**Carbon Markets and Investors Association – Australian Working Group**

**CMIA Submission to the Senate Economics Committee Inquiry into the Carbon Pollution Reduction Scheme Bill**

## Background on CMIA Australian Working Group

Carbon Markets and Investors Association (**CMIA**) is an international trade association representing financial institutions and other service providers to the global carbon market as well as investors in low-carbon technology. Formed to represent businesses working to reduce carbon emissions through the market mechanisms of the Kyoto Protocol, and domestic and regional carbon trading schemes, CMIA member organisations are involved in an estimated three quarters of the value transacted in the global carbon market, worth roughly $US100 billion in 2008.

As a carbon trade association whose membership is restricted to financial institutions, carbon service providers and investors in low-carbon technology, CMIA is positioned as a voice focused on issues impertive to ensuring good policy choices in designing well functioning and effective carbon markets.

CMIA currently has eleven active Policy Working Groups, including the recent launch of the North America Working Group, and, most recently, the Australian Working Group in April 2009.

The aims of the CMIA Australian Working Group are to:

- provide a locally based forum for members to be able to share ideas on the design, development and operation of the carbon market in Australia gained from experience working in different areas of the carbon market (for example, whether this be as a broker selling secondary credits and participating in auctions, a buyer in the primary or secondary markets, a fund manager, a project developer or advisory consultant);
- provide targeted and timely input and advocacy based on our members' market experience into the design and operation of the CPRS in Australia by actively engaging with Government through submissions on key policy proposals and building an ongoing dialogue directly with Government officials;
- provide targeted and timely input and advocacy based on our members' market experience into the formulation and implementation of Australia's negotiating positions on key post-2012 issues relevant to the continuation and enhancement of the global carbon market established under the Kyoto Protocol;
- act as a clearing house between the Australian and global carbon markets for market information and good policy design around carbon markets, to share market development information and good policy design between CMIA working groups; and
- promote awareness and understanding within the media and broader community around the appropriate policy role played by market-based mechanisms as a legitimate and efficient response to the challenge of climate change through targeted and timely advocacy.

## CMIA Submission to Inquiry into Carbon Pollution Reduction Scheme Bill

The CMIA Australian Working Group welcomes the opportunity to respond to the Senate Economics Committee's Inquiry into the Carbon Pollution Reduction Scheme Bill. Our submission covers six high level points. While the submission focuses on the elements of the Bill that have arisen since the Exposure Draft, we also cover other points that we felt the CMIA AWG was well positioned to comment on. We would welcome further engagement on the detail of these issues, and particularly as the regulations are drafted.

CMIA believes that the following general principles are crucial to ensuring an effective and fully functioning carbon cap and trade scheme:

1. the market should have scale and scarcity;
2. the market should have many willing buyers and sellers;
3. the market should deliver credible price signals at which transactions will occur;
4. the market should create and allow a wide variety of tradeable 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;
5. there should be well designed frequent auctions and free allowances should be minimised and phased out over a specified time;
6. banking of permits and allowances between phases of the Scheme should be permitted, so as to reduce fluctuations in the price and increase market stability.

Before setting out the areas which CMIA is particularly concerned about in relation to the proposed CPRS scheme, we would like firstly to list some of the elements of the draft scheme design that CMIA supports and urges the Government to maintain. These are:

- cap and trade model;
- the specification of national trajectories, national scheme caps and gateways for a significant number of future years to 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 allowance of international Kyoto 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 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 some future-year permits (noting that not all of the auction design elements are supported as is discussed further below); and
- the intent to relax restrictions on linking with credible international schemes by allowing export of Australian units over time.

There are, however, important elements of the Bill that CMIA does not support and that we believe could lead to distortions in the functioning of an effective carbon market, both at domestic and international levels. These are set out in detail below:

## 1. Commencement of the Scheme

CMIA does not support delaying the start date of the CPRS to 1 July 2011, and urges the Government to reinstate its previous timetable, with a commencement date of 1 July 2010.

We consider that delaying the commencement of the Scheme will have significant disadvantages for both the liable entities covered by the Scheme, as well as the carbon market services sector who are critical in providing liquidity. Recent economic studies carried out by independent consultancies, such as Frontier Economics, have revealed that the financial impact on certain industries covered by the Scheme has been overstated by some of the entities in these industries, and in fact the impact on many liable entities in the first 3 years of the scheme will be negligible. It is clear that Australian industry is already significantly behind industry in other developed countries in transitioning to a low carbon economy, particularly industry across the European Union and in some states of the United States. Thus given that the Scheme is not likely to place an unmanageable financial strain on these companies, even in the current economic downturn, there seems to be no reason to further delay the commencement of the Scheme by a year with the consequence that Australian industry will fall further behind industry in other countries.

Further, since the announcement on 4 May 2009, some of our members have expressed significant concern about the impact that the announcement is likely to have on the carbon market services sector, which was gearing up to operate in expectation that the Scheme would commence in 2010. Some of our members, particularly carbon brokers and project developers, have expressed concern about their ability to remain viable in Australia in the absence of a functioning carbon market, as a result of the delayed commencement of the scheme.

Furthermore, we consider that it is crucial 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 disrupted by an inability to properly factor in a carbon price. Likewise, the extension of term finance facilities has the added difficulty of participants and creditors not knowing with any precision how and when a carbon price may affect credit terms.

In addition, 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.

Lord Nicholas Stern in his renowned Stern Review has declared climate change "the greatest market failure the world has seen" and he calculated that the costs associated with immediate action to seriously reduce emissions are substantially less than the costs that countries will face if action is further delayed. Thus, it is in the economic, as well as the environmental, interest that the CPRS commence as soon as possible.

There has been much discussion in the Australian media that the commencement of the Scheme in July and in the current financial downturn, will increase costs of production and jeopardise jobs.

In fact, the extensive transition programs (EITE, Electricity Industry Adjustment Scheme, and the Climate Change Action Fund), will limit the extent to which the emitters are adversely affected at the commencement of the scheme and in the medium term. Also, the likelihood that the carbon price will be at the lower end of price forecasts at commencement means that the financial impost will be even further reduced.

In a more recent policy briefing paper of which Stern is a co-author[1], it is strongly argued that a carbon pricing framework will play an essential part in an economy's recovery from the current downturn. This occurs because the long term nature of the framework creates a level of confidence that 'unleashes a wave of creativity and innovation in greening the economy'. In addition, the paper says that governments must guard against 'locking in' higher GHG footprints as a result of the economic recovery phase. The CPRS will be primary tool that ensures Australia's scheme commences the challenging emission reduction task and encourages low carbon investment.

It is necessary for the Government to take a long term and broad approach and focus on the benefits to the economy that taking action sooner rather than later will have for Australia.

[1] Bowen et al, "An outline of a case of a green stimulus", Centre for Climate Change and Economic Policy and Grantham Research Institute on Cliamte Change and the Environment, February 2009

Finally, while Australia's global image on climate change received a long-awaited boost when the Rudd Government ratified Kyoto, it will continue to be viewed as a laggard if it continues to delay the implementation of real and credible domestic action to address climate change. This is particularly so as other developed countries, notably the United States, move swiftly to implement domestic action. It would be embarrassing for Australia if the Obama Administration, taking office more than a year after Rudd Government, implements a domestic scheme before Australia, given the much larger scale of the economy, and industry sectors, in the US.

## 2. Allocation of Allowances and Auctioning

## Post year end auctioning

CMIA 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.

On the one hand, we can see that there is merit in such a structure as an extra element of flexibility to end-year liability management.

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. In the context of concerns about price squeezes in the permit market, a deferred supply of permits will contribute to the very sort of price squeeze that market participants seek to avoid.

## 3. Price Cap

CMIA'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). 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.

We are therefore very concerned with the announcement on 4 May 2009, that the price cap will be $AUS10 in the first year of the Scheme. It is likely that a price cap this low will:

(i) seriously delay and discourage investment in low carbon technologies in Australia;

(ii) disincentivise any reduction of emissions by liable entities under the scheme;

(iii) stifle any development of primary and secondary CER markets in Australia; and

(iv) result in a much steeper learning curve for liable entities and price volatility in the years following the removal of the price cap.

Our concerns on the impact of a price cap on the growth of trade in primary and secondary CERs (or other international credits) markets in Australia are strongly supported by past carbon market data. Based on market trends, the price of primary and secondary CERs is almost guaranteed to be at a level that exceeds $10 , and thus there may be no incentive for Australian liable entities to trade in the primary or secondary markets, or other market entities, such as brokers or investment managers, to establish their businesses in Australia. This is a concern for our members who believe a functioning carbon market in Australia is critical from the outset in Australia in order for Australia to be able to effectively link in to other emissions trading schemes, and also to enable liable entities to participate in international emissions trading. It is also important that experience in carbon trading is gained by Australian entities, as a liquid carbon market will be critical to ensuring the necessary emission reductions are achieved in the long term. Market illiquidity is not in the interests of liable entities, or the carbon services sector, as it creates distortions and prevents entities from gaining experience in the operation of the carbon markets, which will put them at a disadvantage to entities in other countries, where there are no barriers to a well-functioning market.

A price cap that is set too low could also seriously impair the ability of the CPRS to be able to link with other domestic or regional trading schemes, as in effect this cap would be transported into these schemes. Given the exchange rate of the AUS dollar with the US dollar, it is likely that a $AUS40 price cap will act as a disincentive for the US scheme to link to the Australian scheme, as the US will be hoping for a higher carbon price in order to trigger investment in low carbon technology within the US. The EU has declared that it is hoping for a price of as high as 40 Euro in the third phase of the EU ETS. Thus it may not be an attractive proposition if liable entities under the US or EU schemes were able to access offsets priced at a minimum set price. Equally, there would be no point in linking to other schemes if Australian entities were unlikely to be active in participating and purchasing credits/ allowances from these schemes due to the availability of an unlimited supply of cheaper fixed price Australian allowances.

Such a lack of international linkage would greatly reduce the market's scalability, hindering the advancement of Australia's long term interest of becoming a regional carbon trading hub and thus detracting from green job creation. Integration with the global carbon market is necessary in order to increase market efficiency as liquidity begets liquidity, further tightening spreads. A lack of global integration means an uneven playing ground amongst nations with cap and trade schemes.

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", as referred to in the Green Paper. 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.

It will also seriously hinder any behavioural change in liable entities, as there will be no incentive for liable entities to invest in energy efficiency or low carbon technology to reduce their emissions, if there is an unlimited supply of $10 permits available. This will also lead to the prospect of a step-change for companies when they suddenly have to make actual reductions. We think that a price cap, if any, should at least be high enough to encourage some behavioural and operational change in liable entities from the commencement of the scheme, so that at least liable entities can start this operational and behavioural adjustment early, without suddenly being forced to adjust when the price cap ends.

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.

## 4. Linking to other schemes

CMIA advises that the CPRS should be drafted in a manner that provides for forming early international linkages to the NZ ETS, once the necessary legislation is put in place in NZ, and other domestic ETS.

The close economic ties that Australia has with other countries in the Asia Pacific strengthens the rationale behind forming market links at an early stage which thereafter would allow for respective markets to develop and advance in unison.

However, as we have highlighted in the paragraph above, we consider the imposition of a price cap to be a major impediment to effective linking between schemes and we urge the Government to reconsider this aspect of the proposed CPRS in Australia.

## 5. Enforcement / Compliance

There does not appear to be any compulsion on a liable entity to surrender all of their holdings of eligible units before accessing the fixed-charge units. Market circumstances may exist, particularly towards the end of a price-cap period, where there is financial benefit in paying the fixed-charged and banking eligible units held if 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 supply.

We note that the fixed-rate 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.

## 6. Creation of Jobs Supporting Carbon Market

A significant component of the campaign by industry to delay the Scheme in Australia has been its claim that a high number of jobs would be lost if the CPRS proceeded. However, absent from the debate so far in Australia has been any discussion on the number of jobs that would be created by the development of a carbon market in Australia. Discussion about the creation of jobs, particularly in the clean and renewable energy sectors, is playing a much more prominent role in the debate surrounding the implementation of a scheme in the US.

It is evident from experience that the introduction of new regulatory markets has triggered the creation of new services sectors. We have seen this in a range of markets, such as the dot.com boom in Silicon Valley, and also in carbon markets, notably in Europe and especially in London.

As a result of London taking an early lead in the carbon market through the introduction of the UK Emissions Trading Scheme in 2002, which was then phased into the EU ETS in 2005-6, it has become the carbon hub of Europe and arguably the world. A new services sector, uniquely placed to assist business meet their obligations under the UK and EU scheme, has expanded exponentially over the past 7 years. Experts with practical market experience through the whole supply chain of knowledge and products is now well established in London, including financial service providers, brokers, analysts, investors and legal advisors.

In much the same way, Australia, if it moves quickly, has a similar such opportunity. Existing financial market expertise can be leveraged, attracting a critical mass of investment and carbon market know-how, to establish a long term market-dominant position for Australia across all aspects of carbon finance. Given the impact of the credit crunch on financial sector employment, the creation of a new financial market can help to remedy a displacement of skills in this area. With minimal re-training, readily transferrable skills across a range of financial services such as audit, consultancy, risk management, brokerage and trading can be employed in a newly created carbon market. By introducing a scheme on 1 July 2010 and before other countries in the Asian-Pacific region introduce domestic trading schemes, Australia has the opportunity to be a carbon hub for the Asian region.

Imposing a cap on carbon emissions also assists in providing the incentives required to trigger the development of new clean and renewable energy sectors. The introduction of the proposed CPRS has the potential to create a substantial number of new jobs in areas of clean energy and energy efficiency. There is no doubt that Australia, particularly, in which approximately 50% of emissions result from the stationary energy sector, cannot make the substantial reductions in $CO_2$ required, without increasing the development of renewable energy. The timely introduction of the scheme would provide Australia with the opportunity to become a leader in energy efficiency and renewable technologies, providing green jobs and goods that will stimulate the Australian economy and that it can export, particularly in the Asia Pacific region.

* * * *

We hope that the above points are useful in the Inquiry's consideration of the Bills implementing the Carbon Pollution Reduction Scheme.. We would welcome the opportunity to expand upon any of the points, or answer any specific questions in relation to any of the above, as we consider this a fundamentally important time in the development of climate change policy in Australia, and feel we can make an important contribution, based on extensive market experience of our members, to the development of a carbon market in Australia.

Yours sincerely

Paul Curnow

Chair, Carbon Markets Industry Association, Australian Working Group.

02 8922 5173

4 June 2009