



3 October 2012

Senate Standing Committee on Economics
Canberra, Australia

Submitted to: economics.sen@aph.gov.au

**IETA COMMENTS ON DRAFT AMENDMENTS TO THE *CLEAN ENERGY AMENDMENT BILL 2012*
AND ASSOCIATED ACTS NECESSARY FOR LINKING TO THE EUROPEAN UNION EMISSIONS
TRADING SCHEME**

On behalf of the International Emissions Trading Association (IETA), I am grateful for the opportunity to provide comments to the Senate Economics Committee regarding its Inquiry into the suite of amendments to the *Clean Energy Act 2011* and various associated acts necessary for linking Australia's carbon price to the European Union Emissions Trading Scheme (EU ETS). I hope that IETA's perspectives and insights are useful as the Committee moves forward with its Inquiry. See annex 1 for a summary of our comments.

IETA extends its appreciation to the government of Australia for the announcement of intended linkage between Australia's Carbon Pricing Mechanism and the EU ETS, and the draft regulatory amendments aimed at providing the framework for the first steps of linking. An emissions trading scheme (ETS) is the most efficient and effective policy option to address climate change, and linking ETS programmes provides an opportunity for a more robust allowance market to emerge across jurisdictions. Linking leads to price discovery, which helps to reduce overall programme costs by broadening the scope of available mitigation opportunities while further sparking competition to innovate and mitigate greenhouse gas emissions.

Additionally, linkage increases market liquidity and reduces transaction costs by involving more market participants, which also lowers the potential for market manipulation. A carefully designed and well-executed linkage of these programmes, which builds off valuable experiences and lessons learned from other environmental markets, will help maximize these benefits as well as maintain Australia's international reputation as a climate policy leader.

INTRODUCTION

IETA is dedicated to the establishment of market-based trading systems for greenhouse gas emissions that are demonstrably fair, open, efficient, accountable, and consistent across national boundaries. IETA has been the leading voice of the business community on the subject of emissions trading since 2000. Our 150 member companies include some of Australia's, and the world's, largest industrial and financial corporations—including global leaders in oil & gas, mining, power, cement, aluminium, chemical, pulp & paper, and investment banking. IETA also represents a broad range of global leaders from the industries of: data verification and certification; brokering and trading; offset project development; legal and advisory services.

For over a decade, IETA has remained committed to its vision of a global greenhouse gas market. To this end, IETA has facilitated thought leadership on linking through its original research. In 2001, IETA commissioned Eirik Haites (Margaree Consultants) and Fiona Mullins (Environmental Resources Management) to write the first comprehensive report on linking. In 2007, in preparation for COP 13 in Bali, IETA commissioned Dr. Robert Stavins (Harvard University) and Judson Jaffe (formerly Vice President of the Analysis Group) to put together a second report. Since these reports,



IETA has continued to view linking of carbon markets as a critical component of creating a consistent, fair and cost-effective international framework for reducing greenhouse gases.

OVERVIEW OF SUBMISSION

A linked Australian – EU carbon market has the potential to reduce overall combined costs, increase liquidity and assuage concerns about market manipulation. However, proper implementation of a linked market is required to avoid negation of the benefits. IETA believes that in order for a linked market to fully realise these potential benefits, a number of key factors must be taken into consideration in order to provide the foundation for successful linking and market operations. The recommendations and observations contained in this submission are organised as follows:

- 1. Future Program Design Changes & The Importance of Market Signals**
- 2. Improving Auction Design**
- 3. Australian-Issued International Unit (Shadow Unit) Approach**
- 4. Market Oversight Regarding Australian-Issued International Units**
- 5. Procedure on “Surplus Units”**
- 6. Financial Licensing Implications**
- 7. Other General Impressions**

IETA’s intent is to assist the Government of Australia, in any way helpful, to strike the right balance between market oversight and market effectiveness.

1. FUTURE PROGRAM DESIGN CHANGES & THE IMPORTANCE OF MARKET SIGNALS

The Australian system is moving from a design phase and a debate-and-policy-discussion phase into actual operation, with real money, assets, and investments at stake. This is a real market now, with a real compliance obligation. As the government moves through the reality of refining policy and adjusting it to deal with issues that have not been foreseen, there must be a solid process of signalling as to how that is going to work. What are the issues being considered? How is the government looking at dealing with each of those issues as it moves forward in addressing issues that arise in the years ahead?

The recent program amendments have been perceived by the market as a sudden announcement that propose swift changes, which had not been seen as a serious option in the months leading up to them. There had been signals that broad discussions with the EU were going on all the way back to the announcement of the Carbon Pricing Mechanism. But the signalling was not there to lead the market to believe that a serious development (i.e. linking with the EU ETS) was going to be agreed upon so soon between the Australian Government and the European Commission.

Based on this experience, there is a perception in the market that sudden changes will, and could, happen at any time. That is not a healthy situation for an ongoing and establishing market as it matures. We have seen in other (non-carbon) markets that there are very clear processes for signalling—there are clear processes for the government to signal changes, adjustments, enhancements, and responses. We need to make sure that the carbon market in Australia learns from other Australian market practices and adopts adequate market signalling approaches. It is



imperative that there is not a perception in the market that rules and regulations – which investment decisions are based upon – can be significantly altered without notice.

More changes are going to be needed to be made to Australia's Carbon Pricing Mechanism. Inevitably, with complex legislation like this, there will be evolution, enhancements and improvements which will need to be made. Issues that we have not foreseen will arise and they will need to be dealt with, and so a process of signalling those changes to the market will be very important for stability in the market, for confidence in the business community and in making sure that this program is not perceived as subject to sudden design changes without adequate warning.

2. IMPROVING AUCTION DESIGN

An ETS is a very complex policy intervention with a large number of interdependencies. Different design decisions in one regard will have an impact on what you can or cannot do in another. When changes are made in one area, these often open up opportunities to improve the scheme in other areas. The linking decision has opened up a number of these opportunities, one of which is around the design of domestic permit auctions.

Early on in the process to develop an Australian ETS there was an assumption that there would not be a clear price in the Australian market at the outset. It was assumed, quite reasonably, that when we had the first auction of domestic permits, it would also be a process of price discovery for Australian market participants. It was assumed that at the time of the first auctions that there would not be a traded price in the market, and so an ascending clock auction was proposed.

However, the changes that are being proposed in the amendments before parliament substantially alter that assumption. The implications of linking with the EU ETS are that there will be a very clearly known price in the market across the first phase (fixed price) and in the lead up to the second phase, when the flexible price stage begins. The design of the auction process, therefore, is one of those things that could be enhanced, assuming that the linking amendments are passed into law.

IETA recommends that the auction process be improved so that it is cheaper to operate from the government's perspective and it is easier to participate in from the market's perspective. A sealed bid auction is acknowledged as more efficient and practical by market participants, academics, and the consultants who originally proposed the ascending clock design. In comparison to the ascending clock approach, a sealed bid process is much less time consuming and provides far less opportunity for unexpected outcomes from the secondary market on the day of the auction.

There is already a system within the Treasury department—operated by the Australian Office of Financial Management—which conducts the auctions of Treasury Notes, using a sealed bid approach. This auction process happens regularly without disruption, without problem, and includes all of the practical aspects such as collateral, registration of bidders, settlement, and tracking. It would be of substantial benefit for the carbon market in Australia to leverage that existing infrastructure rather than try to recreate infrastructure specifically just for carbon.

IETA would be happy to work with the government to devise an optimal auction infrastructure based on our experience working with various other programs internationally.



3. AUSTRALIAN-ISSUED INTERNATIONAL UNIT (SHADOW UNIT) APPROACH

In the case where a direct link to the EU ETS registry system is not possible, the Australian government has created the provisions for a “shadow unit” approach to operate. This involves creating Australian-issued International Units (AIUs) through a one-way link and a “funnel” account in Europe operated by the Australian Government. IETA encourages a direct link between the registries as planned, as soon as possible, but in the meantime it may be pertinent to also consider alternative options (in addition to the shadow unit approach) to enable the use of EUAs in Australia.

IETA is not opposed to this shadow unit approach. However, IETA would be happy to work with the DCCEE, or other governmental officials, in order to help consider alternative possible “second-best” approaches on the off-chance a direct registry link cannot be negotiated or established. This work is also relevant to the mechanics of further linking arrangements between Australia’s Carbon Pricing Mechanism and emerging carbon markets in the Asia Pacific.

4. MARKET OVERSIGHT REGARDING AUSTRALIAN-ISSUED INTERNATIONAL UNITS

In many areas of ETS design, there is a need to balance proper market oversight in order to deter and prevent fraudulent behavior, with the importance of not burdening the market with overbearing regulation that hampers liquidity. IETA, through its work with the development of several other emissions trading programs throughout the world, including the EU ETS, the California & Québec ETS, and emerging Chinese sub-national ETS pilots, is well placed to work with Australian officials to help find that harmonious balance between adequate market oversight and optimum market participation and liquidity, as well as to determine sufficient accounting and MRV practices that will support both linked systems.

IETA suggests that the proposed amendments should provide a direct power for the Regulator to refuse to “make an entry” if it suspects that the instruction to do so is fraudulent. Such a provision exists in relation to other units in the Act. While this is not an issue in the draft amendments to the ANREU Act, it should be highlighted that the regulations on the registry arrangements will need to strictly address potential for fraud and double counting.

Tight co-operation and arrangements between the EU and Australia will be required with respect to: (i) ownership of the units; and (ii), a check after each electronic notice that is received by the Australian Regulator that the units have been transferred and that all ownership criteria are met, before AIUs are issued.

5. PROCEDURE ON “SURPLUS UNITS”

The current legislation states that when an entity relinquishes more units for compliance than necessary for a year, the excess (surplus units) are rolled over and held by the government on the entity’s behalf for compliance use the following year. IETA recommends that instead of the government holding onto surplus units until the next compliance year, the government return the surplus units to the entities that surrendered them.



We understand and appreciate that there is some level of administrative burden required for the government to return surplus units – however, unlike in the EU ETS where there are over 11,000 installations surrendering compliance units, the Australian ETS covers far fewer (about 300). When taking into consideration the small number of Australian entities likely to regularly over-surrender units for compliance, the actual administrative burden to return surplus units to entities is likely to be very minimal. By returning surplus units, entities are afforded more flexibility to use those units however they see fit within that compliance year.

6. FINANCIAL LICENSING IMPLICATIONS

With the inclusion of European Union Allowances (EUAs) into the Australian system, IETA understands that EUAs will now be considered as Financial Products under Australian legislation, and thus be covered by the Australian Financial Services Licensing (AFSL) provisions. This being the case, what are the implications for licensing requirements for advisors, dealers, and brokers?

Will ASIC now be instructed to develop some form of reciprocal arrangement for AFSL holders in Australia and the equivalent Markets in Financial Instruments Directive (MiFID) license holders operating in the EU? IETA would be happy to discuss options with the government as it best determines effective and efficient licensing arrangements.

7. OTHER GENERAL IMPRESSIONS

Aside from these stated issues, IETA does not foresee significant issues with the proposed draft amendments related to linking arrangements – and ultimately, as stated above, IETA applauds the effort of the Australian government to move forward with linking to the EU ETS. That said, much of the critical detail on the linking arrangement is yet to come – particularly around how the registry arrangements will work and the potential issuance of AIUs. Also very important to stakeholders will be the terms by which Australian Emissions Units, and Australian Carbon Credit Units issued through the Carbon Farming Initiative, are accepted into the EU ETS.

IETA is aware that negotiations with the EU will determine these outstanding important issues in the coming years, and requests participation in the dialogue where possible in order to provide support for the Australian Government from our wealth of expertise on linking and other ETS-related issues from our broad international membership.

CONCLUDING REMARKS

IETA extends its appreciation to the Australian government for its efforts to develop a fully-functional, linked, international greenhouse gas market to achieve Australia's current environmental goals and facilitate the necessary strengthening of ambition. Through appropriate consideration of flexibility and market efficiency – and transparent stakeholder communication on linking design options – IETA believes that a joint Australia - EU ETS carbon market will reinforce Australia's growing international reputation as a leader in innovate climate policy.



IETA reiterates its gratitude to Senate Economic Committee for the opportunity to provide comments, and welcomes further opportunities to engage regarding the linking process and/or anything else in connection with the development of the carbon pricing scheme. We would welcome the opportunity to appear before the Committee if it feels we could add value to its discussions on these issues.

If any further details or clarifications are needed, please do not hesitate to contact IETA's representative in the region, Rob Fowler

Dirk Forrister
President and CEO

ANNEX 1: SUMMARY CHART OF PRIORITY ISSUES AND IETA OBSERVATIONS & RECOMMENDATIONS

Item	Details	IETA Observations & Recommendations
Future Program Design Changes & The Importance of Market Signals	<ul style="list-style-type: none"> Recent experience is that the government has changed significant program elements with little notice, which creates a certain expectation in the market. The market thrives with signalling and as much certainty as possible in order to promote investment and liquidity. 	<ul style="list-style-type: none"> Future changes to the scheme are inevitable. Issues that we have not foreseen will arise and they will need to be dealt with, and so a process of signalling those changes to the market will be very important for stability in the market, for confidence in the business community and in making sure that this program is not perceived as subject to sudden design changes without adequate warning.
Improving Auction Design	<ul style="list-style-type: none"> There is an opportunity to improve auction design in the lead up to the flexible price period over the next several months. 	<ul style="list-style-type: none"> Utilize this opportunity to amend the auction design such that it is cheaper for government, and easier to participate in for the market. Consider leveraging the infrastructure from the Australian Office of Financial Management's Treasury Note auctions, which take place regularly without disruption or problems, and include the necessary financial processes for collateral and settlement. IETA would be happy to work with the government to devise an optimal auction infrastructure based on our experience working with various other programs.
Australian-Issued International Unit Approach	<ul style="list-style-type: none"> If a direct link to the EU ETS registry is not possible, the DCCEE will implement a "shadow unit" approach through a one-way link. 	<ul style="list-style-type: none"> IETA is not opposed to this approach, however we would be happy to work with government officials in order to help consider alternative possible "second-best" approaches on the off-chance that a direct registry link cannot be negotiated.
Market Oversight	<ul style="list-style-type: none"> As linking arrangements progress, tight cooperation between the EU and Australia will be required to address potential for fraud and double counting. 	<ul style="list-style-type: none"> Proposed amendments should provide a direct power for the Regulator to refuse to "make an entry" if it suspects that the instruction to do so is fraudulent. Arrangements between the EU and Australia should be made with respect to: (i) ownership of the units; and (ii) a check after each electronic notice that is received by the Australian Regulator that the units have been transferred and that all ownership criteria are met, before AIUs are issued.
Surplus Units	<ul style="list-style-type: none"> Current legislation states that surplus units relinquished for compliance in a given year will be rolled over and held by the government on the entity's behalf for compliance use the following year. 	<ul style="list-style-type: none"> IETA recommends that instead of holding onto surplus units, the government should return them to entities to use however they see fit.
Financial Licensing	<ul style="list-style-type: none"> EUAs will now be considered Financial Products in Australia. 	<ul style="list-style-type: none"> IETA requests clarity on what the implication for licensing requirements are for advisors, dealers, and brokers. Will reciprocal arrangements be made for AFSL holders in Australia and the equivalent MiFID license holders operating in the EU?