27 March 2009

The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Sir/Madam

Carbon Pollution Reduction Scheme Exposure Draft Bills

The Australian Financial Markets Association (AFMA) is pleased to comment on the exposure drafts of legislation to implement the Carbon Pollution Reduction Scheme (CPRS). AFMA is the national association for participants in the wholesale financial markets. Our membership includes both financial intermediaries and corporates (including 30 energy companies) who use our markets.

A core objective of AFMA is to promote the development of efficient and competitive financial markets in Australia. In this capacity, we played a leading role in the development of spot and forward trading in Renewable Energy Certificates and other environmental products in Australia.

Key aspects of our work include:

- Management of the trading conventions, documentation and data services that ensure the efficient operation of Australia's over-the-counter (OTC) markets;
- Supporting high professional standards through training and officially recognised accreditation for individuals engaged in these markets.

AFMA hopes that the attached submission provides a useful presentation of issues to be taken into account in considering the Bill and suggestions on how it may be improved. We would welcome the opportunity to address the Committee. Please do not hesitate to contact Allen Young, Senior Policy Executive, at ayoung@afma.com.au or on (02) 9776 7941 if further assistance or clarification is desired.

Yours sincerely

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Submission on

Carbon Pollution Reduction Scheme

Exposure Draft Bills

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1. Policy Framework for the CPRS Legislation

AFMA is a trade association with a specialist expertise in the development and operation of financial markets. To assist the Carbon Pollution Reduction Scheme (CPRS) policy design process, we developed the following set of principles that would need 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;

(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.

Set against these principles, AFMA supports the following CPRS design and policy elements that underpin the exposure draft legislation:

- The cap-and-trade model;
- The specification of national trajectories, national scheme caps and gateways for a significant number of future years which provide reasonably high certainty to the market;
- The rolling forward of national trajectories, national scheme caps and gateways well in advance of their future year applicability with provision for a default scheme cap setting if the regulations are not in place by the required time;

- 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;
- 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 predisposition to expand the scheme's coverage to at least include the agriculture sector;
- 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 nature of the carbon pollution permits as personal property that is not involuntarily extinguishable, able to be owned and transferred by any person and the permits being bankable, uniquely identified and with legal title represented by an electronic registry entry;
- The ability to use up to 5% of next-year permits for this-year compliance;
- The progressive movement over time towards 100% auctioning as the mechanism for permit allocation;
- The auction design elements of ascending-clock, monthly frequency and advance auctioning of future-year permits (noting that not all of the auction design elements are supported as is discussed further below);
- The intent to relax restrictions on linking with credible international schemes;
- The commitment to work with the States on appropriate termination arrangements for the various existing state-based schemes.

However, there are significant elements of the exposure draft legislation that we do not support from the perspective of market efficiency:

(1) The setting of the price caps;

(2) The 5% holding reporting requirement;

(3) The post year-end final auction;

(4) The designation of a permit as financial product;

(5) The GST treatment.

These issues are considered in more detail in section 3 below.

2. Start Date for CPRS Market

AFMA supports the existing timetable for the start of the CPRS on 1 July 2010. It is very important that certainty be provided as soon as possible to other existing markets that are currently being affected by the proposed Scheme. In particular, the market for term electricity contracts (for both electricity supply and electricity derivatives) is hindered by an inability to properly factor in a carbon price. Likewise, the extension of term finance facilities has the added difficulty of not knowing with any precision how and when a carbon price may affect credit terms.

A deferral of the Scheme would adversely affect electricity market participants who have taken prudent steps to cover their exposure to the price impact of the CPRS. For example, in the electricity derivatives market, many over-the-counter (OTC) products and all futures contracts in Australia trade on a "clean" basis; that is the forward price factors in the estimated impost of the CPRS. There is no mechanism under International Swaps and Derivatives Association (ISDA) documentation or Sydney Futures Exchange (SFE) rules to adjust prices of deals/contracts should the CPRS be delayed. With any Scheme delay, the National Electricity Market (NEM) pool price post 1 July 2010 will be lower than it would be under the CPRS, unfairly financially disadvantaging buyers of electricity derivatives.

In addition, deferral would undermine development of an efficient forward market for carbon permits by creating new regulatory uncertainty. Any delay in Scheme commencement will necessarily require steeper trajectories and may be expected to create doubt in the market about revised schedules being met. In such circumstances, forward trading is likely to be limited in volume, as the consequences of failure to deliver under ISDA documentation are quite complex.

Another relevant consideration is that the opportunities and benefits for Australia to assert pre-eminence as a regional carbon trading hub will be diminished by any delays in introducing the CPRS. The acceleration of skills, market and product development necessary for such a leadership position would undoubtedly slow, if not reverse, and give advantage to other competing regional centres to fill the gap.

3. Design Problems for an Effective Market

Draft CPRS Bill 2008

3.1 The setting of the price caps

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). However, we were comforted by the CPRS Green Paper position that

"The price cap would be set 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.

Our expectation is that the setting of a price cap at $40 with 7.5% per annum escalation, as proposed in section 89 of the exposure draft Bill, would not deter investment in emissions reduction technology, though it could weaken the market's price stimulus for such change.

We consider the 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". Thus, there is a risk that it may at some point dilute the market signalling process that assists adjustment to a lower carbon environment. Further, the relatively flat escalation over future years leaves open the significant prospect of a step-change in market prices for the years immediately following the cessation of the price cap.

We acknowledge the challenge in setting a price cap to balance the competing policy objectives of emissions reductions and limiting compliance costs, especially in an uncertain environment. However, we think there is a reasonable case to err more on the side of caution in promoting market development through a higher price cap.

3.2 The 5% holding reporting requirement

As stated above, 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 5% holding reporting requirement described in the White Paper and proposed in the exposure draft Bill (Part 16) will effectively support these objectives.

The provision is clearly borrowed from the share market and the White Paper described the reasoning for the provision as a requirement "…which reduces the possibility of entities 'cornering' the market for permits" and "…aimed at promoting efficient price discovery".

In the share market, the substantial shareholder reporting positions are primarily aimed at ensuring an informed market in the context of competition for corporate control. The focus of the reporting requirement in the share market is in the same dimension as the underlying market – that is, it involves the reporting of physical holdings of equities which can be used to vote and influence corporate control. There are other provisions to deal with the risk of market misconduct, including market manipulation (as will be the case for the carbon permits market).

The carbon price formation process, the efficiency of which is the objective of the CPRS reporting requirement, will occur to a much greater degree in the

derivatives market. In particular, market activity in emissions units will likely exhibit a significantly higher ratio of forward settlement trading to cash or spot physical trading. In the European Union Emissions Trading Scheme (ETS), in the 12 months ending February 2009, futures contract trading volume was 1.6 times spot physical trading[1]. This is despite market participants' views that the share of spot trading has risen somewhat in recent months, as the temporary reduction of counterparty forward trading limits has forced a greater use of the spot market verses the forward settlement market.

Consequently, the proposed 5% holding reporting requirement will be of limited value as a market information tool, as it will not reflect underlying market activity.

Indeed, the proposed reporting threshold is likely to be counterproductive, leading to "false positive" reporting in the context of common inventory financing transactions, wherein a substantial holding does not have a bearing on the economically effective position nor give any true guide toward market cornering activity. For example, a permit holder may enter into a spot sale transaction and simultaneously a forward buy transaction in order to finance a holding until nearer the targeted surrender date; the spot purchaser may have a substantial holding (particularly if in aggregate it enters many such transactions) but would not have an economic interest or risk in the price of the permits, as these have already been committed to be sold back to the market at an already fixed price. More generally, traders typically seek to hedge their market exposures, which gives rise to gross holding positions (especially in derivatives) that bear no relationship to their net market exposure.

With unlimited import of eligible units allowed to provide an additional safety valve on domestic Scheme compliance costs and encourage more active participation in the global carbon market, there is a significant notional supply of permits available to the Australian market at any given time – which will be a significant influence on the price of Australian Emissions Units (AEUs). The value of having partial information about a subset of units able to be acquitted is doubtful. Moreover, the Commentary to the exposure draft Bill states that provisions that allow for the future sale and transfer of AEUs to foreign registries (export) over the medium term will be included in the final Bill. This further illustrates the expected integration of the Australian and international markets, which places doubt on the value of the proposed information.

Significantly, there is a range of other measures to prevent attempts to corner the market or significantly limit the benefit from doing so including the market misconduct provisions, government control of the auction process, access to participant holding information by the authorities through the Registry, the

[1] Comparing futures trading on the European Climate Exchange (the dominant futures exchange) with spot trading on BlueNext (the dominant spot trading exchange).

ability of Scheme participants to bank and borrow permits to ameliorate any demand/supply imbalances, access to Kyoto units and the price cap.

The partial information revealed by the proposed 5% holding requirement can be readily rendered, at best, meaningless and, at worst, misleading, apart from which it will generate additional compliance costs. Therefore, having regard to this and the substance of the other protections available, we recommend that this requirement be deleted from the Bill.

3.3 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.

Our soundings of compliance buyers reveal a strong preference for the prudent/conservative risk management approach of matching unit acquisitions to liabilities as soon as, or even ahead of, those liabilities arising. Whilst they do see some merit in a deferred auction, it is couched in terms of "but not for us as we will be fulfilling our purchasing requirements well before that".

The natural consequence of this inherent conflict between immediate demand and deferred supply is that the market price will be forced higher than it would otherwise be. Thus the deferred supply of permits will 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 through the ability to use up to 5% of next-year permits for this year's compliance.

Draft CPRS (Consequential Amendments) Bill 2009

3.4 The designation of a permit as financial product

In the absence of specific regulatory relief as outlined below, designating carbon permits as a financial product[2] will impose a considerable cost on Scheme participants and increase the regulatory burden on business. Indeed, there is a valid case not to treat carbon permits as a financial product.

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 a financial product.

It is not necessary to make carbon permits a 'financial product' under the Corporations Act to provide the quality of market integrity regulation that is

[2] Schedule 1, Part 1, item 6 of the CPRS (Consequential Amendments) Bill 2009.

required to support a fair, orderly and efficient market. Most carbon market transactions in Australia will be in the form of derivatives and, thus, will be regulated as "derivatives" in the Corporations Act. In regard to spot (physical) transactions, the primary market in carbon permits will be operated by the Government and poses few of the risks of normal markets. More generally, the Trade Practices Act would apply to transactions in carbon permits (if they are not a financial product), prohibiting misleading and deceptive conduct and unconscionable commercial conduct.

If the Government, nonetheless, decides to treat carbon permits as a financial product, then it is vital that measures are expeditiously undertaken 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:

Market making and auction participation

The Corporations Act concept of market making is very broadly defined and could encompass submitting bids in the proposed permit auction process and in operating an active trading position. Entities that make a market in a financial product must hold an Australia Financial Services (AFS) licence. The law should be amended to avoid a situation where there is any risk that an entity's participation in the auction process will cause it to require holding an AFS licence. In addition AFMA seeks an exemption for market making where a controlling corporation is simply operating a trading desk to acquire permits on behalf of the 'group'. Otherwise the exemption referred to below for dealing will be of little use if 'controlling corporations' need to be licensed for market making.

Participant compliance costs

Many Scheme participants may need to obtain an AFS licence, or obtain a variation to their licence if they are already authorised to trade in derivatives. For example, if the controlling corporation in a CPRS group allocates permit costs to different group entities, this may result in the permit acquisition itself being treated as being acquisitions on behalf of those group entities, in which case the 'own dealing exemption' in section 766C(3) of the Corporations Act would cease to apply. As a result, the controlling corporation would need to obtain an AFS licence. Our experience is that the licensing process is expensive and time consuming for businesses. One way to avoid this problem would be to expand section 766C(3) to include dealing in 'eligible emissions units' on behalf of a 'group' (as defined in NGERS).

International linkages and integration

The Corporations Act 2001[3] exemptions that enable foreign-regulated wholesale financial services providers to deal in the Australian market do

[3] For example, section 911A(2)(h) enables ASIC to recognise substantially equivalent regulation of foreign wholesale financial services providers by overseas regulators – of

not cover carbon permits. Hence, if carbon permits are a financial product, there will be a barrier to international trade, reducing market depth and adversely affecting international linking opportunities with other schemes.[4] Accordingly, both the quality of our carbon market and Australia's ambitions to be the 'carbon hub' in the Asia-Pacific region would suffer significantly. To avoid this situation, specific regulatory relief is required for carbon trading

Regulatory administration costs

The consequent compliance obligations of treating carbon permits as financial products would also be likely to give rise to significant additional regulatory costs for ASIC. Processes and procedures would need to be developed to address a new financial product and regulatory relief would need to be formulated across a range of areas to provide a satisfactory regulatory outcome.

AFMA is involved in productive consultations with the Department of Climate Change on these issues. The Senate Economics Committee could play a helpful role by acknowledging this process and signalling 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.

3.5 The GST treatment

If the Government's intention is to avoid imposing a GST burden on business as a consequence of the CPRS, then carbon permits must be treated as GST-free. 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 Scheme 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.

The proposed GST treatment would give rise to complexity given the range of possible tax outcomes for trading in eligible permits and associated derivatives – eg spot trading versus derivatives trading versus

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course, countries like the United Kingdom and New Zealand do not regulate carbon permits as a financial product and, as such, most likely will not be considered to have a sufficiently comparable regulatory regime for ASIC to grant relief.

[4] For example, an energy trading desk based in London and not regulated by the FSA in the United Kingdom for carbon trading would not be able to get wholesale licensing relief for its dealings with Australia-based counterparties.

imported/exported units etc. Consequently, business would incur a GST cost through higher tax compliance costs and non-recoverable GST in some circumstances. Intermediaries and active traders would face significant GST-specific implementation costs, as financial dealing systems are typically designed around input taxed securities and are not designed to produce tax invoices or track GST payments.

GST-free treatment would make it less confusing for international participants looking at entering the Australian market, as they would not need to rely on the GST-free export provisions. This would also remove the need to confirm that an international purchaser is not present in Australia to ensure the GST-free export provisions are met. This outcome is consistent with the CPRS objectives, as greater international participation over time will increase liquidity in the market.

In summary, having regard to the desire to minimise tax compliance costs and promote market development, AFMA recommends that eligible spot and derivatives transactions should be treated as GST-free by applying Division 38 of the GST Act to them.

4. Detailed Comments on Provisions in the Draft CPRS Bill

At this stage, AFMA's Carbon Markets Committee has not had the time to comprehensively review the exposure drafts of the legislation. This submission raises some significant issues from a carbon markets context and we intend to further our review and make a submission to the Department of Climate Change. To the extent that time permits, we would be pleased to make additional representation to the Committee.

In general, we commend the exposure drafts for the extent of codification of policy but more should be done to include provisions in the Bill rather than defer them to regulations.

With respect to the inclusion of policy positions in the CPRS Bill, we are pleased to see:

Sec 14 The Minister is under a "must" obligation to set national Scheme caps in a timely manner, giving consideration to key issues but with a default cap setting mechanism in the event of no or slow ministerial decision. There is no power to amend a cap once set.

Sec 15 The Minister is under a "must" obligation to set national Scheme caps within the upper and lower gateways, giving consideration to key issues.

Sec 88 AEUs may only be issued in specified ways.

Sec 93 The Authority must ensure that all available AEU supply is at least offered if not issued. These two sections (88 and 93) preclude the

withholding of any AEU supply from the market or the creation of any reserve supply of AEUs other than by Government purchases at auction.

Sec 103 The Minister will initially set the auction rules, but the Authority is intended to assume this power by 1 Jan 2012. The matters to be the subject of the auction rules appear to be comprehensive.

Sec 129 Emission units that are able to be surrendered for compliance are prior- or current-year AEUs, not more than 5% of next-year AEUs and any issued international units without regard to their vintage.

Sec 133 The unit shortfall penalty is limited to 110% of the average auction price of auctions held within the financial-year (sensibly excluding any auctions held prior to or after the financial year).

Sec 176 The free allocation of AEUs to coal-fired generators is specified as to the maximum amount and the issuance schedule.

Sec 260 (and forward to section 278) The information to be made publicly available is comprehensive and excludes information about a person's holdings of units in their own Registry account.

Sec 353 (and following section) The scope of the independent reviews is largely prescribed and reporting, tabling in Parliament and the Government responding is time-bound.

However, there are a number of policy positions that do not appear to be adequately reflected in the exposure drafts. In particular:

Part 2 It is not clear that Scheme caps will be specifically set as the national trajectory less projected emissions from uncovered sources, that Scheme caps will be increased with the subsequent coverage of uncovered sources and that Scheme caps will not be adjusted for any misalignment with subsequently agreed international commitments.

The setting of gateways is only a "may" not a "must" and there is no mention that gateways be set to 10 years beyond the caps, extended for 5 years each 5 years and narrowed each 5 years.

Part 3 We note that the Australian Bankers' Association (ABA) in its submission to the Inquiry has advised that there is considerable confusion about the concepts of operational control and financial control as contained in the NGER Act and the CPRS Bill (Part 3 Division 6), respectively. Having regard to the issues raised by the ABA, we agree there would be benefit in further consideration being given to these matters, with a view to clarifying the intended outcomes.

Part 4 At Section 89, there does not appear to be any compulsion on a liable entity to surrender all of their holding of eligible units before accessing the fixed-charge units. Market circumstances may exist,

particularly toward the end of the price cap period, where there is financial benefit in paying the fixed-charge and banking eligible units held if the future value of those units exceeds (or is expected to exceed) the fixed-charge. The market consequence would be an excessive release of unit supply under the fixed-charge and an ongoing holding of bankable existing unit supply.

We note that the fixed-charge rises by 7.5% per annum rather than the "5% real rate" of the policy position but regard the simplification to a specified rate to be beneficial.

At Section 87 (and elsewhere), there is no explicit provision that an entry in the Registry is sole and sufficient evidence of legal title. At Section 103, the setting of auction rules is only a "may" and not a "must" which is incompatible with Section 88 specifying auctions as one of only a few ways in which AEUs can be issued.

Further, the auction rules setting provisions should preclude the use of auctions as a supply-side price management tool – for example, delaying AEU release to push prices higher – by obliging regularity, consistency and certainty as the timing and volume of auctions.

At Section 113, the controls over the carry-over of Kyoto units should be qualified as to be set and applied equitably among holders of such units.

Further, we note that the Commentary to the exposure draft Bill refers to provisions allowing future export of AEUs to be included in the final Bill.

Part 5 At Section 129(7), it is not clear that the text adequately refers to the exclusion of particular units that, though initially eligible, become determined as ineligible.

Part 8 The objects of this Part are not adequately reflected in the detail given the absence of any provisions that clarify the means of identifying EITE activities, the amount and timing of transitional assistance and the circumstances in which such assistance is no longer warranted.

Part 16 As mentioned at 3.4 above, the provisions of this Part are unlikely to provide meaningful information that goes to a usefully informed market and reducing the risk of market manipulation activity.

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