how such emission reductions will be treated in the event that a covenant is disbanded and alternative policy instruments are applied. In addition, there will have to be clear rules established with regard to the verification, certification and ownership of such emission reductions.

#### **3.2.2 Research, Development, Demonstration and Commercialization of New Technologies**

The industrial emission reductions identified by the Analysis and Modeling Group are not all the result of the application of existing technologies. In some cases, it has been assumed that new technologies will become available in the period to 2010 that will produce additional reductions in greenhouse gas emissions. Some examples of potential technologies that have been identified by the New Directions Group project team include:

- clean coal technologies that would reduce greenhouse gas emissions from coal-fired power stations; and
- a new cover gas that could replace the use of SF6 in some facilities.

Governments could provide parties to covenants with incentives related to research, development, demonstration and commercialization of new technologies in exchange for stronger emission reduction commitments. Once again, however, it will be difficult to provide generic incentives of this type unless they are performance based.

### **3.2.3 Producing Life-Cycle Greenhouse Gas Emission Reductions**

While there are limits on greenhouse gas emission reduction opportunities within Canada's existing industrial facilities, industry can make a much more significant contribution to reducing Canada's greenhouse gas emissions. To do so, however, requires consideration of the life-cycle of industrial products and the use of incentives and/or complementary policies that would encourage and facilitate the reduction of greenhouse gas emissions on a life-cycle basis. In reality, actions that reduce the greenhouse gas emissions of an industrial product over its life-cycle will have a much greater impact on Canada's greenhouse gas emissions than actions taken simply to reduce greenhouse gas emissions within individual industrial facilities.

Some of the examples of potential life-cycle emission reductions identified by New Directions Group project team members include:

- the use of waste heat to produce electricity (co-generation) can increase a company's direct greenhouse gas emissions, but could reduce the greenhouse gas emissions associated with electricity generation by a greater amount;
- the use of aluminum as a replacement input in some products (e.g., cars) can increase the direct greenhouse gas emissions of aluminum manufacturers, but would reduce the greenhouse gas emissions associated with automobile use by a greater amount; and
- the use of more recycled metal in the production of products would increase the greenhouse gas emissions associated with metal disposal, but would reduce the greenhouse gas emissions associated with metal mining by a greater amount.

Once again, the potential incentives / complementary policies associated with such emission reductions would need to be developed on a sector by sector or company by company basis. In most of these cases the fundamental barriers are policy barriers, not economic ones. For example:

- cogeneration is limited in many parts of Canada by the fact that many potential power producers cannot obtain access to the grid;
- the lack of a fully functioning market for greenhouse gas emission reductions is a barrier to investments that would increase the use of aluminum in vehicles and the lack of any clear rules with respect to ownership of greenhouse gas emission reductions exacerbates the situation; and
- the use of recycled metal is limited by policies that place restrictions on the transport and disposal of used metal products.

Policy barriers like these are preventing the more widespread adoption of products and technologies that would help to reduce Canada's greenhouse gas emissions. Accordingly, producing such emission reductions requires the application of incentives or complementary policies that are linked to the specific product or technology (or a performance standard that could be met by several products or technologies).

If Canada is to have any hope of producing the much more significant greenhouse gas emission reductions that will be required over the longer-term, governments must begin to recognize and understand the life-cycle implications of industrial products and processes. A good first step would be to ensure that life-cycle considerations are explicitly explored and assessed in covenants to reduce greenhouse gas emissions. In fact, covenants provide an opportunity for the creation of public-private partnerships to design and implement incentives and policies that can produce more significant greenhouse gas emission reductions through improved product stewardship, enhanced product application and reducing indirect emissions.

#### **4. Conclusion**

Based on the foregoing, the New Directions Group project team believes that the negotiation of climate change covenants offers a range of opportunities to Canada in meeting its greenhouse gas emissions reduction targets. For covenants to be credible and effective, though, they require policy and regulatory support and the provision of incentives commensurate with their performance expectations. In the absence of those drivers, covenants - individually and cumulatively - are unlikely to make a significant contribution to reducing greenhouse gas emissions.

Given the range of factors that affect the credibility and effectiveness of covenants for the management of GHG emissions, they need to be pursued cautiously. Experience with these instruments is relatively new and is limited. Thus, it is appropriate to consider covenants initially as experiments designed to engage leaders and to determine which approaches and incentives work under which circumstances. Tolerance for failure must be built in to the application of this policy instrument recognizing that covenants will improve over time as Canada gains experience with this approach to reducing its GHG emissions.

## Appendix I: Reference Documents

In addition to the New Direction Group's *Criteria and Principles for the Use of Voluntary or Non-regulatory Initiatives to Achieve Environmental Policy Objectives* (Appendix II), participants in this project were guided by the following documents:

- *Agreement on the Reduction of Greenhouse Gas Emissions Between the Ministry of Environment and the Aluminium Industry*, Norway Ministry of Environment (1997)
- *Climate Challenge Memorandum of Understanding*, US Department of Energy (April 1994)
- *Energy Efficiency Benchmarking Covenant*, Netherlands (1997)
- *Engagement volontaire de maîtrise des gaz à effet de serre et des consommations d'énergie couvrant la période de 1990 à 2000*, Soucrit par le Groupe Pechiney (1997)
- *Environmental Cooperative Agreement between Wisconsin Electric Power Company and Wisconsin Department of Natural Resources* (February, 2001)
- *Framework Elements of a Greenhouse Gas Emissions Reduction System to be Explored Through a Comparative Example Using the US Acid Rain Emissions Program* (undated draft)
- *Incentives-based Approach to GHG Reductions: Covenants Models*, Natural Resources Canada Environment Division (draft June 2000)
- *Memorandum of Understanding for Environmental Protection Through Action Under CCPA Responsible Care*, Canadian Chemical Producers Association and Governments of Canada, Ontario and Alberta (draft November 1999)
- *Negotiated Agreements - A Pragmatic Alternative to Environmental Management*, Confederation of European Paper Industries (December 2000)
- *Policy Framework on Environmental Performance Agreements*, Environment Canada (draft August 2000)
- *Second Generation MoU - Suggested Format*, Ontario Ministry of the Environment (draft October 2000)
- *Umbrella Climate Change Agreement for the Aluminium, Titanium and Magnesium Sector*, Secretary of State for the Environment, Transportation and the Regions, United Kingdom (2000)

This project commenced by contrasting these existing covenants, MOUs and frameworks with the requirements of the NDG's criteria and principles to identify common elements and progressive concepts. This comparison is available as a background document on the New Directions Group website ([www.newdirectionsgroup.org](http://www.newdirectionsgroup.org)).

## Appendix II: New Directions Group Criteria and Principles for the Use of Voluntary or Non-Regulatory Initiatives to Achieve Environmental Policy Objectives

### Executive Summary

New Directions Group (NDG) members wish to ensure the quality and credibility of voluntary or non-regulatory initiatives (VNRIs) employed instead of, or as a complement to, regulations to achieve environmental policy objectives. Recent years have seen an increase in the number of VNRIs but there is as yet no widespread agreement on how to develop these programs, their essential design features and the circumstances in which they should be applied. Existing programs are thus uneven in their rigour and quality. The NDG believes that to engender public trust in VNRIs they must be applied appropriately and designed according to a standard set of principles.

The NDG has brought together leaders from the business and environmental communities to identify those attributes of VNRIs that are essential to ensure their quality, effectiveness and credibility. This document presents a framework of criteria and principles that can provide guidance to governments, industry, nongovernmental organizations (NGOs) and others involved in the development and review of VNRIs.

#### Criteria for the Utilization of VNRIs to Achieve Environmental Policy Objectives

- A. *VNRIs should be positioned within a supportive public policy framework that includes appropriate legislative and regulatory tools.*
- B. *Interested and affected parties should agree that a VNRI is an appropriate, credible and effective method of achieving the desired environmental protection objective.*
- C. *There should be a reasonable expectation of sufficient participation in the VNRI over the long term to ensure its success in meeting its environmental protection objectives.*
- D. *All participants in the design and implementation of the VNRI must have clearly defined roles and responsibilities.*
- E. *Mechanisms should exist to provide all those involved in the development, implementation and monitoring of a VNRI with the capacity to fulfill their respective roles and responsibilities.*

#### Principles Governing the Design of VNRIs

##### *Credible and effective VNRIs:*

- 1) *are developed and implemented in a participatory manner that enables the interested and affected parties to contribute equitably;*
- 2) *are transparent in their design and operation;*
- 3) *are performance-based with specified goals, measurable objectives and milestones;*
- 4) *clearly specify the rewards for good performance and the consequences of not meeting performance objectives;*
- 5) *encourage flexibility and innovation in meeting specified goals and objectives;*
- 6) *have prescribed monitoring and reporting requirements, including timetables;*
- 7) *include mechanisms for verifying the performance of all participants; and*
- 8) *encourage continual improvement of both participants and the programs themselves.*

The complete version of this report can be downloaded from [www.newdirectionsgroup.org](http://www.newdirectionsgroup.org)