Intelligence MEMOS

From: Werner Antweiler

To: Ministers of Environment in Quebec and Ontario

Date: November 3, 2016

Re: **Trouble looming for Quebec's cap-and-trade system should make Ontario think twice before joining in**

In 2015 Quebec joined California's carbon cap-and-trade system and committed to gradually reduce its emissions to about 55 Megatonnes in 2020. As Ontario is about to join Quebec's cap-and-trade system, Quebec's system faces serious challenges as the federal government will introduce a minimum carbon price of $10/tonne in 2018, rising to $50/tonne in 2022. Four challenges lie ahead:

Challenge #1: Cap-and-trade will effectively turn into a carbon tax

Quebec's cap-and-trade system puts a ceiling on carbon emissions, while the federal carbon policy puts a floor on carbon prices. Quebec's cap-and-trade system already uses an auction reserve price that acts as a price floor, which in August was set at $16.45/tonne. This was also the settlement price of the permit auction—the price floor was binding rather than the emission cap. If the federal price floor climbs quicker than Quebec's emission cap declines, there would be no trading taking place and Quebec's cap-and trade system turns effectively into a carbon tax.

Challenge #2: Quebec's carbon price is less certain due to exchange rate fluctuations

California's carbon emissions are much larger than Quebec's. Therefore, the carbon price in the joint system is set more in California than in Quebec and set in US dollars. The Canadian Dollar, which lately has dropped a lot in value against the US Dollar, has helped lift Quebec's carbon price from $12.82 to $16.45. The loonie's volatility makes Quebec's minimum carbon price fluctuate.

Challenge #3: California, for better or worse

Quebec firms benefit from buying permits affordably from Californian firms, while Californian prices remain low due to soft reduction targets. Without California's generous supply of permits, Quebec firms would surely face higher prices to meet Quebec's own targets. Quebec remains vulnerable to California leaving the joint trading system, which is a distinct possibility after the current legal mandate expires in 2020.

Challenge #4: Quebec's Green Fund promises elusive double dividends

Unlike B.C.'s carbon tax, Quebec's cap-and-trade system is not revenue neutral. Revenue from auctions go into the province's Green Fund that is meant to deliver "double dividend" reductions in CO_2 by investing in such things as public transit. But subsidies have a poor track record of delivering results, while politicians may be tempted to use such funds opportunistically for showcase projects. While carbon prices work through markets, green funds use governments to pick their preferred pet projects and technologies. B.C's approach to return carbon revenue through tax cuts is more equitable and offsets other distortions but Ontario announced that it will follow Quebec's lead.

A revenue-neutral carbon tax like B.C.'s is a better option that will avoid these pitfalls, as is Alberta's new hybrid system that combines a carbon tax with smart allowances to energy-intensive trade-exposed industries.

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This Intelligence Memo is based on Trouble looming for Quebec's emission permit system.