Promoting carbon markets in Canada: lessons from existing markets

Workshop Report

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In co-operation with

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Workshop Report[1]

Introduction

This workshop examined ways to advance the development of climate policy in Canada. The focus was on how carbon markets can be developed in order to help reduce Canadian greenhouse gas (GHG) emissions. Carbon markets, and climate change policy more broadly, are at an impasse. The workshop aimed to explore how we might move forward to use the potential of carbon markets to improve Canada's performance on climate change.

The meeting proceeded from the assumption that the key problem is not technical, but political, in character. It thus aimed to explore how the development of policy in other jurisdictions, notably the EU, has been able to build political coalitions that see benefit in the use of carbon markets to achieve emissions reductions.

The workshop brought together policymakers, business people, and researchers with an interest and expertise in climate change, with the aim of advancing the policy knowledge of the design and implementation of climate change policy in Canada. In both of the two sessions, one speaker each from a business, policy and research community presented their perspective on what the central problems are and how we might move forward. The workshop had over 50 participants, from various government ministries, NGOs, think tanks, business organizations, and universities.

Session I: European carbon markets

In the first session, the workshop drew out lessons to be learned from existing carbon markets. Most, although not all, of these markets, are in Europe. The European Union Emissions Trading System (EU ETS), along with the Kyoto Protocol's Clean Development Mechanism (CDM), dominate global carbon markets, accounting for around 90% of intra-market trades. Furthermore, demand in the CDM is largely driven by the way the EU has allowed firms covered by the EU ETS to buy a limited quantity of credits from the CDM as part of their regulatory obligations. As a result, most CDM activity is also organised in Europe.

- Doug Russell, President of MDF Associates, with a wealth of experience in carbon trading, presented his account of what we have learned over two decades of international carbon markets. He showed how in early discussions of carbon markets, in the run-up to the adoption of the Kyoto Protocol in 1997, Canada was a leading actor. In the voluntary carbon markets that started in the early 1990s, Canadian businesses such as Ontario Power Generation and TransAlta were leading players, accounting for over a third of global transactions in 1996. However, when the US pulled out of the Kyoto Protocol, Canadian business became more cautious, worrying

[1] Workshop report prepared by Matthew Paterson, Professor of Political Science at the University of Ottawa based on workshop notes taken by Olivia Saab, and with comments and editing by Helen Morris, Carleton University and Sandra Duarte, British High Commission.

about competitiveness issues raised by the US pull-out. While European and to a lesser extent Japanese firms moved ahead rapidly in developing carbon market activities, in response to their governments' plans for meeting their Kyoto targets, Canadian firms, lacking such a government-driven incentive, fell behind. Companies that had been involved disbanded trading desks and expertise in carbon markets was lost. Some firms have now started advocating carbon taxes over carbon markets and all have argued that Canadian action needed to move in lockstep with the US. In concluding, Russell emphasised that while business in Canada can generate the sort of action necessary to reduce emissions, in order to do this the private sector requires clear signals from government about the direction of policy.

- James Burt, of the UK's Department for Energy and Climate Change, and currently on secondment to the British Columbia Climate Action Secretariat, followed Russell's presentation with an insider's account of the EU ETS and the lessons that might be drawn from that experience. Burt argued that it was crucial to have a combination of clear political leadership that gave business clear signals, and to work closely with stakeholders on the design of the system, so that problems could be avoided or smoothed out, and actors would feel they had a stake in the success of the system. He also emphasised that the design of an ETS needs to be simple (he noted the original document setting out the EU ETS was only 20 pages long). He said that it is more important to get the system up and running and not to let the perfect be the enemy of the good. The system can then be improved over time in the light of experience, including tightening the cap if necessary. Starting with a short learning phase, with an early review, is one way to do this. A strong regulator with credible powers to penalise non-compliant firms is also essential.

- Denny Ellerman, an MIT economist who has specialised in the EU ETS for several years, brought this research experience to bear on the question of how the politics in the EU enabled the ETS to emerge successfully. He suggested that there were three key factors at play. First was the existence of an appropriate political moment, which in this case was the opportunity afforded to Europe in the aftermath of the Cold War, with Europe emerging as a "soft power". Climate change was an ideal "soft" issue, and when the US pulled out of Kyoto, this enabled the EU to make a bid for a leadership role. Second was considerable uncertainty about what carbon markets involved, an uncertainty that was useful to policymakers as those who might otherwise oppose it were slow to organise. Third was the existence of a small group of organised and highly competent EU civil servants who identified ETS as an opportunity to develop EU climate policy, and steered the ETS skilfully through the various political minefields.

Session II: Carbon markets in Canada

In the afternoon session, we turned our attention to the situation in Canada. How, if at all, might the lessons learned in Europe and elsewhere be applied in Canada? What modifications might need to be made to adapt to the particular situation here? What can we learn from the pattern of development of climate policy in Canada?

- First, David McLaughlin, President and CEO of the National Round Table on the Environment and the Economy, outlined his take on the current policy outlook for carbon markets in Canada. After outlining the general development of climate policy in Canada, he described the results of

the ongoing research at the NRTEE and its contribution to the Canadian policy debate, in particular a series of carbon pricing reports, and the current series of *Climate Prosperity* reports. This research is designed to establish how Canada might meet goals of deep cuts in GHG emissions by 2050. This research suggests that the overall macroeconomic impacts of such cuts are small and manageable over time, and that the competitiveness impacts are tied to specific sectors where the challenge is readily identifiable. The research also shows that a strong and durable carbon price signal is a crucial component in any successful policy package to get to such cuts by 2050. It shows that delaying the development and implementation of policy increases the costs of achieving the desired cuts, and that fragmented solutions across the provinces are also more costly than coordinated action at the federal level. Finally, it shows that there are significant economic opportunities in the transition to a low carbon economy, but that Canada is not yet in a position to benefit from those opportunities.

- John Drexhage, Director of the Climate Change and Energy Program at the International Institute for Sustainable Development, followed this up with a focus on the emerging carbon markets at sub-national levels in North America. In the absence of federal action in either Canada or the US, policy has been driven by states and provinces working individually or in cooperation with others. Drexhage outlined in detail the various actions taken in Canadian provinces, specifically, British Columbia, Québec, Ontario, Manitoba and Alberta. Some of these are being enacted in collaboration with each other and with US states, in particular through the Western Climate Initiative, but also the Regional Greenhouse Gas Initiative and the Midwestern Governors Greenhouse Gas Reduction Accord. In each of these, states and provinces are setting targets considerably ahead of federal action, and developing carbon markets as a means to implement policies. He suggested that while many of these regional schemes are designed to stimulate federal legislation in the US in particular, hope for federal action in the US (and consequently in Canada) is waning and thus these sub-national schemes are likely to remain the main carbon markets that emerge in North America.

- Matthew Paterson, a political scientist at the University of Ottawa, returned to the European case to try to draw out some explicit general lessons and see how they might work in Canada. He started by returning to some basic dynamics of climate change as a public goods problem, and argued that what had made carbon markets successful as a policy project was the way that they created concentrated economic benefits for particular actors, notably financiers, which enabled policymakers to build a coalition of support for climate policy. He outlined how this process emerged in the EU ETS, showing how the shift in business coalitions forming around climate policy has moved in favour of business groups favouring further action to reduce emissions, because of these effects of the EU ETS. He then drew out some points about how such a dynamic had not been produced in Canada, suggesting that in part this is because of the design of the carbon market policy already in place in Alberta and which was due to be implemented federally in January 2010. This market has failed to generate regular trading and thus the success of derivative markets and a set of opportunities for financiers which would at the same time give a constant price signal through regular trading is absent. He also focused on the well-known problem of the level and type of federal decentralisation in Canada, suggesting that the EU's model of burden sharing might be something Canada could adapt, with some pro-active provinces accepting targets to reduce emissions deeply allowing others, notably Alberta, to have continued rises in emissions, and a carbon market being a means to depoliticise the resulting transfers between provinces.

Themes

The two session moderators, James Meadowcroft of Carleton University, and Alex Wood of Sustainable Prosperity, closed the event with some thoughts about themes that emerged across the various presentations and question periods. These themes included:

- How much Canada really needs to march strictly in step with the US. Most presenters referred to this problem. In the public debate and business positions, the assumption is usually made that Canada cannot act in a significant way without US action. But a number of presenters challenged this assumption. McLaughlin presented the results of models that showed that the economic impacts of Canada acting in advance of or in the absence of US action were not significantly different to those of Canada waiting until the US acted. Drexhage showed in detail how this logic does not seem to apply in relation to the sub-national programmes being developed. Both they, as well as Paterson and Russell, also emphasised that the various economic opportunities in the low-carbon economy would be lost in the absence of strong policy action.

- How to deal with the federal-provincial question. The question of whether this is a "show-stopper" was raised. Most presenters, most explicitly McLaughlin, were not of the view that this was in fact the case. Nevertheless there is clearly an ongoing debate both about how to coordinate across the split authority between the two levels, as well as how to distribute burdens of climate policy (especially via carbon markets) across provinces whose emissions profiles and trends are widely divergent. Paterson made the link explicit to the EU, in that the EU ETS was negotiated similarly within a highly decentralised polity and across countries with widely differing economic structures. The key question for most presenters was the question of leadership – that a federal government that decided to prioritise climate change action ought to be able to find ways to coordinate provincial activities in line with overall federal aims. This underscored another key conclusion – that federal policy matters and could change the dynamic of climate politics in Canada.

- This raises a third theme across the workshop: where does the political will that seems to have been key to the EU's success (as emphasised by Ellerman especially) and Canada's problems so far come from? One problem raised was the lack of citizen engagement, although here it is notable that public opinion in Canada is not significantly less in favour of action on climate change than in Europe. An alternative way of focusing on this question is in terms of the attitudes of business. Russell showed how business positions in Canada changed from the mid-1990s, when a number of Canadian companies were at the forefront of climate change and carbon market activity, to the 2000s, when they became much more cautious and worried about the economic and competitiveness effects of climate policy, especially in the absence of action in the US. McLaughlin also underscored the importance of this. By contrast, Paterson showed how the EU ETS contributed to a broad shift in business attitudes to climate policy in Europe, seeing it increasingly as an opportunity rather than a risk or threat. Burt and Ellerman also showed how the EU and national governments played active roles in building business support for emissions trading, emphasising again the importance of political leadership.

- A fourth theme is the interactions between climate policy and other political domains. Ellerman argued that the EU's general strategic situation in the 1990s favoured action and bids for leadership on 'soft' issues such as climate change. The external shocks of elections, most obviously that of US President George Bush in 2000, was raised a number of times; Burt observed that a key feature enabling the UK to play a leading role has been cross-party support for climate policy, so business actors have some confidence in policy continuity. Alex Wood in his closing comments emphasised that carbon pricing policy interacts strongly with other policy concerns high on government agendas at the moment, especially fiscal policy in the light of the economic crisis.

Conclusions

The aim of the workshop was not to draw specific policy conclusions, but rather to explore the issues more generally. Nevertheless, a number of conclusions may be drawn from the above themes. Specifically:

- Leadership matters. Governments play a key role in bringing together key actors and in shaping their interests and this power could be used in Canada more productively to put us on a path of reducing GHG emissions more radically.

- Policy matters. Well-designed and regulated carbon markets can play a role not only in reducing emissions in a cost-effective manner, but can draw important sectors of the economy into climate policy, helping build a coalition of interests favouring deeper cuts in the future.

- The federal-provincial divide in Canada is not a "show stopper" in climate change policy. Well-organised and imaginative federal leadership could build on existing provincial action to build an ambitious programme across the country.

- Canada should not wait until the US acts to develop its own programme. Some coordination with the US is desirable, but Canada can act alone and use its leadership in that situation to build an important niche in the low carbon economy.