

POST-ELECTION CARBON OFFSET MARKET UPDATE

The scope of this market update is limited to carbon offsets valid under regulated provincial and federal carbon pricing markets other than Alberta and Quebec. For separate analysis on Alberta and on Renewable Natural Gas markets, or for insights on voluntary markets, please contact Bluesource.

IMPLICATION OF FEDERAL ELECTION RESULT

In the long lead-up to the elections, carbon market players in virtually all markets outside of Alberta and Quebec were largely sitting on the sidelines awaiting clarity on whether a Conservative government would repeal the federal policy or a Liberal government would uphold it. The re-election of the Liberals to a minority government very likely means continuity in carbon pricing policy for several years. This includes the carbon levy and the industrial emitter program (Output-based Pricing System referred herein as 'OBPS'), as well as the proposed Clean Fuel Standard.

Upside: The Liberals are likely to face pressure from the NDP, who hold the balance of power, to make climate targets and policies more ambitious. A desire to do so will likely be tempered by growing resistance in Western provinces to carbon pricing and a heightened sensitivity by the federal government to Western concerns. Liberal campaign promises included carbon neutrality in 2050 and legislated interim targets that may provide a longer-term bullish signal for carbon markets in Canada.

Downside: The Supreme Court Challenge to the federal GHG Pollution Pricing Act remains a risk to the continuity of the federal system. The case is being heard in January of next year and both the 2 lower court decisions and the majority of legal scholars suggest that the Supreme Court is very likely to uphold the constitutionality of the federal policy.

FEDERAL AND PROVINCIAL MARKETS

We are now likely to see Environment Canada (ECCC) proceed with its plan to develop a federal offset system. Our estimation of likely next steps and timing are as follows:

Q4 2019 – ECCC to publish a list of offset protocols from existing provincial programs it will recognize as eligible to create offsets in the federal system. The list should also define other protocols it will develop or adapt and that are not currently approved in a provincial system. We expect the list to include a forest carbon offset protocol.

Q1 2020 – ECCC will likely publish draft regulations for the administration of the federal offset system

Q1 2020 – Start of offset protocol development/adaptation processes, formulation of technical working groups.

Q2 2020 – Approval of federal offset system regulations

Q3 2020 – Approvals processes and offset registries are operational, allowing for offsets to be serialized and transferred.

Regulated emitters in the federal program have been accruing a liability to achieve their performance standard since January 1st, 2019. Offsets will be the least-cost option for these entities to make-up any compliance shortfall and they will have until December of 2020 to do so for the 2019 compliance year. We now expect regulated emitters

and other market participants to enter the market shortly to secure offset volumes for compliance ahead of the infrastructure (protocols, regulations, registries) being in place.

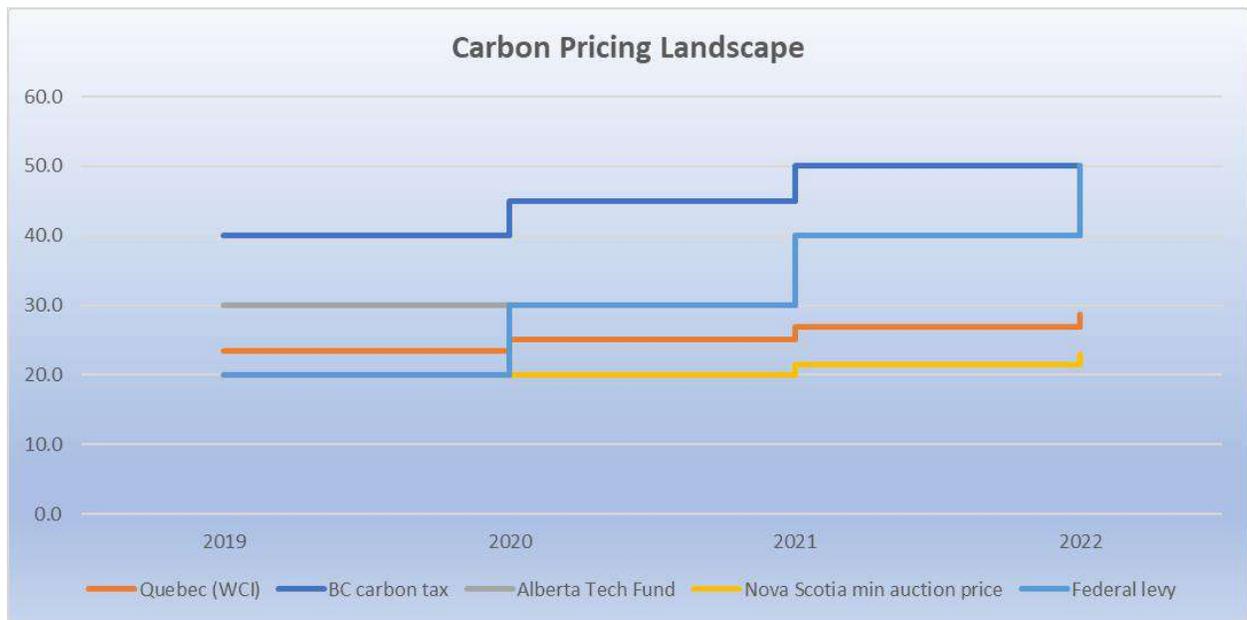
Supply of offsets is likely to be very low at the outset as it will be limited to offsets already approved in existing provincial systems using protocols accepted by ECCC. Alberta is the only existing program with large offset volumes generated using approved protocols and it is not clear whether demand within the federal system can compete with existing demand within the Alberta market. Greater volumes are likely to become available in the federal offset system as new protocols applicable to ON/SK/MB/NS are approved by ECCC.

Pricing is a large unknown at this point but existing offset markets suggest that they will be priced at a 10 to 20% discount to the compliance alternative, which in this case is either the carbon levy or surplus credits generated by regulated emitters who over-achieve their performance targets or the carbon levy. The existing Alberta market serves as a good proxy for pricing in the federal system; it has a compliance payment option at \$30/tCO_{2e} and offsets are currently trading at \$25 to \$27/tCO_{2e}. The federal system will go up \$10/t per year and hit \$50/t in 2022, as depicted in the graph below. Given the ability to bank offsets, regulated emitters are likely to accumulate offsets to use against compliance in 2022 when the alternative is more expensive. This creates significant uncertainty in pricing but is bullish in our view.

BC

The current market for offsets in BC is limited to purchases by the BC Climate Investment Branch and the existence of only one approved protocol; fuel switching. However, there are reasonable prospects for a revised forest carbon offset protocol due mid-2020 and for BC offsets to be eligible in the federal system. This would unlock much needed demand for BC offsets and robust pricing for forest carbon offset projects, amongst others, in the province.

The CleanBC Plan also proposes the adoption of new GHG performance standards for industrial emitters, including LNG Canada. Compliance with the standards would allow industry to avoid paying part of the difference between the federal carbon levy and the provincial carbon tax of \$30/t that was applicable prior to the policy announcement. The current plan does not provision for the use of offsets to meet these standards but we believe the extent of mitigation efforts required by the Plan will ultimately require the type of compliance flexibility and low cost that offsets offer.



SASKATCHEWAN

Saskatchewan has a provincial program that regulates industrial emissions from many sectors while the federal OBPS regulates others. The provincial program has offsets as an eligible compliance unit and the government has started the development of a provincial offset system. It intends to develop offsets regulations, adapt protocols, and put in place a registry in 2020 in order to operationalize the offset system at the beginning of 2021.

Decisions about whether to connect the provincial offset market with those of other provinces or the federal system are yet to be made. This will have a significant impact on the pricing of SK offsets. We expect to see adaptation of many existing Alberta protocols, particularly related to agriculture. We also expect to see a focus on land-based offset protocols such as forest carbon and avoided conversion of grasslands.

NOVA SCOTIA

The province has implemented a cap-and-trade system that is based on the Western Climate Initiative design in effect in Quebec. Offsets are an eligible instrument for compliance within the system but the Ministry of Environment (MoE) has yet to further define how the offset system will work. One of the key unknowns is whether they will link their offset system to those of other provinces or the federal system to allow for 2-way transfers. A decision to do so is likely to lead to very different pricing for N.S. offsets given the very limited demand and pricing mechanisms in the provincial system. The pricing graph above shows how existing floor pricing is at \$20/t and only increases marginally every year. Should prices remain at this level and the system not linked to the federal or other provincial programs, offset values in N.S. would likely trade well below offsets in the federal market.

The MoE intends to develop the offset protocols, regulations, and registries during 2020 in order to have a fully functioning offset system in early 2021. It is currently undertaking a study on offset potential in the province in order to help prioritize the adaptation of protocols.

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