

# A BRIEF LOOK AT THE QUÉBEC CAP-AND-TRADE-SYSTEM FOR EMISSION ALLOWANCES

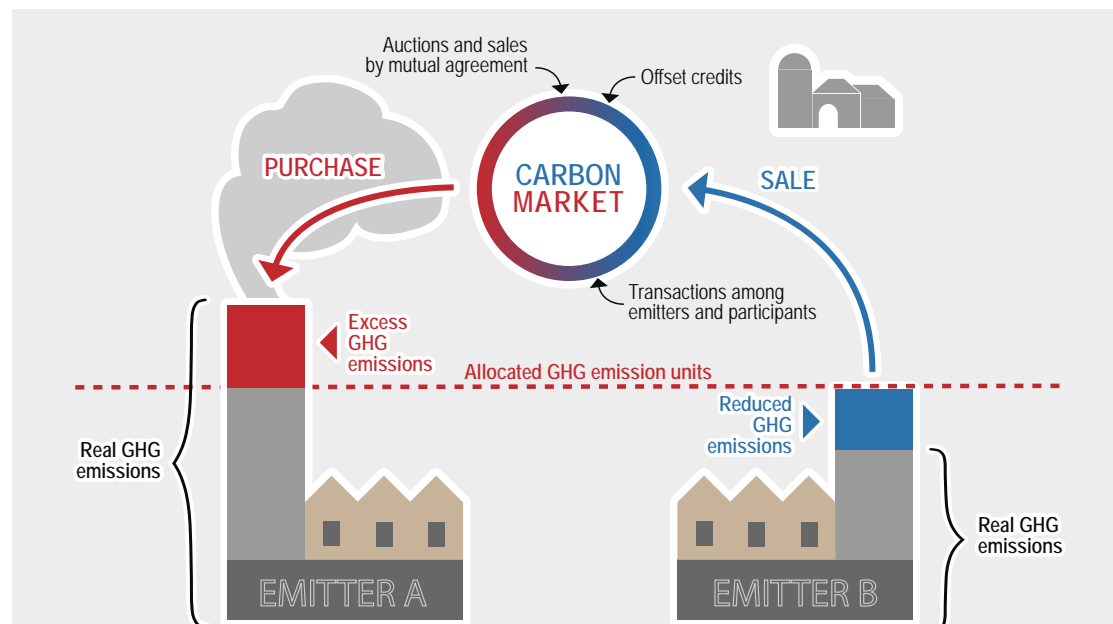
## The beginning of a new era in Québec

January 1, 2013, marked the beginning of a new era in the fight against climate change in Québec—the era of the Western Climate Initiative's (WCI) carbon market. On that day, the Québec cap-and-trade system formally started operating. Henceforth, businesses subject to the system have to take into account the cost of emitting greenhouse gases (GHG) in their decision-making process. A year later, Québec linked its system with that of California, thus creating the largest carbon market in North America, and the first one in the world to have been designed and to be operated by subnational governments of different countries. The WCI's carbon market could expand further with the expected addition of Ontario.

## What is a cap-and-trade system?

A cap-and-trade system is an innovative economic tool that is different from standards and regulations traditionally used to reach environmental objectives.

It is a flexible market mechanism used to induce a carbon cost in business decision-making, and to facilitate lowest-cost GHG emission reductions, while encouraging the implementation of clean technologies.



## What sectors are subject to Québec's cap-and-trade system?

Businesses that emit 25,000 metric tons or more of CO<sub>2</sub> equivalent a year are subject to the cap-and-trade system. For the first compliance period (2013-2014), only the industrial and electricity sectors were subject to the system. However, during the second and third compliance periods (2015-2017 and 2018-2020), fossil fuel distributors are also subject to the system.

In addition, the cap-and-trade system is open to individuals and other entities that would like to participate in the carbon market, even if there is no regulatory obligation for them to do so.

## What is an emission allowance?

An emission allowance is a legal concept introduced by the regulation respecting the cap-and-trade system. It is equal to one metric ton of CO<sub>2</sub> equivalent and is issued exclusively by the government. An emission allowance exists only in electronic form in the cap-and-trade tracking system, called the CITSS, which is jointly operated with California. Emission allowances are identified by type and by year of creation.

There are three types of emission allowances, all of which are fully fungible with California's allowances:

1. Emission units distributed free of charge, auctioned off or sold by mutual agreement by the government;
2. Offset credits stemming from GHG emission reductions in sectors not subject to the cap-and-trade system;
3. Credits for early reductions. Emitters and participants in the cap-and-trade system must each have an account in the CITSS in which their emission allowances are held.

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# HOW DOES THE SYSTEM WORK?

## Setting of annual caps

The government has set a cap on the number of emission units that it will put in circulation each year.

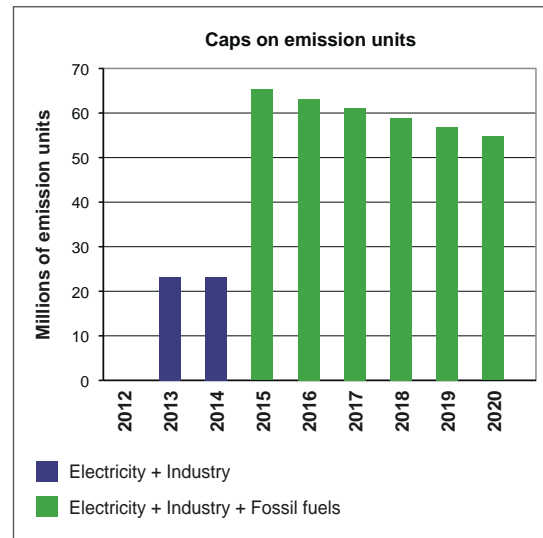
- Starting in 2015, the cap gradually drops each year.
- Annual caps on emission units were set in order to help reach Québec's GHG emission reduction target, notably by encouraging covered emitters to improve their energy efficiency, rely on renewable energy, and use low-carbon technologies.

## Distribution of emission units

Industrial emitters exposed to foreign competition receive most of the emission units they need free of charge in order to prevent what is called "carbon leakage", that is, the offshoring of companies to places without a cap-and-trade system.

Starting in 2015, however, the number of units allocated free of charge to these emitters generally drops about 1% to 2% a year, notably for combustion emissions, in order to encourage them to cut GHG emissions further.

Electricity producers as well as fossil fuel distributors do not receive free allocations.



## Regulatory compliance

At the end of each compliance period, all covered emitters must have enough GHG emission allowances in their account to cover their total reported and audited GHG emissions for the period in question. These emitters, like other participants, can obtain emission allowances during government auctions, by purchasing them from other participants or by purchasing offset credits.

The system does, however, set holding limits to prevent market manipulation and provides for sanctions in case of non-compliance.

## Auctions

Emission units not allocated free of charge are auctioned off by the government four times a year. A minimum price of C\$10.75 was set for 2013, which is scheduled to increase at a rate of 5% plus inflation every year until 2020. For joint auctions with California, the minimum price is set by retaining the higher of the two system's minimum prices at the exchange rate prevailing at the time of the auction. Auctions are open to all emitters and other participants registered with the CITSS. The final sale price of each emission unit is the lowest price bid for which the last available unit is awarded.

The government could also organize sales of emission units for emitters that may have difficulty acquiring enough of them to meet their compliance obligations (sales by mutual agreement).

All auction proceeds go to the Québec Green Fund and are earmarked for the financing of the different initiatives contained in the 2013-2020 Climate Change Action Plan, which aim at reducing GHG emissions and at helping Québec society adapt to the impacts of climate change.

## The cap-and-trade system: a sustainable development tool

In essence, by setting a price on carbon and by permitting the purchase and sale of emission allowances, the cap-and-trade system becomes the cornerstone of an integrated environmental approach aimed at encouraging the most cost-effective GHG emission reduction projects, and at helping Québec develop a low-carbon economy that is less dependent on oil. It thus lays the foundation for an economic strategy focused on developing a green economy.

