



**CARBON MARKET**  
INSTITUTE

27 June 2014

Committee Secretary  
Senate Standing Committee on Environment and Communications  
PO Box 6100  
Parliament House  
CANBERRA ACT 2600

Via email [ec.sen@aph.gov.au](mailto:ec.sen@aph.gov.au)

### **Inquiry into the Carbon Farming Initiative Amendment Bill 2014**

Thank you for your invitation to provide a submission to the inquiry.

The Carbon Market Institute (CMI) supports a market-based approach to emissions reduction to achieve Australia's emissions reduction target.

The attached document provides the background to CMI's submission, the key issues and principles framing the Institute's submission and key design features required for the Emissions Reduction Fund. It was submitted in May 2014 in response to the Government's request for comments on the exposure draft legislation for the ERF.

This CMI submission to the ERF exposure draft legislation was developed from consultation with CMI members through dedicated Working Groups and one-on-one meetings with members, and builds on earlier consultations with CMI members and workshops with the Minister for the Environment and the Department of the Environment in relation to the ERF Green Paper and ERF White Paper. The submission represents a synthesis of CMI member views, but is not representative of any individual company/member view.

Yours faithfully

Peter Castellas  
Chief Executive Officer

*Attachment: Carbon Market Institute submission – Emissions Reduction Fund Exposure Draft Legislation May 2014*



**Carbon Market Institute**  
**Submission – Emissions Reduction Fund**  
**Exposure draft legislation**

May 2014

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## 1. ABOUT THE CARBON MARKET INSTITUTE

The Carbon Market Institute is an independent membership-based not-for-profit organisation. Our aim is to assist Australian businesses in meeting the challenges and opportunities associated with market-based approaches to emissions reduction and the transition to a low carbon economy.

As the peak body for carbon market participants, CMI has established an important role in the evolution of the carbon market in Australia. The Institute facilitates the networks, knowledge exchange and commercial interaction amongst key government policy makers and regulators, industry, financiers and investors, professional services companies and technology solution providers.

CMI membership represents a broad range of professionals, organisations and industry. Our members include leading professional service providers, NGERs reporting entities, secondary market participants, offset providers, academia and international organisations. Individuals within the CMI membership base are some of the most respected Australian carbon market innovators and leaders.

CMI's Working Groups have played a key role in connecting government, bureaucrats and regulators with industry to facilitate the constructive input of member views into policy implementation. Drawing on the expertise of the CMI membership, the Working Groups have provided a vital forum for the exchange of information between market participants, policy makers and government agencies.

This CMI submission to the Emissions Reduction Fund exposure draft legislation has been developed from consultation with CMI members through dedicated Working Groups and one-on-one meetings with members, and builds on earlier consultations with CMI members and workshops with the Minister for the Environment and the Department of the Environment in relation to the ERF Green Paper and ERF White Paper. This submission represents a synthesis of CMI member views, but is not representative of any individual company/member view.

## 2. KEY ISSUES AND PRINCIPLES FRAMING CMI'S SUBMISSION

The Government's explanatory memorandum to the *Carbon Credits (Carbon Farming Initiative) Amendment Bill 2014* states that the primary objective of the Emissions Reduction Fund is to help Australia meet its international obligations under the United Nations Framework Convention on Climate Change and the Kyoto Protocol, to reduce emissions of greenhouse gases and meet its emissions reduction target of 5% below 2000 levels by 2020.

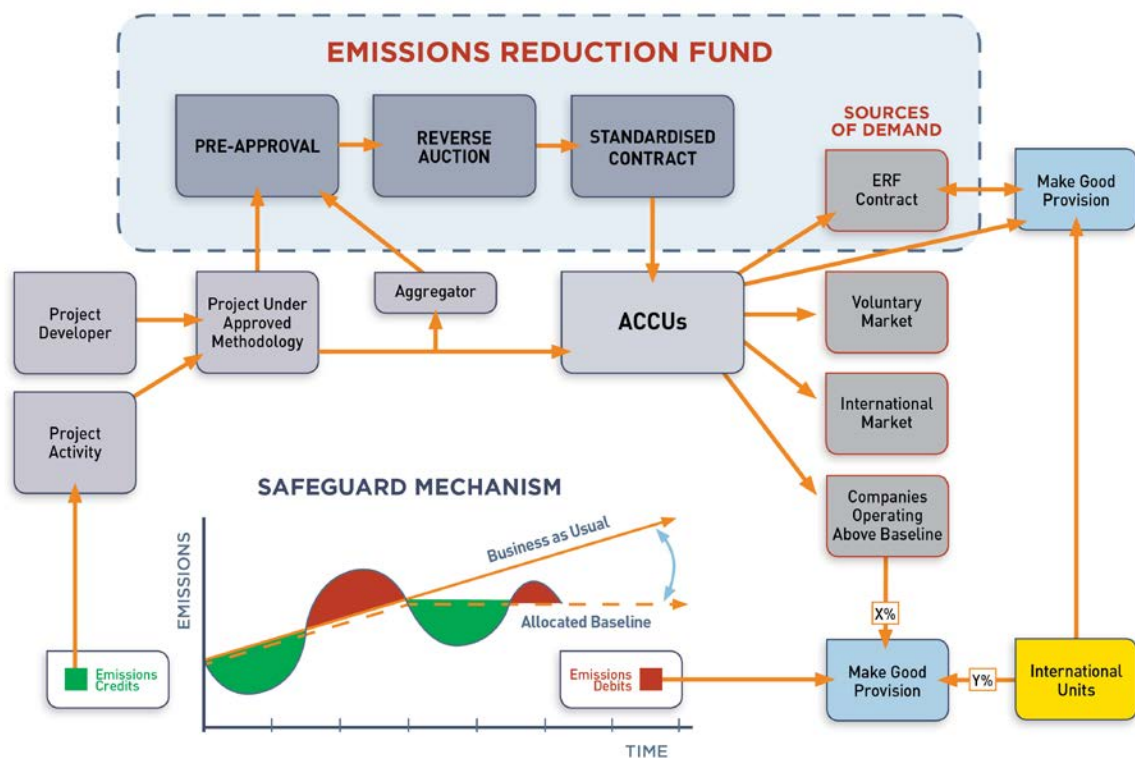
The explanatory memorandum also states that the Emissions Reduction Fund (ERF) is designed to allow businesses, local governments, community organisations and individuals to undertake approved emissions reduction projects and to seek funding from the Government for those projects through a reverse auction or other purchasing process.

In framing the Carbon Market Institute's submission, the key issues and guiding principles highlighted in CMI's submission to the ERF Green Paper have been taken into account.

- Australia's commitment to a 5% reduction on 2000 emissions levels by 2020 is maintained as a minimum and the ERF should make a significant contribution to meeting this target.
- All projects funded by the ERF should achieve real, measurable, additional and verifiable emissions reduction.
- The design of the ERF needs to be flexible to accommodate any potential change to the 2020 target and the post-2020 target.
- If the ERF is to be the primary means to meet emissions targets, more analysis needs to be done to determine the funds required out to 2020 and beyond for the ERF to meet targets under different national target scenarios.
- The design of Australia's national scheme should be considered in context with the policy measures and market developments that are taking place in international markets.
- To cost effectively meet current and future targets, the ERF and safeguard mechanism should incorporate a market-based approach.
- An enduring policy framework should involve the transition from predominantly public sector funding to private sector funding of emissions abatement.
- To meet emissions reduction targets at lowest cost to the economy, the design of Australia's national scheme should keep open opportunities to link and trade with other international markets.

Although the draft legislation does not include the safeguard mechanism proposed in the ERF White Paper, it is important to consider it at this stage to ensure that in implementation the ERF and the safeguard mechanism are linked. This will be crucial to ensure any new policy is enduring and can effectively limit Australia's emission growth to 2020 and beyond. Through the safeguard mechanism, the Government should have the ability to adjust allocated baselines over time to limit emissions growth and meet future emissions targets.

The following conceptual diagram outlines how the ERF and the safeguard mechanism can be linked in a market-based approach.



**Figure 1: Linking the ERF and the safeguard mechanism and including the ability for Government to adjust the baselines, as illustrated under the safeguard mechanism.**

In the initial years of the operation of the safeguard mechanism, baselines could be potentially set to track against business-as-usual or five-year historically high levels, meaning that few companies will be required to incur a financial compliance obligation. However, over time baselines can be set, or allocated, to decline against business-as-usual and historically high levels, increasing the incentive to limit emissions growth and to invest in low carbon technologies or processes.

If allocated baselines for entities covered under the safeguard mechanism are reduced over time, it transfers the 'heavy lifting' to meet emissions reduction targets to covered entities, rather than the tax payer funded ERF. The cost for emissions reduction is transferred to those who are required to buy the credits. Over time the safeguard mechanism can become the primary means to limit emissions growth.

This declining baseline is consistent with driving sustained decarbonisation of major emitting sectors and incentivising more industry-funded abatement to enable Australia to meet its 5% by 2020 emissions reduction target.

If the ERF and the safeguard mechanism are the primary means to meet internationally agreed targets then it is logical to agree and set the post-2020 targets under the UNFCCC process in the lead up to the Paris Agreement in 2015 before the rules on the safeguard mechanism are set. Implicit in this design is the need for long-term certainty on allocated baseline levels and the timing of any changes/review to the mechanism rules, and thresholds that could be set and adjusted according to changes in national emissions reduction targets.

### 3. RESPONSE TO THE DRAFT EXPOSURE LEGISLATION

CMI makes comment on the following aspects of the ERF exposure draft legislation in the context of enabling emissions to be reduced at lowest cost and so that Australia reaches its greenhouse gas emissions reduction targets – both current and future.

The key issues we have expanded on below relate to:

- **Additionality** – Comparable additionality standards should be applied consistently across methods
- **Requirements for project registration** – Supplementary guidance is necessary to provide clarity on the two new requirements for project registration.
- **Crediting Periods** – The crediting periods proposed in the draft ERF legislation should better align with the life of carbon abatement assets.
- **Secondary Market Development** – Consideration should be given to measures which facilitate the development of a liquid secondary market in ACCUs.
- **Contract Terms** – Supplementary guidance on ERF contract terms are required in order for project proponents to appropriately assess risk and raise finance.
- **Spot Market** – Consideration should be given to whether there will be a spot market for ACCUs under the ERF.
- **Pre- vs Post-2020** – The ERF should make a distinction between delivery of pre- and post-2020 ACCUs to ensure contracted abatement contributes to the 2020 target.
- **Make-good Provisions** – Supplementary guidance on options for make-good provisions for under-delivery of abatement would help potential project proponents better evaluate the risk of participation.
- **Aggregation** – Standardised contract arrangements for aggregators will better inform aggregation models to potentially increase participation in the ERF.
- **Kyoto vs non-Kyoto** – The removal of the distinction between Kyoto and non-Kyoto ACCUs could potentially limit the ability of project proponents to access the voluntary and/or international markets.
- **Audit requirements** – Supplementary guidance on risk-based audit requirements is required.
- **Transparency** – In the ERF design, transparency on price, volume and procurement processes are important to ensure integrity and encourage participation in the fund.
- **Auction process** – Moving from an initial single round, pay as bid tender process to a true reverse auction will increase transparency, encourage participation in the fund and better reflect a market mechanism.
- **Timing issues** – There are a number of timing issues for project proponents to consider in relation to the repeal of the Carbon Pricing Mechanism, the commencement of the ERF and the timing of the first auction.

#### **3.1 Additionality – Comparable additionality standards should be applied consistently across methods.**

Under the existing CFI framework, additionality is satisfied if projects are delivered under an approved methodology. Each CFI methodology determination specifies the applicable additionality

requirements ensuring that activities or types of projects must go beyond common practice and be estimated relative to a business-as-usual (BAU) baseline. The Bill removes the common practice test and introduces a requirement that projects must be new and unlikely to occur as a result of another government program. The development of new methods will be assessed by the Emissions Reduction Assurance Committee (ERAC). In absence of the common practice test and BAU baselines, the ERAC will need to ensure that when assessing the suitability of new methods, that they are not intrinsically easier from an additionality perspective than existing CFI methodologies as this could potentially disadvantage projects operating under existing methodologies.

In assessing methods, the ERAC will need to apply the offsets integrity standards in a manner which ensures the consistency of additionality. This is particularly important when considering the consistency of additionality standards between activity methods, for specific emissions reduction actions, and facility methods, which are proposed to aggregate emissions reductions from multiple activities at large facilities. It will be important to avoid the potential for creating two classes of ACCUs. Consistency in the additionality of the emissions reductions generated from these two tracks is critical to provide confidence in the ACCU as a single tradable unit, which would be required to form the basis of a secondary market.

### **3.2 Requirements for project registration – Supplementary guidance is necessary to provide clarity on the two new requirements for project registration.**

The intention of the legislation is that the Government does not spend ERF funds on projects that are already underway with a requirement that the project has not begun to be implemented before it has been registered. At present, it not clear as to the precise point in the project development lifecycle at which the project is defined as having begun. The newness requirement, specifically the point at which a project is deemed new or not new, requires clarification and could be further detailed in regulations.

The Bill introduces a new requirement that the project cannot be registered if it receives funding from another state or Commonwealth government program. This may affect the eligibility of project types that have received funding from other government programs that may not be directly related to the actual emissions reduction project. For example, many savanna burning projects build on existing land management activities which receive co-funding from government programs such as Working on Country, Caring for our Country or Indigenous Protected Area funding. Without clarification, they may be considered non-additional and excluded from participating in the ERF.

### **3.3 Crediting Periods – The crediting periods proposed in the draft ERF legislation should better align with the life of carbon abatement assets.**

Under the existing CFI framework, proponents of registered projects can apply for a subsequent crediting period after the first crediting period has expired. The Clean Energy Regulator can approve a further crediting period if the project continues to pass the additionality test and meets other criteria. The new Bill will provide for a standard seven-year crediting period for emissions reduction projects and a 15-year crediting period for sequestration projects.

In absence of method-specific crediting periods, there is a potential mismatch between the effective abatement generating periods of many carbon abatement assets and the single crediting periods as proposed in the Bill. For many projects, particularly land-based projects, a single seven- or 15-year



crediting period is inadequate. Preventing abatement projects from generating ACCUs beyond these periods may have a number of implications on both the level of participation in the ERF and the general level of private sector investment in abatement projects, including:

- The reduced ability to spread project costs over the effective life of the asset. This may result in a higher average cost per tonne for the ERF, limiting the fund's ability to maximise its contribution towards the 2020 emissions reduction target.
- Some contracts are already in place for which ACCUs could be issued over multiple crediting periods. The limiting nature of one crediting period could impact existing contracts and undermine the business case for future investment.
- For forestry projects, a single 15-year crediting period can impact the financial viability of the project as the cost of implementation can require a 25- to 30-year time horizon to meet return on investment. A longer opportunity for crediting is also logical because of the permanence obligations (100 years for existing projects and potentially 25 years under new projects). In addition, if project owners are only issued with 15 years' worth of ACCUs and the trees keep growing for 25 to 30 years, the Australian Government land accounting system used to develop Australia's National Greenhouse Accounts can lay claim to abatement on private land without the project proponent being able to monetise the benefit.<sup>1</sup>
- Limiting projects to one crediting period may impact the formation of a liquid secondary market in ACCUs and in particular limiting the term of this market. For example, a project with a single seven-year crediting period and a five-year ERF contract would only be able to generate a further two years' worth of ACCUs to supply into the secondary market. The potential for limited liquidity in ACCU secondary market would make it more difficult to manage the risk of make-good provisions required for ERF contract under delivery (see section 3.8). This may result in project proponents under-bidding volume and a higher average cost per tonne for the ERF.
- The development of the voluntary market may also be inhibited by lack of liquidity as the inability to generate ACCUs beyond the single seven- or 15-year crediting period would limit supply into this market.

It is noted that the Bill also enables methods to set crediting periods of different lengths. This method-specific flexibility is encouraged. In the development of new methods, industry and the technical working groups should be consulted to determine appropriate crediting periods which best reflect the effective abatement generating life of the project.

Some consideration should be given to the flexible approaches where the project proponent can determine the most appropriate crediting period. One example where a proponent-determined model is used is in the Clean Development Mechanism (CDM). The CDM affords the project proponent a degree of flexibility to align the crediting period with the life of the carbon abatement

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<sup>1</sup> <http://www.climatechange.gov.au/climate-change/greenhouse-gas-measurement-and-reporting/tracking-australias-greenhouse-gas-emissio-8>

asset by offering a choice of a single 10-year crediting period or a seven-year crediting period which can be renewed twice.<sup>2</sup>

### **3.4 Secondary Market Development – Consideration should be given to measures which facilitate the development of a liquid secondary market in ACCUs.**

The contract conditions relating to non-performance or under-delivery of contracted emissions reductions by the project proponent as set out in the White Paper assume that ACCUs will be available for purchase from a liquid secondary market. A secondary market has already formed around the ACCUs traded in the existing CFI. The legislation and subsequent regulations should give consideration to measures which allow for this market to mature.

The development of supply into the secondary market will be enhanced if crediting periods are better aligned with the life of carbon abatement assets. Restrictive crediting periods will limit the supply of ACCUs into the secondary market and increase the risk premium associated with potential make-good provisions for under-delivery.

As outlined in CMI's ERF/safeguard mechanism conceptual design diagram (see section 2), the secondary market demand for ACCUs is likely to come from four sources:

- ERF contracts with requirements to make-good.
- Voluntary market demand, potentially assisted through programs such as the National Carbon Offsets Standard (NCOS).
- The international market demand, subject to the eligibility of ACCUs in other schemes.
- Through the make-good requirements of companies which exceed their baselines under a prospective safeguard mechanism.

The development of a liquid secondary market in ACCUs will generate a price signal which can be referenced by ERF stakeholders. A mature market will provide an important information feedback loop in which secondary market participants can reference information published by the Clean Energy Regulator, such as the weighted average price awarded to successful projects. ERF stakeholders can in turn reference secondary market data. The development of a liquid secondary market in ACCUs will enhance the ability of project proponents to price abatement and access the private sector investment necessary to finance abatement projects.

### **3.5 Contract Terms – Supplementary guidance on ERF contract terms are required in order for project proponents to appropriately assess risk and raise finance.**

The Government has commissioned a commercial consultant to investigate the types of projects proposed to be bid into the ERF and the contract details that will best meet business needs. This process will focus on market factors that affect the viability of different projects under alternative contract lengths. This market testing process is welcome. The White Paper noted that many businesses have indicated that five year contracts may be too short. Further clarity on the flexibility of contract terms will be important to assist project proponents as they seek to raise finance and

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<sup>2</sup> <http://cdmrulebook.org/310>

prepare their bids. Supplementary guidance on a number of key contractual terms is required, including:

- The concept of an ACCU delivery schedule. To build on contractual processes used in international carbon market transactions, an Emissions Reduction Purchase Agreement (ERPA) could form the basis of the ERF standardised contract. The ERPA is the international industry standard contract used for the purchase of abatement. In a typical ERPA, the emissions reduction delivery schedule details the timing and volumes of contracted delivery. The concept of an ACCU delivery schedule should be a key component of the ERF standardised contract.
- Confirmation is needed on whether there will be any preference when assessing projects for contracting projects which deliver early (ie pre-2020) versus late (post-2020) abatement. For example, the standardised ERF contracts could incorporate a mechanism for preferring the early versus late delivery of ACCUs by employing the concept of present value (PV) ACCUs (see section 3.7). The concept of vintage year delivery within a contract or consideration of a levelised cost or discounting mechanism to preference the early versus late delivery of contracted ACCUs will assist the fund in achieving its mandate and is good risk management.
- Whether there will be a flexibility provision in the ERF standardised contract to allow for the management of 'unders and overs' against the ACCU delivery schedule, without any penalty. For example, would the ERF standardised contract allow for an acceptable range (for example, 80% to 120%) of under- or over-delivery to allow for a degree in variation against the ACCU delivery schedule so long as the total contract volume is delivered at the end of the contract?
- Detail on the options available for the final make-good provision for contract under delivery (See section 8 – Make-good provisions).
- Whether there will be a separate process with a standardised contract for the ERF to purchase spot ACCUs. The spot market, also known as the cash market or physical market, is a commodities market in which goods are sold for cash and delivered immediately. An ERF spot market facility would provide projects proponents with the ability to monetise surplus ACCUs. It would also encourage project participants with highly variable abatement projects to participate in the fund without the requirements and associated risks of entering into a forward contract (see section 3.6).

### **3.6 Consideration should be given to whether there will be a spot market for ACCUs under the ERF.**

A lack of a spot market or secondary market reduces liquidity and increases risk. Without both of these operating efficiently it may increase the difficulty of achieving project finance for new projects.

Should there be only one successful ERF bid per project, no spot market and no established secondary market with depth and liquidity, then project proponents would carry a potentially unacceptable high level of delivery risk. The ability to bid into a spot market increases flexibility; in

particular it will help proponents of projects where there is natural variability to manage delivery risk and benefit from the upside when a project has surplus production.

Allowing only one successful bid per project also potentially disadvantages some existing CFI models for large projects with multiple offtake partners. The multiple partners often funded these projects so that they could use ACCUs to hedge their potential carbon liability. The multiple partners are usually unrelated and are likely to have different views on price, timing etc which makes the restriction of one successful bid per project difficult to manage. This issue could be managed by enabling multiple bids from projects, enabling spot bids into the ERF or enabling the various partners to efficiently register as a project proponent in their own right for the ACCUs they receive from a project and bid into the ERF in their own right.

### **3.7 Pre- vs Post-2020 – The ERF should make a distinction between delivery of pre- and post-2020 ACCUs to ensure contracted abatement contributes to the 2020 target.**

Although the ERF's emissions reduction outcome is focussed on contributing towards the 2020 target, the draft legislation does not define any preference in contracting abatement for pre- vs post-2020 delivery. It is important that the legislation or following regulations make the necessary distinction between the delivery of pre- and post-2020 contracted abatement to ensure the ERF's contribution towards the 2020 target.

The process adopted by the Clean Energy Regulator should define whether there is an explicit preference for pre-2020 delivery over post-2020 delivery and at what stage of the purchasing process this would be considered. The issue could potentially be considered as part of the assessment in the pre-qualification stage.

### **3.8 Make-good Provisions – Supplementary guidance on options for make-good provisions for under-delivery of abatement would help potential project proponents better evaluate the risk of participation.**

The Bill states that carbon abatement contracts will be commercial contracts with commercial terms and conditions. In line with Government policy set out in the Emissions Reduction Fund White Paper, this will include, for example, conditions relating to non-performance or under-delivery of contracted emissions reductions by the contractor, including make-good provisions. Potential project proponents require detailed supplementary guidance on the options to make-good so as to appropriately inform their risk-adjusted bids.

The contract conditions relating to the make-good provisions as set out in the White Paper assume that ACCUs will be readily available for purchase on the secondary market. The legislation should consider the implications of an inability to make-good should there not be a liquid secondary market in ACCUs and incorporate a degree of flexibility to allow project proponents to appropriately manage their under-delivery risk.

ERF contract make-good provisions could potentially be managed using a waterfall mechanism as follows:

- a) In circumstances where a project under-performs and is unable to deliver the contracted volume of ACCUs, the project proponent could procure ACCUs from other sources such as projects

generating surplus ACCUs, aggregators and other secondary market participants to make-good on the shortfall, upon which the balance of payment will be received at the contract price. In this instance, the project proponent's make-good through delivery of ACCUs ensures that the contract remains valid. It is possible, particularly in the early years of the fund's operation, that there will be a limited supply of uncontracted or surplus ACCUs necessitating the need for an additional, more liquid alternative to manage the make-good provision.

- b) In circumstances where the project proponent is unable to purchase a sufficient volume of ACCUs to make good on contract under-delivery, the project proponent could have the option to deliver a set percentage of contract volume using other prescribed eligible units. The make-good provision could consider allowing the use of eligible international units. The international market is established, deep and liquid and would allow proponents to be able to effectively manage delivery risk should the ACCU secondary market not develop. In this scenario, the proponent would only be paid the contract price for the ACCUs delivered. They would not be paid for any of the make-good international units delivered so there would not be any arbitrage opportunity. The use of international units as a make-good is a cost effective and simple way of hedging delivery risk. So as to discourage unrealistic bids into the ERF, the percentage of international units allowed for the make-good would need to be set at an appropriate level and the balance of the make-good would be required in ACCUs. In this instance, the project proponent's make-good through delivery of other prescribed eligible units also ensures that the contract remains valid.
- c) In circumstances where the project proponent is unable to procure ACCUs or prescribed eligible units to make-good on under-delivery within a given timeframe, this would constitute a breach of contract and the contract would be terminated. The ERF could then purchase prescribed eligible units sufficient to cover the non-performing or under-delivered contract. The balance of funds (expected to be considerable due to the current large discount on international units relative to ACCUs) could then be rolled over into the next auction to provide additional demand for domestic abatement.
- d) Using such a waterfall mechanism for the make-good provision ensures an appropriate balance of risk between the Government and private sector participants. Allowing access to liquid international markets enhances the bankability of the ERF offtake contracts and ensures that the ERF contributes significantly to the 2020 target while preferencing domestic abatement.

### **3.9 Aggregation – Standardised contract arrangements for aggregators will better inform aggregation models to potentially increase participation in the ERF.**

The Bill removes a number of barriers to project aggregation to make it easier for businesses to find innovative ways to reduce costs and increase participation by small companies, landholders and households. This is welcome, however there is limited detail on aggregation in the draft legislation. Supplementary guidance on the preferred model(s), rules and standardised contract terms for aggregators would better inform potential aggregators. For example, further details are required on how project proponents with registered projects could assign the rights to an aggregator and avoid contracting directly with the Government.

### **3.10 Kyoto vs non-Kyoto – The removal of the distinction between Kyoto and non-Kyoto ACCUs could potentially limit the ability of project proponents to access the voluntary and/or international markets.**

There is no provision in the draft legislation for projects that may want to sell into the voluntary market or the international Joint Implementation (JI) market to do so. The JI is a flexible mechanism of the Kyoto Protocol which allows parties to trade a proportion of their national emissions to other nations, based on emission units generated by reductions or sequestration of greenhouse gases.<sup>3</sup> The previous provisions which allowed for the exchange of Kyoto ACCUs to Assigned Amount Units (AAUs) during the first commitment period for JI (which had expired in 2013) are proposed to be repealed, but no revised provisions are made to accommodate the second commitment period.

There is likely to be a number of projects that will either (i) not meet the eligibility requirements of the ERF, (ii) will not be competitive under the ERF, (iii) will seek to benefit from the sale of units after the end of a single crediting period, (iv) may already be registered under another voluntary scheme and wish to continue to participate in that scheme, or (v) may prefer to access the voluntary market rather than participate in the ERF. Many of these projects may no longer be eligible to access the voluntary market due to concerns about their emissions reductions being double counted by the Australian Government. That is, the government will not get the benefit of emissions reductions if the projects are implemented in Australia unless it makes it clear that it will cancel corresponding AAUs for those projects. Project participants should have the ability to access other markets and the Government should agree to cancel AAUs if that will enable those projects to be undertaken in accordance with schemes such as the Voluntary Carbon Standard (VCS).

It is noted that the White Paper indicated at section 3.5 that the Government would cancel AAUs for those ACCUs that companies sought to use for meeting carbon neutrality under the National Carbon Offsets Scheme (NCOS). This is not reflected in the draft legislation.

### **3.11 Audit requirements – Supplementary guidance on risk-based audit requirements is required on specific details.**

The Bill introduces a risk-based approach to auditing emissions reductions and provides flexibility to report emissions reductions more frequently to allow project proponents to optimise their cash flow thus make it easier and less costly to participate in the ERF. The application of a risk-based approach is welcome, though supplementary guidance of the specific audit arrangements will be required for project proponents to appropriately cost and procure audit services.

The ERF's risk-based assurance approach should be applied to all abatement projects successful in obtaining funding and could potentially be applied on a sliding scale. For example, projects could be classified as either large-, medium- or small-scale based on their contract requirements to deliver above 125,000 tCO<sub>2</sub>-e, between 50,000 to 125,000 tCO<sub>2</sub>-e, or below 50,000 tCO<sub>2</sub>-e of abatement over the reporting period.

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<sup>3</sup> <http://www.cdmrulebook.org/321>

All project audit costs should be borne by the proponent, other than those mandated by the Clean Energy Regulator where non-compliance is suspected but not found, as per the draft legislation's position. If an ACCU is to be maintained as a single tradeable unit then audit requirement should remain consistent across the entire crediting period. For example, where credits are generated from a project outside of an ERF contract period (that is, from a seven-year crediting period where only five years are contracted under the ERF), these units and associated reports should also be subject to an assurance audit prior to being accredited for ACCUs.

The existing NGER framework of registered auditors, the audit determination and assurance standards should be maintained and in some circumstances strengthened. A strong audit and assurance program regime will limit the risk and impost on the Clean Energy Regulator during the 'pre-qualification' process, reduce the risk of under-delivery for all parties involved and underpin the overall integrity of the ERF. The proposed suggestions above balance the requirement for rigor and integrity without adding excessive barriers to entry associated with compliance costs.

### **3.12 Transparency – In ERF design, transparency on price, volume and procurement processes are important to ensure integrity and encourage participation in the fund.**

The Bill allows for the Clean Energy Regulator to have significant discretion regarding the form and conduct of the purchasing process. This includes the purchase of abatement through a reverse auction, a tender or other purchasing processes. The rules and regulations which follow the Bill should detail appropriate measures to ensure equivalent transparency across the range of procurement processes. This will be important to provide ERF participants with confidence in the integrity of the fund management process and encourage participation.

It is noted that the Bill allows the Clean Energy Regulator to negotiate bi-laterally on larger, more complex projects. If not properly managed, this may have the potential to be disruptive to the fund's other procurement channels. It is important to maintain equivalent levels of transparency so as to avoid the development of a two-tiered market. It is also noted that legislative rules can be made by the Minister, allowing for further guidance to be provided regarding the conduct of reverse auctions or other purchasing processes. In exercising ministerial discretion it is important to consider the principle of transparency to enhance the integrity of the fund.

The Clean Energy Regulator may publish certain information about the purchasing process including when the process occurred, the weighted average price paid in an auction and other information or statistics. The release of this data is welcome as it will assist proponents who are considering participating in the fund. As a standard principle of best practice market design, CMI encourages the timely and consistent release of such pre- and post-auction information. In doing so, it should define the appropriate communication channels and provide a forward calendar of dates for the release.

### **3.13 Auction process – Moving from an initial single round, pay-as-bid tender process to a true reverse auction will increase transparency, encourage participation in the fund and better reflect a market mechanism.**

It is acknowledged that there will be significant learning-by-doing by the Clean Energy Regulator when conducting the first few ‘auctions’, as in the early phases of the ERF it will be somewhat unclear as to the type of projects that are likely to bid and at what price and volume. The picture is likely to become clearer after the initial rounds. If the ERF is to function as a true market mechanism, it should incorporate fundamental principles of best practice market design. The single round, pay-as-bid tender process with an undisclosed benchmark price, as discussed in the White Paper, does not promote transparency or efficient price discovery and may discourage ERF participation.

Whereas emissions trading schemes result in an explicit cost of carbon, the ERF’s reverse auction process, if appropriately designed, has the potential to generate an implicit, incentive-based carbon price signal. The efficient formation of this price signal will be used to inform abatement investment decisions, secure project finance and quantify potential risks associated with bidding into the fund. Moving from a tender process to a true multi-round reverse auction platform, with associated intra-auction and inter-auction price discovery processes allows for the iterative formation of a price signal of the marginal cost of abatement across the economy.

By reconfiguring the existing infrastructure for the auction of carbon units, a multiple-round reverse auction could be run on a real-time electronic platform. Such an auction would open at a publicly disclosed auction benchmark price, with the price incrementally stepping down until the value of the remaining bids just covers the total value of the funds allocated to the auction. The auction would then clear at a single auction clearing price which would subsequently be disclosed. Successful bidders could enter into a standardised offtake contract at the auction clearing price. Through their participation in multiple bidding rounds, unsuccessful bidders will know if their project was close to the auction clearing price or out significantly. It is important to note that there is as much price information in an unsuccessful bid as there is in a successful bid. This information can be used by ERF participants to better inform their future investment decisions in emissions reduction projects.

### **3.14 Timing issues – There are a number of timing issues for project proponents to consider in relation to the repeal of the Carbon Pricing Mechanism, the commencement of the ERF and the timing of the first auction.**

The ERF was initially scheduled to start on 1 July 2014, but is now more likely to commence operation following the repeal of the Carbon Pricing Mechanism (CPM). Given the uncertainty around the precise timing of CPM repeal and subsequent ERF commencement, there should be appropriate consideration for the level of commercial and regulatory risk associated with the variable start date.

For example, the unknown start date for the ERF impacts projects that are gearing up to bid into the ERF. There is no ability to pre-register and give confidence to project developers that their projects will be deemed ‘not new’ because of timing related to implementation.

The draft legislation does not detail the relationship between the existing methodology determination process which is ongoing and those for new methods, and how existing



methodologies are to transition across. Supplementary guidance on these issues would benefit potential project proponents.

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