

25 March 2009

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

Westpac submission: Inquiry into the exposure draft of legislation for the Carbon Pollution Reduction Scheme

Westpac is an active participant in ongoing public policy dialogue on the design and operation of a market-based response to climate change and welcomes the opportunity to provide a submission on draft exposure legislation to implement the Carbon Pollution Reduction Scheme.

Westpac has accepted the scientific consensus on climate change for a number of years now. We believe that climate change will have significant economic, social and environmental impacts in the regions where we operate. Upon examining the subsequent projected economic impacts on Australia, we formed the view that a precautionary approach to managing current and future risks is required.

Having reviewed the various policy options available to government to regulate the reduction of national greenhouse gas emissions, we quickly came to the view that an emission trading scheme and the application of broad based market mechanisms is the most effective, affordable and flexible means of transitioning to a low carbon economy.

Today, there is no doubt that there is broad industry consensus on a 'cap and trade' emissions trading scheme as the most appropriate policy response for Australia.

This will need to be implemented as part of a suite of policy responses aimed at tackling the various policy and market challenges associated with structural adjustment to a low carbon economy, including support for a comprehensive global agreement, a practical strategy for accelerating the commercial deploying of low emission technology, support for investment in renewable energy, adaptation strategies for impacted communities and awareness raising across the community to promote behavioural change.

Emissions trading, and putting a price on carbon, is the mechanism which makes all other policy responses affordable and achievable.

Westpac has played an active role in participating to the development of an appropriate cap-and trade model for Australia, under both the current and previous Commonwealth governments, and at the state and regional level. We have worked closely with the Australian Bankers Association (ABA) and the

Australian Financial Markets Association (AFMA). We provided a number of submissions to the Garnaut Review.

Westpac has also participated in a number of multilateral industry-led initiatives over the years, aimed at promoting a better understanding of the challenges involved in implementing an effective policy response to climate change. This has included the 2006 Australian Business Roundtable on Climate Change (www.businessroundtable.com.au), the 2007 Australian Business and Climate Group review of investment barriers for clean technology (www.businessandclimate.com) and the 2008 Australian Agricultural Alliance on Climate Change (hosted at www.climateinstitute.org.au). Westpac was also one of nine founding members of the United Nations Environment Program Finance Initiative (UNEPFI) in 1991, which now has 171 signatory financial institutes globally and an extensive work program focusing on this and related environmental, social and governance risk issues.

This submission also draws upon the bank's considerable experience in factoring environmental considerations into business policies, systems, and procedures as well as our practical participation in environmental markets to date. Westpac has been trading in the EU ETS since 2006 and undertook the first trade of Australian Emission Units (AEUs) under the Carbon Pollution Reduction Scheme (CPRS) in May 2008, agreeing to purchase 10,000 units at \$19 a tonne for delivery 2012.

Westpac has not sought to respond to or comment on every aspect of the draft exposure legislation. We support the technical recommendations provided through the Australian Bankers Association and the Australian Financial Markets Association. This submission has sought predominantly to raise a number of contextual arguments to the legislation which will influence final design and to highlight a short list of four specific issues yet to be resolved.

Current state of the carbon market

It is worth noting that a nascent market is already forming around the impending CPRS. This includes both forward trading around future permit allocations (AEUs), preparation for offshore credit (CER) trading and the incorporation of carbon price considerations into existing markets which will be correlated to the carbon market (the electricity market).

Policy uncertainty is causing increased volatility in all these markets.

- **AEU trading:** To date there have been around half a dozen trades in AEUs, mostly energy companies and brokers and predominantly starting out from 2011-12 or 2012-13 with an average volume of around 10,000 units traded OTC. Prices have ranged from \$18 to around \$24. In early February 2009, the first-ever trade in the 2010/11 AEU contract was reported, when 50,000 permits changed hands at A\$21.
- **CERs:** Australian businesses are increasingly looking to secure a pipeline of Certified Emission Reduction credits (CERs) from international markets with many already having established an inventory. This is for two reasons: Firstly, the CPRS allows unlimited use of CERs for compliance purposes and secondly, because the price of sCERs in international markets has halved in the last few months (currently at approx ten euro) making them a very affordable option for Australian companies.

The price of a CER is predominantly influenced by the EU ETS and standard supply and demand factors. The unlimited use of CERs in the CPRS means that the price of Australia permits, or AEUs, will be set by the price of CERs from offshore markets. This is currently placing downward pressure on the forward price of AEUs, and is expected to keep them below, or close to, the \$20 level for the foreseeable future.

- **Electricity trading:** Prices in the Australian National Electricity Market already reflect inclusion of the price of carbon from mid-2010. This is a live market in which participants and corporates are making real, irreversible, long term investment decisions. Regulatory uncertainty around the start date of the scheme exacerbates the volatility of these prices. In addition, other factors such as the carbon intensity of particular states and generators, as well as the level of compensation or free permits accessible to particular companies, are also influencing market movements today.

As an indication of the immediate market impact of the current political debate, when Prime Minister Rudd accidentally stated in a radio interview (5 March) that the scheme would commence at the end of 2010 and not mid-year, over the 15 minutes it took for a correction to be made, the 2011 forward market immediately and violently traded down before moving back to its original starting price after a public correction was made.

More broadly, in the last six months Westpac has witnessed a significant increase in the levels of awareness and active management of carbon liabilities in the businesses we have spoken to. In addition, companies are investing significant amounts of capital into preparing for the advent of the scheme.

Clearly, different companies are at different levels of development, depending upon their industry, the view they are taking on the political outcome and their particular state of preparedness. However, we have seen a significant uptake in business response to carbon management through client engagement to date, involving moving beyond undertaking carbon inventories to formulating an investment and trading response.

The Carbon Pollution Reduction Scheme – exposure draft bills

Westpac supports the majority of the design and implementation detail set out in the exposure legislation. We believe it will support a market which is broad and deep enough to promote least cost carbon abatement across liable entities and the broader Australian economy over time.

We also acknowledge there are a number of outstanding technical details to be finalised and continue to work with the government in engaging around specific aspects of the market. We have identified four key areas to discuss in further detail.

- ***The \$40 price cap***

Westpac has continuously argued against the application of price control mechanisms on the carbon market, on the basis that it distorts behaviour and undermines the price signal. We have conceded that if a price cap were to be applied, it must be sufficiently high as to avoid any likely possibility of being hit. Our opinion is that \$40 is not sufficiently high to meet these criteria.

While we note that the CPRS exposure legislation has increased the annual adjustment of the price cap from 5% to 7.5%, we would argue that the starting figure for the price cap should at least \$50 a tonne, rising by 10% per annum.

- ***The designation of permits as financial products***

Westpac supports the argument that market manipulation and market misconduct in relation to transactions in the CPRS should be prohibited. This will be fundamental to the operation of an orderly and efficient market. However we do not believe that the current proposal to treat permits as financial products is necessary to address this issue.

Westpac believes that the primary trading of permits will be adequately covered by the market conduct provisions of the Trade Practices Act, while any derivatives products would already be considered a financial product and therefore covered by existing financial market provisions.

Over-regulation of the market will limit the number of participants, unnecessarily increase transaction costs and will introduce a significant number of legal obligations and compliance costs.

We further note that no other jurisdiction have sought to designate carbon permits as a financial product and have instead regulated carbon derivatives markets via existing financial market provisions.

The banking and financial services sector is currently engaged in ongoing dialogue with the government on this issue, and Westpac would also support additional commentary provided by the ABA and AFMA to the Committee.

- ***The GST treatment of trading activity***

Westpac does not support the application of the Goods and Services Tax (GST) to CPRS transactions.

Westpac believes that applying the GST to carbon transactions will unnecessarily add to the compliance costs for liable emitters and will create pricing differentials between permits and offset credits traded in the Australian CPRS and with other international markets. This would unnecessarily limit the appetite of foreign players in the Australian scheme and damage any early-mover advantage to becoming a regional carbon hub.

We would also note that the New Zealand government recently reached a similar conclusion on this matter, and decided not to apply this approach to the New Zealand Emissions Trading Scheme.

In addition, Westpac supports the specific feedback provided on this issue via the AFMA submission.

- ***The auction process***

Westpac notes that there are a number of technical aspects of the auction process yet to be finalised, and is continuing to engage in ongoing dialogue with the government on the auction procedures, policies and rules of operation.

While we are broadly in agreement with the Ascending clock auction model proposed, Westpac is strongly opposed to the proposal for delayed settlement (allowing exchange of permits and payment at an agreed future date to limit cash flow impacts).

Westpac believes that allowing liable emitters to delay settlement for permits acquired at auction, would severely undermine the development of secondary markets for future vintages and reduce liquidity in the market, for limited benefit.

Concluding comments

Westpac is well known in the market for adopting strong risk management practices and a forward looking progressive approach to identifying emerging material risks and opportunities for our business. We recognised a number of years ago that climate change is ultimately a business issue requiring the same approach.

As markets and policy frameworks develop as a means of taking greenhouse gas emissions out of everyday lives, financial institutions have a critical role to play in partnering with customers across all areas of our business to help transition to a low-carbon future.

There are no significant advantages for Australian business in delaying the commencement of the CPRS. Practically speaking, business responds to issues when they need to. If the Government delays the introduction of the scheme, business will delay implementing an effective response, and Australia's

emission reductions targets, and legal obligations under the Kyoto Protocol and the subsequent implications for the Australian taxpayer, will become more difficult to achieve in the longer term. Further future attempts to proceed would also consequently be met with a high level of scepticism and inactivity.

Economic modelling undertaken both domestically and internationally, consistently demonstrates that delaying an effective policy response increases the economic costs and shock to the economy, while beginning now and ramping up the response gradually will reduce costs and smooth out the transition of Australian business into a carbon constrained economy.

Failure to implement an effective and comprehensive policy response at this stage will increase the amount of regulatory uncertainty currently hindering investment in clean technology and the structural adjustments required to de-carbonise the Australian economy. This is part of an inexorable global market trend. There is no competitive advantage to Australian businesses to maintain the status quo.

There is no doubt that the impact of the introduction of a price on carbon will be felt across industry and across the economy. This is the intent of a market-based mechanism aimed at achieving greenhouse gas emission reductions. There is also clearly a case for a number of adjustment support mechanisms to be established with the introduction the scheme to allow business and members of the community to transition into a carbon-constrained economy.

However, we believe that the overall design of the scheme should not be significantly re-cast to respond to short term and immediate economic considerations. The current design of the CPRS, as a market based mechanism and in other design elements, has significant price and market buffering measures in place to respond to current economic conditions.

In addition there is a strong argument that decreased economic activity as a result of the current economic downturn and the subsequent easing in projected emissions growth, will provide Australia with the breathing room required to implement a comprehensive carbon market mechanism. This would be done while supporting Australian business through the transitional period, building the framework to ensure that Australia is able to meet it's international legal obligations under the next iteration of the Kyoto protocol in a more cost-effective manner.

It is easily forgotten amidst the fear of change and the challenges of the unknown that the financial incentive provided by a cost on carbon will result in innovation and a growth industry for Australia as the world economy stabilises. Westpac is already seeing the seeds of such endeavours.

As stated earlier, Westpac has not sought to respond to or comment on every aspect of the draft exposure legislation. We support the technical recommendations made through the Australian Bankers Association and the Australian Financial Markets Association. This submission has sought to raise a number of contextual arguments to the legislation which will influence final design.

We would be happy to comment further on any specific aspect of the CPRS legislation in person. Please do not hesitate to contact us directly, if we can provide any additional information or be of any further assistance.