Intelligence MEMOS

From: Daniel Schwanen and Benjamin Dachis

To: The Hon. Catherine McKenna, Minister of Environment and Climate Change Canada

cc: Ontario Premier-designate Doug Ford

Date: June 28, 2018

Re: **Federal carbon pricing backstop can reduce the litigation costs of cap-and-trade phaseout**

On June 15, Ontario's Premier-designate Doug Ford announced that his government's first act upon taking office tomorrow will be to cancel the province's cap-and-trade scheme. The new government will need to get many details right in finding a path to an orderly wind-down of the market.

This move comes with many risks of future litigation. The first shoe to drop was California and Quebec halting trading between their companies and Ontario companies. The likely next shoe to drop will be from Ontario companies that have bought permits for the rest of the compliance period through to 2020. The government's action risks rendering worthless some of the permits for which companies paid $2.8 billion in good faith. These companies will now be at a government-imposed disadvantage against others in Ontario that would have been expected to also buy permits, had the scheme continued, but now will not have to make the purchase.

The money paid by companies for emission permits is already in provincial coffers. The net cancellation cost to the province will depend on the share of already-sold permits that firms have yet to match to an emissions obligation. Further, if the government can cut planned but uncommitted spending on programs intended to be paid for with cap-and-trade revenues, refunding companies will not have as much net fiscal cost.

Having said this, Ontario, the federal government and the private sector should be keen to limit both the fiscal risks and the uncertainty around environmental policy that this cancellation entails. The province can uphold the value of past permits by requiring that a company must hold an emissions permit for pre-June 29, 2018 emissions. In that case, only a few hundred million dollars' worth of future year permits would be stranded assets.

Here's one way to reduce the litigation cost from those permit holders.

The federal government has committed to enacting a carbon pricing "backstop" to provinces that do not provide for their own carbon pricing scheme (tax or cap and trade). That is, emitters in provinces that do not have an emissions pricing scheme in place will be subject to the federally set price, set at $20 per tonne as of January 1, 2019.

The federal government can step in to prevent a lawsuit against the Ontario government by recognizing the value (one option suggested here) of existing permits held by Ontario companies as equivalent to meeting the federal backstop. Specifically, emitters would get a credit against the new federal tax payable, up to the amount they paid for permits under Ontario's cap-and-trade scheme. Emitting companies that don't hold permits would need to pay the full federal carbon tax. That would put all Ontario companies back on a level playing field, and provide for a bridge between a soon-to-be-defunct cap-and-trade regime in Ontario, and a federal pricing regime that was meant to backstop it. Conveniently, the latest price for cap-and-trade permits is very close to the 2019 backstop price.

The federal government has many incentives to step in. These include ensuring continuity and coherence in climate policy across the country, and avoiding the cost of investor-state disputes that any potential foreign holders of Ontario permits might initiate under trade agreements, for which the federal government may be on the hook financially if panels find against Ontario.

Ontario, meanwhile, would have an incentive to recognize the (generally little questioned) validity of the proposed federal scheme given the chance to get a potentially large financial liability off its books. No doubt there will be related discussions on whether gross revenues from the federal carbon tax raised in Ontario can, in whole or in part, be directed to the Ontario government's coffers.

The Ontario and federal governments will need to act quickly to announce how they will treat cap-and-trade emissions permits held by Ontario companies. If they don't, and companies sue for the costs they face, the cost to taxpayers could be substantial. If the federal government wants a carbon pricing regime to work across Canada, it would be best to be able to resolve issues raised by the provinces that do not agree with them.

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