AFMA

15 April 2009

Mr John Hawkins
Committee Secretary
Senate Select Committee on Climate Policy
PO Box 6100
Parliament House
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By email: climate.sen@aph.gov.au

Dear Mr Hawkins

Inquiry into Policies Relating to Climate Change

The Australian Financial Markets Association (AFMA) is an industry association representing members who have a specialist expertise in the development and operation of financial markets. Our membership includes both financial intermediaries, energy companies and other corporates, which are the main participants in both the over-the-counter (OTC) and exchange traded markets. AFMA has a successful track record in the environmental markets; for example, we played an important role in facilitating the development of the Renewable Energy Certificate market by providing standard transaction documentation, dealing accreditation and dealing protocols, amongst other things.

AFMA wishes to respond to the Committee's call for public submissions primarily by addressing item (1) of its terms of reference - "the choice of emissions trading as the central policy to reduce Australia's carbon pollution…". Our answers to this question do have a relevance to the other matters being investigated by the Committee; notably the market's capacity to send appropriate investment signals for green collar jobs, research and development etc.

1. The Choice of Emissions Trading Policy

AFMA has consistently held the view that a cap and trade emissions trading model is the most effective way to implement climate change policy. A market-based approach will place a price on carbon emissions, which is the most effective and economically efficient mechanism to achieve the Government's emissions reduction objective.

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The relevant issues have been formally considered in depth by a number of enquiries and reviews in the lead-up to the development of the final Carbon Pollution Reduction Scheme (CPRS) policy and they supported a cap and trade scheme.

The former government's *Prime Ministerial Task Group on Emissions Trading* concluded that market-based approaches that deliver a price on carbon will achieve greenhouse gas abatement, commensurate with an emissions target, at least cost. The *Garnaut Climate Change Review* subsequently stated in its final report that a well-designed emissions trading scheme has important advantages over other forms of policy intervention.

We are unaware of any reason to revise the conclusions of these reports in this regard or even to readdress in a substantive way the issues they considered. Conversely, the case for a cap and trade scheme has strengthened, especially with the President of the United States recently endorsing a cap and trade system as the means to implement climate change policy in the US. One reason an emissions trading system is better than the alternatives, such as a tax on carbon emissions, is that it provides the capacity for effective integration with international schemes thereby reducing the compliance cost for Australian business.

We can see no reason to deviate from the decision to adopt a cap and trade system at this late stage. Indeed, we would caution against a delay in the introduction of the trading system. In our submission to the Senate Standing Committee on Economics in March 2009, we stressed the need for certainty around Scheme implementation noting that any deferral in Scheme commencement would undermine development of an efficient forward market for carbon permits by creating new regulatory uncertainty. Such uncertainty would first manifest itself in reduced activity in the forward market, which is of concern because active forward markets provide market signals that enable long-term investments to be undertaken.

From AFMA's perspective, the most important issue to be considered now is how to ensure that the carbon market, as a central component of the CPRS, does in practice operate in the manner anticipated, by delivering reliable price signals that promote carbon abatement in a cost effective manner and remove uncertainty that is a barrier to long term investment.

2. Conditions for an Effective Carbon Market

The carbon market is a transactional space that enables the efficient transmission of permits to economic agents for whom they represent the greatest economic value. The bulk of trading is likely to be effected through forward transactions for permits rather than through spot (or cash) trading.

Experience has shown that the right organisational and regulatory conditions must exist for markets to deliver the allocative and capital usage efficiency and the transaction cost minimisation benefits expected of them. In respect of the proposed carbon market, it is vital to ensure the market framework and infrastructure exists to support the market.

In particular, the infrastructure must support a high level of user confidence in the fairness and efficiency of the market as a whole. In practical terms, this requires conditions to be met in relation to market hardwired infrastructure (eg trade settlement systems), certainty about legal rights, access to market relevant information in a timely manner and oversight by a strong market regulator, amongst other things.

The carbon market starts from an advantageous position to the extent that it is being designed from the outset with a specific purpose in mind and its operational components are being shaped to serve this purpose. Other markets typically evolve over time with fewer resources and do not have the benefit of the same degree of intensive planning and coordination of related activity.

Moreover, as financial and commodity markets go, the carbon market poses much less risk to its users from a regulatory perspective than do other markets. The Government is the issuer of permits which makes them reputable and reliable instruments and the Government will set the rules for auctions in the primary market. Most transactions will occur in the derivatives markets which are already regulated under the Corporations Act and, more generally, the market will not exhibit the extent of information asymmetry that exists in some other markets.

Existing Market Infrastructure Capacity

Australia's financial system has a strong capacity to support the development of an efficient emissions trading market.

The necessary base infrastructure exists and can be adapted to meet requirements at all levels in the emissions transaction chain including price discovery, trade execution, clearing, settlement (ideally on a "delivery verses payment" basis), permit registration and data services. Both OTC and exchange market venues for trading are well developed. High-quality support services like research, market analysis, risk management, product development and investment advice are available. The key market participants in the carbon market have experience through their involvement in the existing range of energy and enviro-markets. The effectiveness of Australia's financial regulatory system is held in high regard internationally and this national capacity meets another vital condition for a successful market.

It will be necessary to build some key components of market infrastructure; for example, a bespoke permit registry, but many other market operational systems and practices can be customised and adapted to facilitate carbon trading.

Elements of an Effective Market

To assist the CPRS policy design process, AFMA developed the following set of principles to be observed if an effective carbon market is to be created:

(a) The market should have scale and scarcity;

(b) The market should have many willing buyers and sellers;

(c) The market should facilitate competition in the provision of market services;

(d) The market should not have asymmetric information or concentration of buy-side or sell-side demand;

(e) The market should deliver credible price signals at which transactions will occur;

(f) Forward market prices should be more meaningful than the spot price, as they provide the focal investment decisions;

(g) The market should be able to create a wide variety of tradable products and instruments to satisfy the risk management requirements of participants and serve as building blocks in the design of products to meet the multifaceted needs of business and investors;

(h) The market governance process should support market integrity;

(i) The market, through market operators and the National Greenhouse and Energy Reporting System (NGERS), should provide information to facilitate research and market analysis;

(j) The market's design should be as simple as possible; and

(k) The market and its ancillary service providers in legal, funds management, risk consulting etc is an industry that can readily develop export services via regional pre-eminence.

3. Adequacy of the Proposed CPRS Framework

AFMA believes that the CPRS policy and implementation process, as reflected in the White Paper and exposure draft legislation, will support an effective market. Nonetheless, there are several features that we believe could be refined to improve the operation of the market as outlined in section 4 below.

Important design features of the CPRS that we support as being necessary for an effective market include:

- The specification of national trajectories, national scheme caps and gateways for a significant number of future years which provide a reasonably high level of certainty to the market;
- The non-adjustment of scheme caps, once fixed, for subsequent non-alignment with internationally negotiated national targets;

- The broad coverage of the Scheme to support market scale and a market composed of many participants (with no restriction on participation);
- The use of the obligation transfer mechanism to enable large fuel users to voluntarily downstream emissions liabilities and, thus, broaden the number of market participants;
- The allowance of international units as eligible compliance units;
- The use of a one-year compliance period with an administrative penalty plus make-good requirement as the non-compliance penalty;
- The treatment of carbon pollution permits as personal property that is able to be owned and transferred, uniquely identified and with legal title represented by an electronic registry entry;
- The ability for holders of permits to bank them for future use;
- The progressive movement over time towards 100% auctioning as the mechanism for permit allocation; and
- The intention to link more effectively over time with credible international schemes.

4. Factors to be Wary of in Market Design

Several features of the proposed CPRS require further consideration. While they would not prevent the functioning of the market in a relatively effective manner, they would impose a higher cost than is necessary, having regard to the Government's climate change and broader policy objectives. We provided details in our submission to the Senate Standing Committee on Economics in March 2009, so we have summarised the issues here.

The Setting of a Price Cap

A CPRS price cap would prevent the desired combination of economic efficiency and carbon pollution reduction that is sought from being achieved.

AFMA's in-principle position is that the market should be free to operate without the distorting intervention of a price cap (or a price floor for that matter). We were comforted by the Government's desire to set the price cap high enough above the expected permit price to ensure a very low probability of use and that it would only operate in the first five years of the Scheme. However, we consider the proposed price cap to be set at a conservative level and it is not clearly and demonstrably set at a high enough level to ensure a very low probability of use.

The 5% Holding Reporting Requirement

AFMA supports measures that ensure market efficiency and integrity and prohibit market manipulation and market misconduct in relation to transactions in permits and other emissions units. However, we do not believe that the proposed 5% holding reporting requirement[1] will effectively support these objectives.

The provision is borrowed from the share market but its purpose and rationale there do not sensibly transfer to the carbon market. The partial information revealed by the 5% holding requirement would be rendered, at best, meaningless and, at worst, misleading, apart from which it would generate additional compliance costs. Significantly, there are other substantive measures to prevent market misconduct. Therefore, we recommend the 5% reporting requirement should not be adopted as part of a CPRS.

The Post Year-end Final Auction

AFMA opposes the withholding of a portion of the supply of current-year vintage permits until a late auction beyond the end of the current compliance year. The deferred supply of permits could well contribute to the very sort of price squeeze that market participants and designers seek to avoid. There is, in any event, a more natural solution to concerns about meeting end year compliance obligations through the ability of liable entities to use up to 5% of next-year permits for this year's compliance.

The Designation of Carbon Permits as a Financial Product

In the absence of specific regulatory relief, designating carbon permits as a 'financial product' under Chapter 7 of the Corporations Act will impose a considerable cost on Scheme participants and increase the regulatory burden on business. It is not necessary to make carbon permits a financial product to provide the quality of market integrity regulation that is required to support a fair, orderly and efficient carbon market.

Carbon permits are not intrinsically in the nature of a financial product but are more in the nature of a commodity. This is recognised in the United Kingdom and New Zealand regulatory regimes, where they are not treated as a financial product.

If carbon permits are to be treated as a financial product, then it is vital that measures are taken to reduce Scheme participant compliance costs and minimise constraints to the development of a vibrant market. Matters that must be addressed in this regard include:

- The Corporations Act must be amended to avoid the risk that an entity's participation in the auction process (including as a group representative) will cause it to require holding an AFS licence;
- The Corporations Act must be amended to avoid the likelihood that many Scheme participants will need to obtain an AFS licence, or obtain a variation to their licence – a time consuming and expensive process.

[1] Described in the White Paper and outlined in the exposure draft Bill (Part 16).

- Regulatory measures that enable foreign financial services providers to deal in Australia's wholesale financial markets must be adjusted so they cover trading in carbon permits – this is a prerequisite to the desired level of international integration for the Scheme.

We request the Committee to signal its desire for an outcome that deals with these issues expeditiously and in a manner that promotes low compliance costs and the development of the Australian carbon market.

The GST Treatment

AFMA recommends that eligible carbon permit transactions should be treated as GST-free by applying Division 38 of the GST Act to them. This would meet the Government's desire to minimise tax compliance costs and promote carbon market development.

We note that New Zealand has sensibly applied a zero-rated GST in its ETS to ensure that GST has a neutral impact and does not hinder the acquisition and disposal of emission units across international markets.

The GST is a consumer tax, whereas the CPRS is a business-to-business market, so GST-free treatment would not affect tax revenue (other than an undesirable cash flow pick-up from business). GST-free treatment would be simple and efficient to comply with (easing the burden for both taxpayers and the ATO), so this approach would align with the Government's policy to minimise the cost burden that regulation places on Australian business.

5. Concluding Comments

AFMA hopes that this submission provides a useful overview of the superiority of emissions trading in achieving the stated needs of the CPRS. We would welcome the opportunity to address the Committee. Please do not hesitate to contact Allen Young, Senior Policy Executive, on ayoung@afma.com.au or (02) 9776 7941 if further assistance or clarification is desired.

Yours sincerely

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