



Submission of Comment on Ontario's Cap and Trade Program Design

Prepared by:

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Prepared for:

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Climate Change and Environmental Policy Division

Statement of Support

The Ecofiscal Commission firmly supports Ontario's advancement of a cap-and-trade program as a means to price carbon and reduce greenhouse gas emissions in an effective and cost-effective manner. Further, we were pleased to note a number of smart and practical approaches to policy design outlined in the November 16th options document:

- We support Ontario's intended direction to link immediately with Quebec's market, adopting a proven carbon pricing architecture.
- We applaud the intention to broadly cover greenhouse gas emissions
- We strongly agree with the proposed option to reduce Ontario's cap annually in order to achieve the province's 2020 emissions targets.

The recommendations that follow focus on one key opportunity for improved program design, notably the allocation of free allowances in relation to carbon leakage mitigation. These recommendations are grounded in and supported by a recent research paper by Ecofiscal commissioners, *Provincial Carbon Pricing and Competitiveness Pressures*. Please find a copy of that paper attached to this submission for your reference.

Recommendations for Targeted, Temporary, and Transparent Free Allowance Allocation

It is worthwhile to consider competitiveness concerns and carbon leakage in the design of any carbon pricing policy, as addressing these issues is important for both economic and environmental policy performance. As Ontario continues to develop its cap and trade program design, we suggest that the government consider the following recommendations in its approach to addressing carbon leakage with free permit allocations:

- (1) An explicit policy objective of Ontario's cap and trade program design should be to address genuine business competitiveness concerns defined specifically by the risk of leakage.
- (2) The sole purpose of free allowance allocation should be to achieve the above stated objective.
- (3) Free allowance allocation should be narrowly targeted to industries and firms that meet clearly defined thresholds for genuine competitiveness risks.
- (4) The thresholds that define level of risk should be grounded in objective data, and the process by which firms are evaluated in terms of their risk should be public and transparent.
- (5) All free allowance allocations should be time-limited, with a clearly articulated end date.
- (6) Base allocations to firms should be determined by output benchmarks.



Rationale for Recommendations

- ***The best use of free allowances is to address leakage, as opposed to a more broadly defined economic transition.***

Within a cap-and-trade system, allowances have inherent value. By issuing allowances for free, the government forgoes the opportunity to generate revenue that could be meaningfully reinvested into Ontario's economy for broader benefit. This makes policy less cost-effective. Therefore, a well-designed carbon pricing policy will strictly limit the amount of free allowances issued.

Distributing allowances for free decreases the average cost of carbon. While free allowances do *not* affect the marginal cost — and thus the incentives to reduce emissions in existing facilities — they do affect incentives around building new facilities and the emissions associated with them.

It is sensible to use free allowances to address the competitiveness challenges faced by the most emissions intensive and trade exposed industries in order to reduce the risk of carbon leakage. This is fundamental to successfully lowering absolute carbon emissions and supporting business competitiveness. While it is fair to acknowledge that any number of businesses would benefit from a gradual carbon pricing transition period, this should not necessitate the broad distribution of free allowances.

Using free allowances to provide transitional support to *all* industrial emitters should not be the main objective of allocation. In many ways Ontario has already laid the groundwork for that transition by setting the 2017 cap at a business-as-usual emissions level and decreasing it gradually over the three years that follow. Given the costs of free allocations discussed above, they should be limited to emitters facing carbon competitiveness pressures resulting from higher carbon prices in Ontario relative to other jurisdictions.

- ***A small number of Ontario industries, producing less than 2% of the province's GDP, will face genuine competitiveness concerns.***

Ecofiscal analysis concludes that with a \$30/tonne price on carbon, a very small share of Ontario's economy (2%) will be exposed to genuine competitiveness concerns that could result in leakage. With a starting price closer to \$15/tonne, that share of exposure is likely even smaller. Though our research is not conclusive in identifying with specificity which industries and firms face genuine pressures, our results do offer a meaningful picture of the extent to which Ontario industries are both emissions intensive and trade exposed. Therefore it is fair to conclude that realistically addressing the issue of leakage under Ontario's cap and trade policy requires only the narrow targeting of free allowances.

- ***Risk thresholds should be defined and applied thoughtfully and transparently.***

As noted above, and in the paper attached, significantly more public data and transparent analysis is required to accurately determine the leakage risk levels of Ontario firms. Undertaking that work is critical both in terms of good policy design as well as establishing public trust in the new cap and trade program.

One major consideration is how to define levels of risk. The options document suggests that Ontario may consider adopting California's approach, which, like Ecofiscal's analysis, takes both emissions intensity and trade exposure into account. However, it is important to consider that California's tool puts greater weight on emissions intensity than it does on trade exposure. Furthermore, California's threshold for emission-intensity is fairly low. Under California's system, if a sector has an emissions intensity of at least 100 tonnes of CO₂e per million dollars of value added, it is considered *at least* medium risk for leakage—irrespective of trade exposure—and therefore eligible for free allowances. That is roughly equivalent to carbon costs of 0.3% of GDP, or well below the 5% used in



Ecofiscal's analysis. The result is that California's approach results in less targeted free allocations, decreasing the cost-effectiveness of policy.

Some degree of arbitrariness exists in any threshold used to define those emitters exposed to carbon competitiveness pressures. To avoid perceptions of subjectivity and avoid undermining the credibility of the cap-and-trade system as a whole, Ontario should use clear, transparent, data-driven approaches to identify which emitters will receive targeted support in the form of free allocations.

- ***Competitiveness pressures will decline over time; so should support measures.***

As more jurisdictions implement carbon pricing and as the market works to drive innovations in technology and processes that lower carbon emissions, competitiveness pressures will ramp down. Support measures such as free allowances should be designed to anticipate this shift and thus be explicitly temporary in nature. Furthermore, establishing a clear end date for support creates a strong incentive for emitters to expedite low carbon solutions.

- ***Output-based allowance allocations are best-suited to address leakage concerns.***

Not all approaches to free allocations have the same effect. Distributing free allocations based on historical emissions or energy use (as discussed in the options document) will be much less effective in addressing competitiveness concerns. Allocating permits based on emissions in the past does not alter current and future incentives for firms to close or shrink facilities based on competitiveness pressures. Similarly, allocating permits based on current energy use decreases incentives for energy efficiency under the carbon price.

If addressing leakage is the objective of free allocations—as we have argued it should be—then providing allocations based on an output benchmark is a better approach. This approach effectively subsidizes output in targeted, vulnerable sectors. It pairs an incentive from the carbon price for facilities to improve their emissions performance with an incentive from the output subsidy to maintain production levels (i.e., not to relocate production to jurisdictions with less stringent carbon policy).

In Conclusion

We thank the Ministry for its consideration of the recommendations outlined in this submission and reiterate our support of the province's efforts to thoughtfully, transparently and inclusively refine the details of its cap and trade program. We stand by ready and willing to further discuss the content of this submission and the supporting research, should that be of value to the Ministry.

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