

Chapter 3

Linking carbon markets

3.1 Submissions to the inquiry and testimony to the committee indicated broad support for the concept of linking to international carbon markets.

3.2 Submissions identified a range of advantages that would accrue to Australia as a result of linkages to international carbon markets generally and to the EU ETS specifically. These advantages included promoting access to low cost abatement for Australian liable entities, strengthening the Australian carbon market and improving its efficiency, and building on and contributing to a growing global push to price carbon and tackle dangerous climate change.

3.3 While most submissions indicated support for the link to the EU ETS, several submissions expressed some concerns regarding the integrity of the EU ETS and the impact the linkage would have on Australian control over the CPM.

Promoting lowest cost abatement

3.4 The Minister for Climate Change and Energy Efficiency explained the logic of linking Australia's CPM to international markets in his second reading speech:

It is common sense to support international linking because it assists in providing emissions reduction at least cost and contributes to knitting together different national and regional schemes. It develops a common carbon price across economies, a common incentive to cut emissions, and fairly shares the burden of doing so.¹

3.5 The committee heard that the structure of the Australian economy makes linkage to international carbon markets key to low-cost carbon abatement. The fact that Australia is a primary producer and exporter of fossil fuels and energy means, as the International Emissions Trading Association (IETA) explained:

...we will always have a challenge of how we effectively meet the increases in our emissions trajectory from our own domestic economic capability. It is important for us that we are linked into effectively the mitigation frameworks of our trading partners so that we are able to source abatement at its lowest cost.²

3.6 IETA also made the point that Australia is an open economy, and it is appropriate that Australia seeks to ensure its scheme includes 'all the flexibility mechanisms that we can have to be able to make the adjustments that an open economy has to have.' Australia has been 'very successful' in building an open

1 The Hon Greg Combet MP, Minister for Climate Change and Energy Efficiency, *House of Representatives Hansard*, 19 September 2012, p. 1159.

2 Mr Emile Abdurahman, IETA, *Proof Committee Hansard*, p. 27.

economy through reform and economic regulation and deregulation; there is no reason to approach Australia's carbon policy any differently.³

3.7 In assessing the linkage, submissions from industry groups tended to emphasise the importance of lowest-cost abatement, and welcome the linkage, at least in principle, as a step in this direction. As Mr Alex Gosman of the Australian Industry Greenhouse Network (AIGN) told the committee, 'we do welcome movement towards linkages and we do welcome the move towards an international approach on carbon pricing, so this is one step towards that.'⁴

3.8 In a similar vein, the Institute of Chartered Accountants Australian (ICAA) told the committee that it was 'imperative that Australian businesses be allowed to access the lowest cost abatement through accessing global carbon markets.'⁵ Expanding on this point, ICAA told the committee that its support for allowing Australian businesses to access lowest cost abatement through international carbon markets was very much related to its advocacy of the broader principles of ensuring that Australian business can compete effectively on a level international playing field.⁶

3.9 Conversely, the costs of Australia pursuing a stand-alone carbon pricing scheme would, as IETA told the committee, prove 'exceptionally high.' Without access to international carbon markets, domestic power and manufacturing costs would rise 'to levels that would be exceptionally disadvantageous to the economic structure.'⁷

3.10 In evidence to the committee, Treasury officials were able to quantify the impost a stand-alone scheme would create for Australian entities: even at the more modest end of the emissions reduction spectrum, if the CPM did not allow access to international units, the price of carbon would likely rise to about \$62 per tonne.⁸

Strengthening the Australian carbon market and enhancing risk management capacity

3.11 Both ICAA and IETA explained to the committee how the link to the EU ETS would provide the Australian carbon market with the liquidity and depth it required to operate efficiently. This advantage was underlined by the fact that, whereas the Australian carbon market was relatively small and might struggle to generate sufficient liquidity and depth if operating in isolation, the EU ETS is the largest and most liquid carbon market in the world.⁹

3 Mr Emile Abdurahman, *Proof Committee Hansard*, p. 31.

4 Mr Alex Gosman, AIGN, *Proof Committee Hansard*, p. 18.

5 Mrs Geraldine Magarey, ICAA, *Proof Committee Hansard*, p. 18.

6 Mr Yassar El-Ansary, ICAA, *Proof Committee Hansard*, pp. 18-19.

7 Mr Emile Abdurahman, *Proof Committee Hansard*, pp. 27, 29.

8 Mr James White, DCCEE, *Proof Committee Hansard*, p. 38.

9 Mrs Geraldine Magarey, *Proof Committee Hansard*, p. 18; and Mr Emile Abdurahman, *Proof Committee Hansard*, p. 25.

3.12 IETA further explained that the linkage with the EU ETS would promote price discovery and provide investors in power generation and other assets with an enhanced capacity to manage long-term price risk. Under the proposed arrangements, Australian businesses can 'link to Europe, which has a very well-developed long-term pricing structure,' meaning 'that we now have the ability to tap into market-based mechanisms to manage long-term price risks.'¹⁰

3.13 In its submission, the Australian Financial Markets Association (AFMA) made similar points, suggesting that links with 'sound international schemes has been consistently requested by AFMA as a mechanism to increase market depth, achieve least cost abatement and reduce overall risks for participants.'¹¹

Building on the global push to price carbon and tackle climate change

3.14 The committee heard that the link to the EU ETS both reflected and would further add to the growing global momentum towards pricing carbon and tackling climate change.

3.15 IETA told the committee that the linkage would promote additional bilateral trading links with other nations, and provide the architecture for new and emerging carbon pricing schemes. There needs to be an efficient, low-cost, and consistent global approach to reduce carbon emissions and prevent dangerous climate change, and IETA suggested 'the current amendments are [a] step in the right direction.'¹²

3.16 The Climate Institute made a similar point, suggesting the linkage would provide 'a template for how future linkage arrangements between other countries are developed, and that is a good thing.' Australia's negotiating position in seeking other linkages, including linkages with emerging carbon markets in China, South Korea and other parts of Asia, would be strengthened by its link to the EU ETS.¹³

3.17 Sustainable Business Australia also argued that 'the linking arrangements between Australia and the EU will strongly influence similar agreements with other emission trading markets.'¹⁴

3.18 ICAA, meanwhile, noted the importance of Australia remaining alert to the possibility of additional links with new and emerging carbon markets.¹⁵

3.19 As IETA explained to the committee, the linkage arrangement will allow a new global pricing benchmark to be established, providing a 'more robust mechanism'

10 Mr Emile Abdurahman, *Proof Committee Hansard*, pp. 24, 27.

11 Australian Financial Markets Association, *Submission 8*, p. 1.

12 Mr Emile Abdurahman, *Proof Committee Hansard*, p. 24.

13 Mr Erwin Jackson, The Climate Institute, *Proof Committee Hansard*, pp. 25-26.

14 Sustainable Business Australia, *Submission 14*, p. 1.

15 Mr Yassar El-Ansary, *Proof Committee Hansard*, p. 20.

for new entrants to carbon pricing markets, particularly Australia's trading partners in Asia and the United States.¹⁶

3.20 WWF Australia emphasised that the link to the EU ETS would strengthen the environmental integrity of the global carbon market at a time when there is growing global momentum toward carbon pricing, including in nations like China and South Korea.¹⁷

3.21 The committee also heard from DCCEE that international linkage would promote 'greater global ambition' to reduce emissions, and foster the growth of global carbon markets.¹⁸

Business and industry issues regarding competitiveness

3.22 A number of submissions argued that the linkage would do little to address the broader impact of Australia's carbon pricing scheme on the competitiveness of Australian industry.

3.23 The Australian Petroleum Production & Exploration Association (APPEA) argued that while the link may provide short-term cost savings, the competitive challenge to trade exposed industries, including the Australian LNG export industry, continues to be from countries that are not taking action to introduce carbon pricing.¹⁹ The Australian Coal Association, AIGN and the Cement Industry Federation expressed similar concerns to the committee.²⁰

3.24 The Australian Coal Association also told the committee that Australia was locking in the world's 'highest explicit economy-wide carbon cost impost on industry over the next few years.'²¹

3.25 However, some of these claims from industry bodies were challenged by other submitters. For instance, the Climate Institute contended in both its written submission and in evidence to the committee that Australia's carbon price is neither the highest in the world nor unusually broad in its coverage.²²

3.26 The Australian Coal Association also acknowledged that while Australian and European coal producers did not compete in Asian export markets, they did compete in providing coal to European markets, particularly in thermal coal.²³

16 Mr Emile Abdurahman, *Proof Committee Hansard*, p. 27.

17 WWF Australia, *Submission 11*, p. 3.

18 Mr James White, *Proof Committee Hansard*, p. 36.

19 Mr Damian Dwyer, APPEA, *Proof Committee Hansard*, p. 7.

20 Australian Coal Association, *Submission 17*; AIGN, *Submission 16*; and Cement Industry Federation, *Submission 4*.

21 Mr Peter Morris, Australian Coal Association, *Proof of Committee Hansard*, p. 9.

22 Mr Erwin Jackson, Climate Institute, *Proof Committee Hansard*, p. 25. Also see the Climate Institute, *Submission 1*, p. 3.

23 Mr Peter Morris, *Proof of Committee Hansard*, p. 15.

3.27 On the whole, concerns raised by some business and industry groups related to pre-existing concerns with the broader Clean Energy Package, rather than with the amendments under consideration. These concerns should be weighed against the acknowledgement from business and industry groups that the linkage to the EU ETS will provide new compliance options and likely result in potential cost savings for Australian entities in meeting their carbon liabilities.

Assessing the strength and integrity of the EU ETS

3.28 While there was broad support for the concept of linking Australia's CPM to international markets, some submissions expressed concerns regarding the integrity of the EU ETS. Areas of particular concern included the apparent over-allocation of permits and less-than-rigorous monitoring, reporting and verification (MRV) mechanisms.

3.29 While supportive of the linkage, COzero noted that over-allocation of permits had proven problematic in the EU ETS. The EU experience highlights the importance of regularly reviewing carbon inventory, and COzero suggests that the Government should consider a higher frequency of inventory reviews than is currently mandated in the CPM.²⁴

3.30 Professor Paul Frijters and Mr Cameron Murray (School of Economics, University of Queensland) were particularly concerned with these integrity issues, as was evidenced in both their joint written submission and their subsequent evidence to the committee. They discussed at some length the problems of over-allocation of permits in the EU ETS, and what they characterised as weak MRV systems that were subject to fraud, manipulation and politically driven 'fudge factors'.²⁵

3.31 Prof. Frijters and Mr Murray expressed strong doubts regarding the capacity of the European Commission to enforce more robust MRV systems in individual member states. The EC does not have any budgetary powers, making it difficult for it to provide incentives for concerted action by member states to implement proper accounting systems. Moreover, tackling climate change is now a secondary political concern in Europe, and that makes it even harder 'to corral all of those countries into an equally strong enforcement system'.²⁶

3.32 ICAA also noted well documented problems around integrity and fraud in the EU ETS. ICAA told the committee that to address these issues, the EU has undertaken a review, and in October 2011 the European parliament passed regulations to improve the integrity of both its energy market and its emission trading scheme.²⁷

3.33 From ICAA's perspective, the problems that have previously been apparent in the EU ETS serve to highlight the importance of regulators in Australia working 'closely with their EU counterparts in order to minimise the risk or likelihood of

24 COzero, *Submission 9*, p. 2.

25 Prof. Paul Frijters and Mr Cameron Murray, *Submission 6*.

26 Prof. Paul Frijters, University of Queensland, *Proof Committee Hansard*, p. 4.

27 Mrs Geraldine Magarey, *Proof Committee Hansard*, p. 18.

disruptive or confidence-damaging shocks to the linked schemes.²⁸ In contrast to Prof. Frijters and Mr Murray, the ICAA suggested the EU ETS remained fundamentally robust and efficient. Indeed, compared to the Australian carbon market, the European carbon market:

...is a more mature market that has had the benefit of a longer time frame over which to develop and refine those safeguards and protections that ultimately will flow through to the benefit of Australian businesses as well.²⁹

3.34 In an exchange between Senator Cameron and Mr Emile Abdurahman from IETA, the point was made that fraud and manipulation, far from being unique to the EU ETS, can and does occur in all markets. What matters, then, is having a robust regulatory and enforcement framework to prevent occurrences of fraud and manipulation to the greatest extent possible. Mr Abdurahman told the committee that integrity problems could be largely avoided through 'mechanisms of diligent oversight and also sanction,' adding that Australia had a proven capacity to implement robust financial regulatory mechanisms.³⁰

3.35 For its part, DCCEE assured the committee that it remained confident that the EU ETS MRV system was sound.

3.36 DCCEE told the committee that it believed the European approach of having MRV settings made a central level (that is, by the European Commission), but implemented at a national level (that is, by individual EU member states), was sound. Indeed, this approach was analogous to how Australian governments work together through the Council of Australian Governments—except that in the EU, agreements between governments are legally binding. There may be variations in the how EU member states undertake MRV, just as there are variations in Australia when the Commonwealth and states need to work together on national reforms. However, there are also review processes in place to ensure MRV systems are not compromised. In particular, the overall EU ETS system is subject to an external review by the United Nations. This ensures that units that will be transferred between the Australian and EU systems 'are matched by equivalent emission reductions in each economy.'³¹

The impact of linkage on Australian policy control

3.37 Some submissions expressed concern about the apparent heavy reliance of EU member states on policy drivers to shape the EU carbon market. A related concern was that Australia would be surrendering a substantial measure of control over its CPM to the EU, with a corresponding reduction in Australia's control over the price of carbon itself.

28 Mrs Geraldine Magarey, *Proof Committee Hansard*, p. 18.

29 Mr Yassar El-Ansary, *Proof Committee Hansard*, p. 19.

30 Mr Emile Abdurahman, *Proof Committee Hansard*, p. 31.

31 Mr James White, *Proof Committee Hansard*, p. 43.

3.38 Professor Frijters told the committee that the unequal treatment of Australian permits under the one-way linking arrangement did not augur well for Australia's likely influence over European decisions affecting the price of carbon. Europe's decisions will be informed by internal considerations and dynamics, and Australia's interests 'will count for very little in the internal deliberations of the European Union.'³²

3.39 Others submitters suggested that, due to the imbalance in market size, the Australian carbon price will effectively be determined by policy decisions in Europe. As Mr Peter Morris of the the Australian Coal Association put it, this raises the risk 'that the EU will be making scheme design decisions in line with their own interests and economic structures that will not necessarily be in Australia's interest.'³³

3.40 Similarly, in its submission, the Business Council of Australia suggested that a key question for business was how, in the negotiations for the two-way link, Australia's competitiveness and economic strengths will be ensured, given 'the EU will be making scheme design decisions in line with their own interests and economic structures.'³⁴

3.41 The Business Council of Australia expressed particular concern regarding the Government setting the Australian carbon price ceiling in reference to the likely EU ETS price in 2015-16, given the EU 'will determine the price in their scheme to suit its policy agenda and economy. This may not be in Australia's best interest.'³⁵

3.42 This being the case, the Business Council of Australia recommended that the Government consult with business in the course of setting a new price ceiling and negotiating the two-way link between the CPM and EU ETS.³⁶

3.43 The Cement Industry Federation questioned whether the Australian Government would have 'sufficient negotiating power with the EU on future scheme changes (particularly after the establishment of a two-way link) given the relative size of the two schemes.' On this basis, Cement Industry Federation argued that Australia should not surrender control over scheme design unless the scheme becomes truly international. Moreover, Australia 'should adopt an aggressive stance toward supporting Asian friendly (international) scheme design, particularly with regard to allowable offsets.'³⁷

3.44 DCCEE conceded that given the larger size of the European carbon market, 'decisions about the parameters of the European emissions trading scheme will have

32 Prof. Paul Frijters, *Proof Committee Hansard*, p. 5.

33 Mr Peter Morris, *Proof of Committee Hansard*, p. 12.

34 Business Council of Australia, *Submission 2*, p. 3.

35 Business Council of Australia, *Submission 2*, p. 3.

36 Business Council of Australia, *Submission 2*, pp. 3-4.

37 Cement Industry Federation, *Submission 4*, p. 5.

more influence on the overall price than decisions about the parameters of the Australian emissions trading scheme.¹³⁸

3.45 Consistent with this analysis, a Regulation Impact Statement (RIS) prepared by DCCEE acknowledged that under the linking arrangement the domestic carbon price ‘will be affected by decisions taken in Europe to support the price of European allowance units’. However, on balance this cost was outweighed by ‘the advantages of providing liable entities with access to another secure source of international units, greater effective assistance to recipients of free permits and reduced administrative complexity.’³⁹

Fungibility of European Union Aviation Allowances (EUAAAs)

3.46 In its submission, Qantas registered its concern that the draft legislation does not allow for the use of EUAAAs in the Australian CPM. Qantas argues that EUAAAs should have the same fungibility as European allowance units.⁴⁰

3.47 The Explanatory Memorandum notes that EUAAAs are a subclass of European allowance units that can currently only be used for compliance by aircraft operators that have a liability under the EU ETS. They are not intended to be eligible for surrender in the CPM.⁴¹

Committee view

3.48 The committee commends the linkage of the CPM to the EU ETS, and the broader principle of linkages to international carbon markets, on the basis that such linkages will assist in facilitating emissions reduction at least cost.

3.49 The committee acknowledges that international linkages will help develop a common carbon price across economies and a common incentive to cut emissions and tackle dangerous climate change.

3.50 The committee recognises that, for an open, growth-orientated and outward focused economy like Australia, it is common sense to seek out market-based linkages to international carbon markets. It further notes that such linkages build on the growing global push to price carbon through market-based mechanisms, and will place in Australia in a good position to link to new and emerging markets, particularly in the major economies of Asia.

3.51 The committee notes that some submitters were concerned by issues relating to the integrity of the EU ETS, but concludes that there is strong countervailing evidence to suggest the European carbon market is robust and well regulated.

38 Mr James White, *Proof Committee Hansard*, p. 43.

39 RIS summary in Replacement Explanatory Memorandum, pp. 13-14.

40 Qantas, *Submission 15*, p. 2.

41 Replacement Explanatory Memorandum, p. 25.