



Cap and Trade in Ontario - Avoiding the EU's Pitfalls

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The [European Union Emission Trading System](#) (EU ETS) is the world's largest cap and trade system, covering all countries in the European Union. It is also one of the world's most troubled, as it has largely failed to live up to the expectations of emissions reductions that it was initially touted to bring about. This blog post analyzes the impediments to the success of EU ETS, and then provides a forward-looking analysis of the applicability of those impediments to the proposed Ontario cap and trade program.

A Snapshot of the EU ETS: Program Design and Implementation Problems

The EU ETS was initially implemented in phases, with a pilot Phase I from 2005-2007, followed by a Kyoto Phase II from 2008-2012 and a number of subsequent phases. The initial system covered approximately half of EU CO₂ emissions across 31 EU countries. The system was limited to certain sectors, as many sectors, such as transportation, were exempted because of concerns about competitiveness with non-participating jurisdictions.

The initial process for setting caps on emissions was decentralized by member states, which created strong incentives for individual states to propose high cap limits that favored emission intensive industries in their jurisdiction. This, combined with weak emissions data, led to an overly generous allocation of allowances relative to emissions when the market opened in 2005.

While the price of allowances was initially high, the oversupply in the market quickly depressed demand and prices, causing the price of a single allowance to drop from €30 in 2005 to effectively €0 by 2007. This price drop was exacerbated by the inability to hold allowances over multiple phases in the EU ETS, which guaranteed that the price of an allowance earned in any particular phase would go to zero at the end of that phase. As further aggravation on a strained system, there was some suggestion that companies were passing on the 'costs' of allowances to the end consumer even where they had been given free allowances by the government.

The EU responded in subsequent phases with a planned tightening and centralization of the cap, an expanded scope on covered industries, and an ability to bank allowances between phases. While this initially increased allowance prices to over €20, prices have continued to bottom since that point. The current price varies between €0 and €10. This is in part due to a combination of a weakened post-recession EU economy and the increased use of offsets under the Clean Development Mechanism, which grants allowances for offset projects in developing countries.

Looking Forward: Lessons for Ontario

In creating a cap and trade program, there are a number of lessons the Ontario government can apply from the mixed successes of the EU ETS. Each of the key lessons are listed below.

Addressing Over-Allocation

First, it is crucial to avoid over-allocation of allowances in the inception of a cap and trade program; as such over-allocation can be banked by companies to keep the price of allowances low for years to come. Avoiding such over-allocation requires that the Ontario government has good data on emissions in Ontario on which to base an initial cap. Over the past several years, the Ontario government has been collecting emissions data from companies that release more than 10,000 tonnes of GHG a year or are involved in particular industries. This data has led the Ontario government to set an initial cap of 142 megatonnes of GHG, which is presumably equivalent to what the government believes actual emissions will be in 2017. In other words, the Ontario government is anticipating that there will be no over-allocation of emission allowances. Only time will tell if this anticipation proves true.

Banking Allowances

Second, the Ontario government should ensure that companies can bank allowances over multiple periods in the program. While such a model can exacerbate the negative effects of allowance over-allocation, it is necessary to avoid an external collapse of allowance prices at the end of a given period. Such a model is currently in place in the regulations of the Ontario government's cap and trade program, where one may submit allowances with a vintage year that is in the year of the compliance period or an earlier year.

Limiting Free or Exempt Allowances

Third, while granting free allowances to certain sectors can be politically palatable, it is a risky way to deal with issues of competitiveness. When allocations are not linked to production, they cannot affect marginal costs, which eliminates incentives to reduce or relocate emissions for entire sectors. The government may be better served by including these sectors in the cap and trade program in some manner that maintains the incentives applied to other companies, but does so in a more gradual fashion. Anecdotally, we believe many industries will be allocated free allowances towards the start of the cap and trade program in order to ease the transition to a low-carbon economy. These free allowances will somewhat dis-incentivize the need to address climate change in the short run.

Robust Offset Rules

Fourth, offset policies must be properly monitored and maintained. The increasing popularity of the Clean Development Mechanism lies in its allowing companies to apply for offsets when they reduce emissions in foreign jurisdictions. These jurisdictions, which are often third-world countries, lack the regulatory and reporting structures to adequately confirm these emission reductions. Unsurprisingly, the Clean Development Mechanism has been rocked by allegations of fraud by participating companies. The Ontario government should ensure that their offset program is heavily monitored and controlled, especially where the applicable offset reduction takes place in a foreign jurisdiction. The Ontario government has not yet released an offset regimen for its cap and trade program. However, it will likely take guidance from Quebec and California. These programs both have strong oversight requirements to ensure that actual offset reductions are taking place. The Ontario government will likely adopt similar requirements.

Coordinating Complimentary Policies

Lastly, some authors have suggested that the issues with the EU ETS are caused by complementary EU environmental policies related to the cap and trade program. These policies, in the view of their critics, relocate emissions, increase emissions reduction costs, and, in the absence of a price floor, depress allowance prices. This is a complex issue that would require further analysis. That said, there are a number of things the Ontario government can do to prevent this potential issue. First, it has installed a

price floor on allowance auctions, which should ensure that the price of allowances is not driven to zero. Second, it can confirm that complementary policies are addressing emissions not covered by the cap and trade program, thereby ensuring that the programs are fully complementary and not serving as impediments to the cap and trade program, or vice versa.

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