A change in government has brought a change of direction for Ontario’s climate change response. Following its June election, the new Progressive Conservative government has acted on its campaign pledge to rescind the province’s carbon market. Michael Berends, Michiel Ten Hoopen and Nicolas Girod lay out the chaos and cost of this move.

On 3 July, Ontario’s new government revoked the cap-and-trade regulations, ‘effective immediately’, one and a half years into the programme, replacing it with a new regulation preventing the purchase or sale of compliance instruments. The cancellation of the Ontario cap-and-trade programme, along with 758 renewable energy contracts, has been the first major action by the province’s Progressive Conservative (PC) government under Doug Ford. The province’s cap-and-trade system began in 2017 and linked with Québec and California’s carbon markets to form the Western Climate Initiative (WCI) in 2018. In total, the market covered 247 participants, representing 85% of provincial emissions, in the first compliance period (2017-20).

The carbon pricing landscape in Ontario is becoming increasingly murky

With the imminent revocation of cap-and-trade legislation and the recent constitutional challenge by Ontario’s Attorney-General Caroline Mulroney to the federal government’s carbon pricing backstop legislation, the carbon pricing landscape in Ontario is becoming increasingly murky. On 25 July, Minister of the Environment, Conservation and Parks Rod Phillips introduced new legislation to rescind the cap-and-trade market in Ontario, which sets out the legal framework for the wind-down of the programme and includes a compensation framework for entities which had already bought allowances. While the value of the allowances sold in the auction alone had a value of approximately C$2.9 billion (US$2.23 billion), the estimated final compensation amount, according to the PC government, is expected to be up to $5 million (see Figure 1).

As the basis for the compensation breakdown, the government used the roughly 220 million emission allowances that were either given for free or sold in the auction in the cap-and-trade system (which at the time of writing had a value of approximately C$3.88 billion). From this, C$1.25 billion worth of allowances were allocated freely (for which the government does not believe compensation is required). Of the remaining C$2.63 billion, C$2.4 billion worth of allowances will be ‘matched to emissions’, which entails some degree of compliance. As part of the compensation framework, this compliance obligation would be for emissions between 1 January 2017 up to 3 July 2018.

---

(1) O.Reg 386/18: Prohibition Against the Purchase, Sale and Other Dealings with Emission Allowances and Credits. (2) However, this legislation, The Cap & Trade Cancellation Act, 2018, is yet to pass, at the time of writing (late August 2018) and will be delayed until the fall legislature.
From the remaining C$243 million, C$171 million worth of allowances were purchased by oil companies and natural gas distributors, which were able to pass along their costs to customers - therefore the government does not believe these entities need to be compensated. Thus, based on the breakdown above, the government estimates they will likely need to compensate 'up to C$5 million' worth of allowances held by capped entities that will not be required for compliance. This is interesting to note as it appears as though there will be no consequences for an entity that, as of 3 July 2018, did not hold enough allowances to cover their emissions since 1 Jan 2017 (the period between the start of the programme and the cancellation date).

**IMPACT ON WCI**

Ontario’s exit from the WCI market was abrupt and unexpected. Per the WCI agreement, there was meant to be a year’s worth of written notice, and any departure was intended to be at the end of a compliance period. This obviously was not the case, and California and Québec regulators acted swiftly to ensure Ontario entities were unable to flood the market with allowances (which would have driven the price down significantly). Despite this, around 13.2 million allowances ended up in California and Québec accounts, which will add supply in the short term – with more aggressive buyers in the first two joint auctions (purchasing 2021 vintage instruments for example) primarily located in Québec and California.

Based on modelling forecasts up to 2030, the new cumulative balance of emission units (without Ontario entities) would see the WCI market short by 2027, compared to previous estimates of 2025 with Ontario included in the forecast. This shows how important Ontario was for the market, and its absence could have a bearish impact on prices in the long run. Based on ClearBlue’s price forecasts, prices were estimated to increase above the price floor in 2020; however, now they are expected to rise above the floor in 2023/24 (see Figure 2). This delayed allowance shortfall not only impacts prices, but it could also impact hedging demand and speculative interest in the market.

**FEDERAL BACKSTOP CARBON PRICE**

The Canadian government’s national carbon pricing plan is intended to be implemented in whole or in part in provinces without their own carbon pricing programme. Previously, Ontario was not considered a backstop jurisdiction due to its cap-and-trade system; however without a form of carbon pricing in place, the province will find itself within the federal program.

The backstop is a hybrid system, consisting of a fuel levy (which is proposed to start at C$20/tonne of CO2e in 2019 and increase by C$10/year, reaching C$50/tonne of CO2e by 2022) and an output-based pricing system. The carbon levy is a charge on fossil fuels (eg, gasoline, diesel, propane, natural gas) which would be paid by fuel producers and distributors. For consumers in backstop jurisdictions, the levy will be embedded in the cost of fuel.
An output-based pricing system (OBPS) would apply for industrial facilities with annual emissions of 50,000t CO2e or above. Industrial facilities in the OBPS would not have to pay the carbon levy, but instead they would face a price on carbon based on the amount they emit above a specified limit (a benchmark based on output). The benchmark will begin at 80% as the starting point for all sectors, with room for additional increases depending on the sector. These further adjustments will be developed for risk exposed sectors, focusing on Emissions Intensity (EI) and Trade Exposure (TE). Those sectors that are considered high risk will have their emissions benchmarks increased to 90% of the national average.

Ontario entities are in for quite a ride in the following months

Ontario entities would have options when it comes to compliance for emissions above the benchmark under the OBPS framework. Surplus credits (similar to emission allowances) would be granted to any entity that emits below the benchmark for their specific sector - and the entity would then be able to either bank these credits for future compliance (for up to five years), or trade them to other entities in a backstop jurisdiction. If an entity emits above the benchmark for their industry, they could either pay an excess charge for any emissions over the benchmark, surrender credits either banked from the preceding five years or purchased in the OBPS market from other entities, or purchase offsets in the primary (ie, backstop registry) or secondary markets for compliance. In the OBPS, Ontario entities could use any combination of these compliance options with no limits, as the federal government is hoping to ensure flexibility and the lowest cost to emitters moving forward.

As Ontario is currently challenging the federal government’s constitutional jurisdiction when it comes to imposing the backstop (in addition to Saskatchewan), it is still unclear if the Ford administration will propose an alternative climate change plan in line with the backstop. If the federal backstop indeed begins in Ontario in January 2019, it will remain in place for four years, which will lead into 2023.

It is important to note a similar challenge was proposed by Manitoba’s provincial government earlier this year, but it was quietly abandoned after it sought independent legal advice. Whatever does happen, one thing is clear: Ontario entities are in for quite a ride in the following months, as 1 September 2018 is the deadline for provinces to have a carbon pricing plan in place (to avoid the federal backstop). Your move, Ontario.

Michael Berends is Managing Director, Origination at ClearBlue Markets and has over 15 years of experience in Carbon Markets, in particular with carbon pricing strategy, offset development and trading. Prior to ClearBlue, Michael worked at EcoSecurities, Barclays Capital, Vattenfall Energy Trading and ICL Ltd. Michael has executed thousands of carbon product deals, structuring transactions for offsets, allowances, and allowance related products in the primary and secondary carbon markets in over 50 countries.

Michiel ten Hoopen is a Managing Director and Head of Advisory at ClearBlue. He has over 17 years of in-depth policy and practical trading experience that provides clients with a unique perspective that is unparalleled in the market. Michiel led the ClearBlue team that developed one of Ontario’s largest gas distributor’s Compliance Instrument Purchasing Strategies for 2017 & 2018 and are currently developing the 2019 & 2020 Strategies. Michiel has worked globally on emission reduction projects with a wide variety of technologies such as industrial energy efficiency.

Nicolas Girod is a Managing Director and Head of Markets at ClearBlue Markets and has over 10 years of experience in carbon markets. He has a deep understanding of the integration of the energy and carbon markets, having worked for banks and utilities as a risk manager, market analyst and trader. Nicolas developed ClearBlue’s in-house analytical models and leads the team that provides weekly updates for the WCI market and USD/CAD trends.