



29 October 2010

The Secretary
Senate Select Committee on the Scrutiny of New Taxes
PO Box 6100
Parliament House
CANBERRA ACT 2600

Dear Sir/Madam

Inquiry into Carbon Tax Pricing Mechanisms

The Australian Financial Markets Association (AFMA) welcomes the opportunity to make a submission to the inquiry into Carbon Tax Pricing Mechanisms. AFMA is the peak industry association for participants in Australia's financial markets.

In summary, with the Government having set an objective to reduce greenhouse gas emissions, AFMA believes that adoption of a market-based mechanism is the economically superior approach to achieve this objective and the introduction of a carbon tax would be a costly mistake for the economy.

AFMA has played a leading role in the development of spot and forward trading in Renewable Energy Certificates (RECs) issued under the Renewable Energy Target, NSW Greenhouse Abatement Certificates (NGACs) and other environmental product markets in Australia. As the national association for participants in the wholesale financial markets, we have established trading protocols and developed standard contract documentation, as well as providing data services, dealer accreditation and training to facilitate the efficient operation and development of the markets. AFMA has also developed industry standard documentation to support a cap and trade greenhouse gas emissions trading scheme (ETS), in anticipation of an ETS being introduced.

Many of AFMA's energy members have compliance obligations under the existing Commonwealth and state-based climate schemes and are experienced traders in environmental products, including RECs and the NGACs.¹ Other members act as intermediaries and provide extra liquidity and depth to the energy and environmental product markets.

AFMA's members have a vital interest in the form of action taken by the Government to reduce greenhouse emissions and we have taken a close interest in the development of government policy on emissions trading. The key benefits of an ETS are comprehensively outlined in the Garnaut Climate Change Review Report, the

¹ OTC market trading mechanisms also cover the ACT Greenhouse Abatement, Victorian Energy Efficiency Target, NSW Energy Savings and Queensland Gas Electricity Schemes.

Government's White Paper on Climate Change and the report of Prime Minister Howard's Task Group on Emissions Trading. Hence, we do not propose to present them here other than in summary form. However, we do wish to make a number of comments about the relative advantage of a market-based response over a carbon tax.

1. Rationale for an ETS

AFMA has promoted a broad-based ETS based on a cap and trade model, in preference to a carbon tax, as the most efficient and least cost mechanism to price carbon and thus reduce greenhouse emissions. This position is widely supported by member firms and reflects the strong preference of our energy company members.

In a cap and trade system, the amount of carbon emissions that is permissible is limited by the amount of permits issued by the Government (which is determined by its emissions reduction target). Under this system, emitters with low cost abatement opportunities will reduce their emissions while companies with a higher cost abatement curve will buy permits to meet their obligations. By allocating carbon permits between liable entities in this way, the cost of abatement for the economy as a whole is minimised. The cost can be further reduced by mechanisms that enable Australian emitters to tap into low cost abatement opportunities that exist in other jurisdictions.

The market process of allocating carbon permits to the companies who value them most sets a price for carbon. The carbon price covers both spot and forward values, so the market provides important information to help liable companies plan their investments and manage their carbon exposures over time.

A number of pre-conditions must be met in order for an ETS market to operate effectively. For example, the market should:

- have scale and scarcity to attract risk capital to promote liquidity;
- have many willing buyers and sellers to assist price formation;
- not have asymmetric information so as to form prices efficiently;
- have a governance process to support market integrity and promote participant confidence in an efficient, fair and orderly market;
- provide information to facilitate research and market analysis so as to support effective trading and investment decisions;
- have simple and transparent market rules.

Within this framework, an ETS could commence operation with coverage of key sectors and expand on a pre-set timetable. The broader is the coverage of an ETS then the more efficient it is, so it is desirable to start from the broadest possible base. Also, an ETS has the advantage of being able to link with overseas cap and trade schemes.

The Carbon Pollution Reduction Scheme (CPRS) would have provided a workable market from this perspective.

Other jurisdictions, including the European Union and New Zealand have successfully implemented an ETS. Moreover, the existing energy and environmental product markets of scale in Australia (eg electricity, RECs and NGACs) operate effectively, with turnover expanding significantly over the last year, which illustrates the available market experience and infrastructure that can be built upon when creating an ETS.

The Federal Government has now spent considerable resources and built a significant knowledge base on developing and implementing an ETS. We consider it both unnecessary and undesirable to put this work to one side to consider a carbon tax, which has previously been considered and rejected.

2. A Carbon Tax

2.1. Policy Framework

To stimulate a reduction in greenhouse gas emissions, it is necessary to put a price on carbon in some form or other. At its most basic level, the difference between a carbon tax and an ETS is that the Government will set the price of carbon if a tax is adopted and the market will set the price if an ETS is adopted. Two key points about this choice need to be considered.

1. Policy Objectives

The objective of climate change policy is to reduce the quantity of carbon emissions to a given target. The Committee's terms of reference include "(d) the likely effectiveness of these taxes and related policies in achieving their stated policy objectives". In this regard, we note that a tax is an inherently inferior approach to dealing with the climate change problem. Government can control either the price or the quantity of carbon but not both. If the Government decides to control the price (ie introduce a tax), then it forfeits the ability to meet a quantitative target. However, in contrast, through an ETS the Government can set a quantitative target and prices adjust to enable this target to be met.

A further complication is that taxation involves both the setting of a price and transfer of the associated revenue from carbon emitters to the Government. This increases risk that the price will not be set at an appropriate level to achieve the climate change outcome, as the rate of tax will become part of the political negotiations about the net allocation of the cost of abatement (ie the net impact of taxes and subsidies/compensation). An ETS separates the different tasks of setting a carbon price and providing compensation to affected stakeholders, which increases the likelihood of a correct price being struck for carbon.

A carbon tax would also introduce a risk of conflict in policy objectives. Taxes of their nature are about revenue collection to support government services and there is no doubt that at some point the carbon abatement and government revenue objectives of a carbon tax would become confused. We are concerned that the purpose of a carbon tax would drift from providing a (heavily compromised) price signal to promote carbon abatement to being a general revenue gathering exercise to fund other government programs (the continuance of the Sydney Harbour Bridge

toll is an example of this change in purpose).

2. Effective Price Formation

AFMA accepts the economic consensus that markets are generally better at setting prices than governments are, so we believe a positive case must be established to demonstrate the superiority of the government price determination process for carbon before a tax approach is adopted. The Government would require an immense amount of information about the abatement cost curves of individual firms across the economy to determine the correct level of a carbon tax to meet the climate change target. The Government does not have this level of information but an ETS would automatically capture it through the market, as the market adjusts to actions taken by emitters in response to its price signals.

2.2. Policy Implementation

It is sometimes argued that a carbon tax would provide a simpler and more certain solution to the greenhouse gas problem than would an ETS. AFMA has had extensive involvement in the tax reform process for more than a decade and our experience does not support this conclusion for several reasons.

Typically, a tax is simple in concept and complex to deliver. The GST is a good example. While the policy that underpins the GST is straight forward, the complexity of its application to some common commercial transactions presents enormous problems for business (hence, multiple reviews have been conducted since its introduction). This arises because the concept cannot be easily applied in every situation for practical reasons (eg financial services) and because certain goods and services are excluded for good social policy reasons (eg most food). Once there are inclusions and exclusions, then rules have to be introduced to combat the risk of tax avoidance, which further increases the complexity of the system.

There is no reason to expect that a carbon tax would be any different, as various stakeholders in the economic community would seek to negotiate terms to meet their specific circumstances. As we know from the CPRS experience, an ETS would experience the same challenges as groups would seek compensation or other forms of relief but we do not see a natural advantage for a tax in terms of simplicity from this perspective. In addition, the practical challenges of consistent measurement of liable amounts, preparation and audit of records etc would have to be managed in implementing a carbon tax.

Another argument made in favour of a carbon tax is that it would provide greater certainty by fixing the carbon price for business. The situation in practice is more complicated than this statement suggests and a tax comes at the cost of compromising the underlying policy objective. While a carbon tax would provide a more stable price for a period, it is likely that it would change over time (unless the carbon emissions target is abandoned altogether). There is no mechanism to hedge against future tax changes, though in an ETS carbon emitters may hedge against price volatility.

Related to this point is the fact that an ETS would support both a spot market and a

forward market, so the price signals would more effectively capture both the current price for carbon and expectations about future prices based on information available to the market. Auctioning of permits, including supplies of future vintages would build a transparent set of forward prices on which investment decisions can be based. As well, a forward trading market is expected to develop, enhancing the ability of liable entities to lock in the price of their forecast carbon exposures for some period of time. The information content in the forward price signal would assist business to understand and plan their management of the evolving demand/supply balance for carbon and it would also provide additional real time information to assist policy makers about the likely economic impacts of the policy. In contrast, unanticipated tax changes, particularly if frequent and irregular, would engender greater uncertainty about future costs to industry, making longer term planning more difficult.

We also note in this context that we do not expect the carbon price from a well-run ETS that operates within a certain policy framework to be more volatile than other commodity prices that businesses manage on an ongoing basis.

There is growing recognition that a forward carbon price is critical in evaluating long-term investment proposals. For example, significant reductions have been made of late to forecasts of capital expenditure in the power generation industry (which is responsible for over 40% of Australia's greenhouse gas emissions) due largely to uncertainty around policy design with respect to carbon. When, in May 2009, the Government announced that the commencement of its CPRS was to be deferred by a year (and then with a fixed price for the first year) our members reported that forward trading of carbon (which was patchy at best because of Scheme implementation uncertainty) effectively ceased.

Another important advantage of an ETS over a carbon tax is that it provides a framework through the Kyoto mechanisms for more effective international integration. The opportunity cost of emissions reduction varies across countries, so the cost of policy implementation can be reduced through recognition of abatement measures undertaken overseas. Taxation is inherently local in nature, with international tax treaties negotiated on a bilateral basis. We do not envisage a harmonised global tax could be negotiated, as the existing international tax conventions and mechanisms do not accommodate the creation and transfer of tax credits in the way that would be required to facilitate this.

Finally, we also note from a broader policy perspective that one of the benefits of the GST reforms was to remove a range of state-based indirect taxes. The Henry Review of Australia's Future Tax System considered further reform in the area of state taxation to be desirable. Hence, the merit of a carbon tax would need to be assessed against the backdrop of possible measures to reduce the number of taxes as a means to improve the efficiency of the tax system as a whole.

3. Concluding Comments

It is possible that the changed economic environment as a consequence of the global financial crisis, and in particular the lowering of international growth expectations, has tempered the appetite of some for climate change action given the costs involved.

Whether this is the case or not, it does not detract from the advantages of an ETS over a carbon tax as a mechanism to implement climate change policy. Moreover, an ETS might provide greater transparency to policy change as it is being made.

AFMA appreciates the opportunity to make a contribution to the Committee's important work on carbon pricing mechanisms. We are happy to provide further assistance if required.

Yours faithfully

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