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NEXT STEPS FOR ONTARIO CAP AND TRADE PARTICIPANTS

By John McCloy for **Canadian Clean Energy Conferences**

In the run-up to the 2nd Annual Ontario Cap and Trade Forum on April 18-19 at the Beanfield Centre in Toronto, Canadian Clean Energy Conferences is producing a series of articles featuring the key topics concerning regulated entities under Ontario's program. Visit the news section of the Forum's website to read other stories and sign-up to receive news. **http://capandtrade.canadianclean.com**

CANADIAN CLEAN Energy Conferences

NEXT STEPS FOR ONTARIO CAP AND TRADE PARTICIPANTS

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Participants in the Ontario Cap and Trade program are facing increasingly significant challenges. Potential political change in Ontario has called the entire future of the program into question, and a lack of regulatory details, post-2020, has left many participants unable to form long-term business plans.

Despite this uncertainty, participating businesses maintain a positive outlook on the program as a whole, the advantages brought about by linkage with the Western Climate Initiative (WCI), and a growing secondary market in carbon allowances.

"A key concern for Ontario participants is the upcoming election, and the stated promise of the opposition party to dissolve the cap and trade program," comments Douglas Russell, Climate Change and Energy Expert at MDF Associates. "Insofar as the system itself, it seems to be functioning well. The linking regulations are now out, and they seem to be sensible enough. We also know what the caps will be, within the program itself, up until 2020. So there have been a number of positive steps."

Key Participant Concerns

Fundamental to the current atmosphere of uncertainty surrounding the future of Ontario's cap and trade program, is the upcoming 2018 election. As part of the Progressive Conservative's (PC) election platform, party leader Patrick Brown has promised to end the Liberals' cap-and-trade program by July 1, 2019, and to withdraw from the WCI. The PC's Party's offered alternative is to opt into federal carbon pricing benchmarks and return the proceeds of the program to taxpayers.

"One the largest concerns is political uncertainty," notes Robert Cumming, Director of Environment at Lafarge Canada. "If you know the program is going to be around for 30 years, or that it might be canceled in three years, it makes a big difference in terms of how you're going to act as a market participant. It's a big question mark for the efficiency of the whole cap and trade system."

In addition to dealing with the cap and trade program's uncertain future, participants also face the challenge of negotiating an increasingly complex regulatory framework. Regulatory difficulties are compounded by the complexities of combining long-term financial, engineering and industrial production planning to ensure compliance.

"Our top concern is dealing with the cumulative impact of the regulatory landscape in Ontario," comments Michael Kandravy, Director of Fuels Quality & Regulatory Affairs for Suncor. "We have to deal with stricter air emissions and emission standards for sulfur dioxide, volatile organic compounds, and benzene. These are primary initiatives for us, relative to Greenhouse Gas (GHG) abatement because those are "must do" items, we don't have the optionality of buying emission credits or buying allowances on the marketplace. So our major concern is the cumulative policy burden."

Lafarge's Cumming agrees that constructing a compliance team from disconnected internal departments is one of the program's more understated difficulties. "The marriage of the two systems, financial and technical, is a challenge, organizationally. We have our environmental team who understand the technical side and our finance team

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who are familiar with market aspects and here the two are coming together in a new way. Making sure that partnership works smoothly can be difficult."

In the opinion of Duncan Rotherham, Vice President of ICF, compliance with the program's declining cap remains a leading concern for large industrial emitters. "You've got more significant targets, and you've got less and less allowance because the caps are coming down," he points. "This is a significant concern for the large industrials today. They don't have a big liability now, but if they don't create abatement in the economy with the proceeds of the sale of allowances now, that's going to impact the future trajectory of emissions, and they're going to have to pay a lot more later."

An Uncertain Future

With the 2019 Ontario election putting the cap and trade program's future into question, participants are finding it increasingly difficult to form long-term plans, points out Michael Berends, Head of Carbon Sales at ClearBlue Markets. "The big discussion when it comes to cap and trade in Ontario is, will there even be a cap and trade program post-2020?" he reports. "Especially in light of recent press releases that suggest some of the political candidates would dissolve the program by 2019. At the moment there are a lot of overlapping areas of uncertainty, and this makes it difficult for participants to understand what the future holds in regards carbon pricing."

ICF's Rotherham goes further in suggesting that the differing views of the three leading parties in the Ontario Election, and their desire for swift change after the election, will make it extremely challenging for participants to produce any cohesive roadmap that moves beyond the election. "It's going to be tough for industry to navigate a compliance strategy that accommodates all the three parties' different takes on carbon pricing and it's pretty clear that the opposition parties want to move pretty quickly after the election to either keep the status quo, or change, rather quickly, the way the system currently works."

The PC Party's desire to institute the federal carbon pricing benchmark is also a source of some concern for current cap and trade participants. "There remains a real risk in the global marketplace that, if you raise the cost to produce manufactured goods in one area, then the manufacturer could simply move somewhere else, making the whole endeavor self-defeating," points out Lafarge's Cumming. "The current cap and trade system takes that into account in a very clever way, and it will be interesting to see, if the program does change, how that same mechanism will be replaced under a new government."

Greater Regulatory Transparency

While the outcome of the 2018 election remains a question mark, current cap and trade participants are increasingly calling for greater clarity on post-2020 regulatory details. "If the cap and trade system remains in place, the questions being asked by entities who receive allowances will be focused on the regulatory details," points out Berends. "What will the benchmark be, what the reallocation will be and how will those be calculated. Those are really important questions when it comes to cap and trade."

Increased transparency on the details of the program, post-2020, would allow participants to, at least, formulate plans based on the potential continuation of the program. However, as Russell notes, there are still fundamental questions about future regulation that have yet to be answered. "There are two major factors involved; firstly, are they going to continue to have an assistance factor in their formulas equal to one, allowing everybody in the industry free allowances, or are they going to start to wean people off of those?," he asks. "The second level of uncertainty relates to the application of the cap decline. Does it apply to process emissions, as there is a number of large industries in Ontario who produce process emissions or will it just be based on combustion emissions? Those are two critical issues that are yet to be decided at this point."

The release of crucial information on the structure of the post-2020 cap and trade program would allow participants a limited ability to plan for the future, but, as Cumming clarifies, the mix of regulatory and political uncertainty makes long-term planning all but impossible. "We are unable to think post-2020, which is a problem because, while it seems a long way off, in business terms it's right around the corner. Until we know what the program looks like after 2020, longer-term investment decisions become difficult questions for us, and we have to handle them very carefully."

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The Benefits of WCI Linkage

While an uncertain political and regulatory situation may be clouding the cap and trade program's future, the benefits of linkage to the WCI are becoming increasingly apparent. "From the point of view of a functioning market, the benefits are very clear," opines MDF's Russell. "The WCI linkage allows the market to do what it's supposed to do; deliver the least cost reduction and provide liquidity. There are criticisms that have been leveled at the system around it moving money into different jurisdictions, but that's a political issue as opposed to a mechanical one, mechanically it works fine."

There are, however, continued concerns around Ontario's place within the market, with Ontario-based businesses anxious to make sure regulation is unilaterally fair, as opposed to empowering one jurisdiction over another. "One of the concerns about the market is making sure that Ontario is not put at a disadvantage because of rules that are made for California or Quebec," notes Berends. "It's vital that rules are fair across the board and it will be important to engage with the provincial governments to ensure that companies are not put at a disadvantage because of rules that may only be relevant in California or Quebec. But overall, we see the larger market as a positive step forward."

One of the main benefits of the WCI linkage is the propensity for carbon allowance prices to be lower than if Ontario attempted to meet its 2020/2030 targets in a vacuum. But this lowered cost of allowances also comes with potential drawbacks, as Rotherham points out."The quid pro quo associated with low price is that Ontario will be buying allowances from California because Quebec is also going to be short," he reports. "Essentially they'll be buying the right to emit CO_2 in Ontario from California, and therefore there'll be a transfer of wealth from Ontario to California. That transfer of wealth will be reasonably material and will be in the hundreds of millions of dollars of between now and 2020."

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Secondary Market Issues

The growth of the secondary market in carbon allowances has been slow in Ontario. MDF's Russell suggests that continued concern over achieving compliance may be at the root of this sluggish development. "A lot of companies are still getting used to it, and most are holding onto their allowances, keeping them for compliance purposes. I am not sure that there has been a tremendous amount of trading of allowances back and forth between entities in the secondary market."

ClearBlue Markets' Berends suggests that the linkage to the WCI may be the factor that revives interest in the secondary market and that expectation of the linkage may have contributed to its slower growth. "In Ontario, the secondary market development has been slow and defiantly slower than was expected. We believe that many entities were expecting the linkage, through the WCI, with California. California has a much larger and stronger secondary market, with that in mind, we suspect that many companies were waiting for that linkage and were potentially already acting in that Californian market."

The Next Steps for Cap and Trade

While the 2018 Ontario election will continue to represent a source of uncertainty for cap and trade participants in the short term, increased clarity on post-2020 regulation remains a vital next step in allowing those participants to plan for the future. "There's an election in Ontario in six or seven months; between now and then, the government

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As Berend's points out, this greater transparency in regulatory detail also extends to the WCI linkage, where changes in regulation for other jurisdictions will impact Ontario. "Finalising the post-2020 regulation is an essential next step for cap and trade, especially in Ontario. There are also still key decisions to be mode in California relating to the price ceiling, the pricing data points and details on the offset pools. Once those details are resolved, the question becomes whether Ontario will follow California's direction on these details or will they make their own road and if they do what effect will that have."

While there are, undoubtedly, still essential questions to be answered about the future of the program, as Cumming points out, its benefits, to both industry and the environment are just as clear. "It's vital that obstacles to low-carbon implementation are removed. Government procurement should include a carbon life-cycle consideration. There should be more incentives for companies, builders, architects, and designers to look at innovative technologies and low-carbon methods of building homes. We, as a society, need to figure out a way to partner together to speed up the rate of adopting lower carbon solutions."