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Ontario's cap-and-trade system: Too fast, too furious?

By Geoff Zochodne

Ontario will eschew a two-year "lag period" that Quebec and California used for their cap-and-trade systems.

Ontario has a need for speed when it comes to combating climate change, which is why the province's cap-and-trade program will arrive in 2017 without the phase-in period for fossil fuels that both Quebec and California had.

The quick pace has raised concerns - but it's also crucial to the government hitting its emissions reduction targets.

This leaves plenty of details to be determined in a shorter period of time, including how the province's energy regulator will set natural gas rates that will be affected by the costs of the carbon pricing system.

The government likely will be distributing hundreds of millions of dollars in free carbon-burning allowances for big emitters as well, giving them a softer landing. These details (and much, much more) were included in the climate change bill, draft cap-and-trade regulation and 2016 budget that were published last week.

Under the regulation, the first compliance period for Ontario's cap-and-trade program would start on Jan. 1, 2017, less than a year away. By comparison, Quebec's first compliance period began on Jan. 1, 2013, and included around 80 big emitters. The opening phase in Quebec also kept out fuel distributors until the second compliance period that started last January, but this won't be the case in Ontario.

"There was sort of a two-year lag period there in [California and Quebec], but that won't happen here," says **Duncan Rotherham**, vice-president at ICF International, a professional services firm.

Ministry of Environment and Climate Change spokesperson **Lindsay Davidson** said in an email that the government's approach, "strikes the right balance between reducing greenhouse gas pollution, protecting consumers and fostering economic growth."

The climate change legislation, when it passes, will also enshrine greenhouse gas reduction targets in law. This is a big reason why the province is moving quickly on cap-and-trade: it must get 15 per cent below 1990 emissions levels by the end of 2020.

Keith Brooks, the clean economy program director at Environmental Defence, says the government should act fast, and that cap-and-trade should just be part of a "comprehensive suite of policies" to reduce GHG emissions, including changes like more energy-efficient building code changes.

"The concern on our end is that it's taken too long to get to this point," Brooks told *QP Briefing*. "I think most people saw the writing on the wall and knew that we were going to see a cap-and-trade system here."

But Ontario's deadline means there is a lot of work that still needs to be done in a short amount of time.

The Ontario Energy Board, which sets natural gas rates, isn't entirely sure yet how it will account for cap-and-trade. The regulator is currently reviewing the legislation and regulation that's been published, and is using the available information to craft a "regulatory framework" for natural gas distributors.

Brian Hewson, a senior manager of strategic policy at the OEB, said the regulator is responsible for assessing the activities natural gas distributors must take to comply with cap-and-trade, how much those actions will cost, and determining how to establish a way for utilities to recover their costs.

Hewson said the OEB will start public consultations soon to gather feedback.

The 2016 budget predicted gas prices will go up 4.3 cents per litre and natural gas bills by about $5 a month under cap-and-trade; private-sector forecasts were a bit higher[1]. Rotherham says the OEB now needs to provide "pretty precise guidance" on how natural gas distributors can pass along the costs of cap-and-trade to the customers, who will need to be mentally prepared for the price hikes.

Tyson Dyck, a partner at Torys LLP and a member of the law firm's environmental and energy groups, says a similar issue in California took months to sort out.

"I think generally there's a concern that this program is moving very quickly," Dyck told *QP Briefing*. "It's a very complex system, and the quicker you move, the more likely there is to be some unexpected outcomes."

Torys has clients that will be participating in the cap-and-trade program, which Dyck says is fairly similar to the California and Quebec models. One difference, however, is that natural gas distributors received some free emissions allowances in California, but won't in Ontario. Instead, the province's two largest gas companies, Enbridge Gas Distribution Inc. and Union Gas Ltd., will be the two largest purchasers of carbon credits under cap-and-trade.

But there will be a fair number of free carbon credits allocated elsewhere, as the government tries to soften the blow and avoid "carbon leakage," the term for companies ducking out for jurisdictions with lesser environmental rules. This has been a sensitive subject at Queen's Park, with the opposition accusing the government of giving businesses a free ride.

A recent research paper[2] from the University of Western Ontario's Lawrence National Centre for Policy and Management predicted free allocations in Ontario "are expected to represent roughly 25 percent of the total allowances in 2017, consistent with the amount of free allowances in the Quebec system." That research was supported by Ontario's Ministry of Environment and Climate Change.

Among the details released about the cap-and-trade program were predicted proceeds from selling carbon credits, such as $1.9 billion in 2017. The budget also said the emissions cap will be ratcheted down at a rate of approximately 4.17 per cent each year, while the regulation stated that 142.3 million carbon credits will be created in the first year of the system.

If 25 per cent of the initial allowances are given away free, and the allowances are priced at about $18 each (as they're expected to be in 2017), Ontario would be giving away approximately 35.6 million allowances next year, which would be worth more than $640 million.

The government is planning to phase out the "transitional allowances" in the years that will follow.

"The value of transitional allowances will be subject to the final regulation and to future carbon market prices, therefore it would be premature to speak to their value," said Davidson.

According to the draft regulation, applications for free credits are due by Sept. 1. The allowances will be deposited into emitters' accounts by Jan. 15 of next year.

Sussex Strategy Group's **Robyn Gray** says Ontario is offering assistance "to acknowledge that this is moving fairly quickly and industry needs some time to make that transition."

But Gray says the companies receiving free carbon credits will still have to pay increased fuel and natural gas costs because of cap-and-trade.

"So no one's really getting a free ride out of this."

To contact the reporter on this story:
gzochodne@qpbriefing.com
416-212-5913
Twitter: @geoffzochodne[3]

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