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CARBON MARKET: ARE YOU READY TO TAKE ADVANTAGE OF IT?

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AS OF JANUARY 1, 2013, QUEBEC AND CALIFORNIA WILL EMERGE AS THE FIRST TWO WESTERN CLIMATE INITIATIVE (WCI) PARTNERS TO CREATE A CARBON MARKET THAT IMPOSES BINDING TARGETS ON BUSINESSES IDENTIFIED AS MAJOR GREENHOUSE GAS (GHG) EMITTERS. THESE NEW REGULATIONS[1] ARE RAISING SOME CONCERNS AMONG THE REGULATED INDUSTRIES BUT THE GOVERNMENT IS TAKING THE GAMBLE THAT BUSINESSES THAT UNDERTAKE THE NECESSARY ADJUSTMENTS WILL PROFIT FROM THIS NEW EMISSIONS TRADING SYSTEM WHILE REDUCING THEIR ENVIRONMENTAL FOOTPRINT.

The implementation of the cap-and-trade program falls within Quebec's goal to reduce its GHG emissions by 20% against 1990 levels[2] by 2020. Aware that GHG emissions threaten climate stability, WCI member provinces and states[3] have been working together since 2007 to implement a common tool for regulating polluting emissions[4].

The solution proposed by the WCI partners benefits both the environment and the economy since it uses the market to promote the implementation of cleaner and more sustainable industrial technologies[5]. Unlike traditional regulatory systems in which regulated entities must comply strictly with certain emission limits or pay fees commensurate with their consumption, the carbon market provides a financial incentive to outperform established standards. However, day-to-day management of the system will be significantly more complex and costly for regulated emitters in terms of human resources. Managing an emission allowance portfolio will require that the businesses concerned retain the services of specialized professionals.

[1] See *Regulation respecting a cap-and-trade system for greenhouse gas emission allowances* c. Q-2, r. 46.1 and new sections 46.1 to 46.18 of the *Environment Quality Act*.

[2] Ministère du Développement durable, de l'Environnement et des Parcs, press release, "GHG Emissions Reduction Target" (November 23, 2009): [http://www.mddep.gouv.qc.ca/communiques_en/2009/c20091123-cibleges.htm].

[3] California, British Columbia, Manitoba, Ontario and Quebec to date have maintained their commitments, while Arizona, Montana, New Mexico, Oregon, Utah and Washington all announced their decision to withdraw from the WCI since the outline agreement was signed.

[4] As provided in section 3 (10) of the Regulation cited above, the GHGs currently covered by the program are carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_2O), hydrofluorocarbons (HFCs), perfluorocarbons (PFCs), sulphur hexafluoride (SF_6) and nitrogen trifluoride (NF_3).

[5] For a more detailed description of the WCI Cap-and-Trade program, see *Design for the WCI Regional Program* (July 2010) and *Design Recommendations for the WCI Regional Cap-and-Trade Program* (September 23, 2008), documents published by the Western Climate Initiative: [http://www.westernclimateinitiative.org/].

HOW WILL THE SYSTEM WORK?

The carbon market operates broadly on the same model as any other exchange: it is a market where investors buy and sell securities and, in turn, fix the price thereof. Each unit traded on the carbon market represents the equivalent of one metric ton of carbon dioxide (CO_2e). The number of emission units available on the market will reflect the GHG emission cap fixed by decree. The cap will be gradually lowered on a linear scale in the years leading up to 2020, that is until reduction targets for polluting emissions are achieved. A mutual recognition agreement between Quebec and California will allow for the trading of emission allowances among regulated entities across both jurisdictions. Similar agreements will then be entered into with other WCI participating jurisdictions upon joining the market.

In early 2013, industries identified as major GHG emitters will be allocated a certain number of free emission units. These units will be allocated on the basis of the GHG emission reduction threshold applicable to the relevant industries. At the end of the compliance period[6], emitters that have managed to reduce their emissions below the regulatory threshold may then sell excess units in the form of "carbon credits" and thus recoup at least a portion of the investment initially required to comply with their reduction thresholds. Conversely, emitters that are unable to achieve their regulatory quotas will be required to cover their outstanding GHG emissions by purchasing emission allowances on the carbon market. Businesses that fail to cover their deficit balances will be liable to fines of up to $250,000[7].

The objective underlying the relative flexibility for achieving reduction thresholds is to allow regulated businesses to plan their investments by enabling them to choose the most opportune time for modernizing their equipment and optimizing their processes. In the interim, the option of buying emission allowances on the market will remain available.

In an effort to treat fairly those industries that have already embarked on "permanent and irreversible" initiatives to reduce their environmental footprint, the new regulatory framework also provides credits to GHG emitters that voluntarily reduced their emissions between January 1, 2008 and December 31, 2011[8]. It must be noted, however, that regulated emitters who qualify for early-reduction credits must file an application before December 31, 2012.

WHO WILL BE REGULATED?

The "major emitters" targeted by the cap-and-trade system implemented as of January 1, 2013 are essentially commercial operators in the industrial and electrical power sectors whose annual GHG emissions equal or exceed 25,000 tons of CO_2e[9]. In turn, the Government of Quebec estimates that approximately 75 emitters will be covered by the program in its first year of implementation[10]. These regulated emitters include refineries, aluminum plants, paper manufacturers, cement plants, and pellet plants.

As of January 1, 2015 (the beginning of the second compliance period), that number will increase when business operators who distribute or import motor or other fuels in Quebec and whose annual GHG emission thresholds exceed 25,000 tons of CO_2e will also be subject to the system. The transportation and building sectors, which are responsible for a major part of the polluting emissions, will thus be regulated as of that date.

[6] The system will have three compliance periods. Because of legal problems in California that delayed the coming into force of the cap-and-trade system, exceptionally the term of the first compliance period will be two years. It will begin on January 1, 2013 and end on December 31, 2014. The other two compliance periods will be for three years each.

[7] Section 73 of the Regulation cited above.

[8] Sections 65 to 70 of the Regulation cited above.

[9] Section 2 of the Regulation cited above.

[10] Ministère du Développement durable, de l'Environnement et des Parcs, "The Quebec Cap and Trade System for Greenhouse Gas Emissions Allowances" (consulted July 31, 2012): [http://www.mddep.gouv.qc.ca/changements/carbone/Systeme-plafonnement-droits-GES-en.htm].

WHAT ARE THE RISKS?

While no one could fault Quebec for demonstrating initiative in fighting climate change, certain stakeholders in Quebec's business community are concerned about the risks of committing to such a system with so few partners[11]. Except for California, all other US signatories of the WCI outline agreement, namely Arizona, Montana, New Mexico, Oregon, Utah, and Washington State, have since withdrawn. Furthermore, the other Canadian provinces that are WCI partners – British Columbia, Manitoba and Ontario – have yet to implement the regulations required for their participation in the system[12].

According to the Conseil du patronat du Quebec (CPQ) and the Fédération des chambres de commerce du Quebec (FCCQ), implementing a cap-and-trade program with California as sole partner could adversely affect the short-term competitiveness of Quebec-based businesses against their competitors in jurisdictions not subject to the same regulatory constraints[13]. Given the current economic context, it is particularly important to gradually implement the cap-and-trade system so that Quebec's economic competitiveness is not undermined in relation to its competitors, particularly those based in jurisdictions, such as developing countries, whose environmental regulations are less stringent.

Furthermore, with a GDP six times lower than that of California, Quebec may well find itself playing a secondary role in the decision-making process concerning the administration of market rules[14]. Despite criticism, the Quebec government has nonetheless decided to forge ahead with its cap-and-trade regulations in the hope that a show of leadership regarding climate change will convince other states to participate in the system.

HOW TO TAKE ADVANTAGE OF THE PROGRAM?

The current year is essentially a transitional period during which businesses wishing to get acquainted with the program on a voluntary basis prior to its coming into force can already do so. Emission units will be auctioned at a minimum price of $10[15] during a joint meeting of Quebec and Californian emitters in November 2012[16].

Undoubtedly, the carbon market presents a unique opportunity for businesses to stand out from their competitors. The key to seizing this opportunity rests on businesses first acknowledging the extent of their environmental footprint on ecosystems and then taking effective measures to reduce it.

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[11] See " La Bourse du carbone se dessine ", *La Presse canadienne* (July 7, 2011): [http://www.radio-canada.ca/].

[12] See " Bourse du carbone: le Quebec pourrait être à la merci de la Californie ", *La Presse canadienne* (June 28, 2012): [http://www.ledevoir.com/].

[13] See " Pour ou contre la bourse du carbone? ", *Magazine MCI* (February 1, 2012), online: [http://magazinemci.com/].

[14] See Joel Wood, " Réduction des émissions de GHG: le Quebec ne devrait pas se joindre au système californien ", *Perspectives* (Summer 2012), at pp. 6 to 11.

[15] See s. 49 of the Regulation cited above. For auctions conducted after 2012, the minimum price will be increased by 5% annually and indexed in the manner provided for in section 83.3 of the *Financial Administration Act*, R.S.Q., c. A-6.001.

[16] Ministère du Développement durable, de l'Environnement et des Parcs, press release, " État d'avancement des travaux au sein de la Western Climate Initiative " (March 30, 2012), available online (in French only): [http://www.mddep.gouv.qc.ca/].

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