

SUBMISSION TO THE GARNAUT CLIMATE CHANGE REVIEW

IN RESPONSE TO

ISSUES PAPER 2

FINANCIAL SERVICES FOR MANAGING RISK: CLIMATE CHANGE AND CARBON TRADING

A personal submission from Mr Jeremy Burke (London, United Kingdom)

Introduction

The issue of climate change, and its related effects on the quality of life within the developed and developing world, is a key issue at all levels of society. As a young Melbournian living in London I am delighted to be given the opportunity to respond to the issues being considered by the Garnaut Review.

The opportunity that this review has to consult with the public of Australia and provide appropriate advice to the Rudd Government should not be underestimated. The public of Australia, and its business community, are ready and willing to work together to lead the world in combating the effects of climate change. Ultimately to work together we need clear direction and a well sign-posted road map and while there may well be winners and losers in any policy framework the well-being of our planet and its inhabitants must be the focus.

Please find below my submission in respect of the questions posed in Issues Paper 2 “Financial Services for Managing Risk: Climate Change and Carbon Trading”.

Are there any institutional inhibitors to the emergence of an Australian ETS?

As noted in the Issue Paper it is generally recognised that Australia has the necessary infrastructure and institutions required to support an appropriately sized ETS. Consideration is therefore given to the less technical issues that could inhibit the initial development and on-going success of an Australian ETS.

The two key institutional inhibitors worth noting are:

- Lack of binding emission reduction targets

The terms of reference note that developed countries need to reduce their greenhouse gas emissions by 60 percent by 2050 against 2000 emission levels. However, without adequate short and medium term targets on which to plan appropriate policies and investment decisions the capability of the ‘market’ (loose definition encompassing all participants i.e. business, government and community) to achieve any long term goal in an efficient manner (least cost/minimal time-frame) diminishes significantly.

An appropriate ETS should therefore be framed with reference to appropriate short term and medium term goals, which should be fixed in advance, enabling regulatory certainty and not able to be subject to detrimental special-interest group pressures (in particular attention is drawn the adverse consequences of allowing significant

borrowing of permits which would enable the deferral of meaningful emissions reductions).

A potential ETS design that I believe is worth considering encompasses a number of aspects (particularly the fixed yearly emission permits) to facilitate meaningful emission reductions, particularly in the early years of an Australian ETS. The utilisation of such a design, with appropriate consultation and education pre-implementation, will ensure that actual verifiable emission reductions are achieved, through the utilisation of fixed period permits, thereby providing a meaningful demonstration to all market participants of the achievability of the (previously well communicated) emission targets.

The ability to achieve rapid emission reductions with minimal cost should be the starting point in setting any short term emission reduction targets, with a consequentially high number of fixed term permits being an obvious mechanism to do so.

- Incumbent market participants

Significant lobbying and pressure will undoubtedly ensue in the consultation period, particularly regarding a desire to increase free or subsidised allocations of permits. As Hepburn et al comment 'economists almost unanimously recommend more auctioning' while 'business tends to oppose it'. Yet it should be appropriately recognised that incumbency does not accrue a right to pollute, nor does it restrict the right of government, at the behest of the people, from changing regulations to better serve the community.

While the European Round Table of Industrialists contend that 'Environmental objectives are not advanced by arbitrarily destroying shareholder value in existing firms' any policy framework (e.g. permit allocation) should not reward companies whose activities are in contradiction to the purpose of the policy. We are acting in a free market environment, yet it will no doubt be the same parties who seek to benefit from this system that will be looking to obtain an economic advantage from free permits. The rationale must be that those who contribute to the problem should pay, thus benefiting those firms who invest in leading technologies and rightfully penalising those who will not adapt. In fact to allocate purely on current emission levels would further benefit incumbents who not only cause the biggest issues but have been slow to respond to this ever approaching issue.

Is permit price realisation and discovery best facilitated through the use of auctioning under an ETS?

Price realisation and discovery are clearly best facilitated through the use of auctioning. With a well documented framework, provided with adequate notice, market participants will act in their own self interest, thereby ensuring that the permit auction reflects the marginal cost of emission abatement. The use of free allocations (where not warranted on international or pricing grounds as discussed below) will distort the market in a number of ways:

- Provides an incentive to not invest in emission abatement programs and technologies up until an allocation benchmark time, essentially rent seeking. Similarly this will apply in future periods where permits are allocated free;
- Decreases the rate at which companies will invest in emission abatement post trading commencing, as average allocation costs will be reduced through the free permits;
and
- Diminishes price discovery in respect of the auctioned permits as the level of market participation has decreased (potentially by number of firms and by volume demanded). Coupled with this free allocations may favour the most polluting firms, who if involved in the auction process would bid the price higher due to their increased marginal abatement costs (which reflect better the marginal cost of emissions).

To provide further price discovery I recommend an ETS with the following attributes:

- Fixed term permits (eg. 2010, 2011 and 2012 vintage) – which decrease in volume to match pre-determined emissions reduction rates;
- Non-fixed term permits (subject to banking) – providing flexibility and enabling firms to plan investment decisions appropriately;
- Simultaneous auctions for the fixed term and non-fixed term permits, thereby providing price discovery in respect of the cost of emissions in the near term and the medium term – enhancing the information available for investment decisions
- Futures and derivative markets – which will facilitate price discovery through flexible instruments (futures/options/combined fixed term permits) that will provide market participants with greater insight into the true cost of emissions reduction over various periods

To what extent, and on what basis, might it be desirable that permits are not allocated via an auction system?

Subject to an overriding goal to maximise the allocation of permits via an auction system (thereby increasing the effectiveness of the ETS and minimising the cost) the following scenarios would warrant the allocation of permits other than via an auction system:

- Regulatory price controls

Free allocations would be justified in limited circumstances where companies are subject to regulatory price controls. However, the ability for regulated pricing to increase in an appropriate manner (say over 2 -3 years) to accommodate the marginal cost of fully purchasing permits must be considered. For example Hepburn et al note that “it is now beyond doubt that the electricity sector generally profits from free allowances under the EU ETS”. This profiteering can be prevented by assessing the revenue streams that are subject to regulatory control and through appropriate mechanisms reducing the constraint to pass through the cost of emissions, thereby complying with a polluters pays principle.

While somewhat out of scope it is worth noting here that revenue from the auction process could be re-directed to assist end users who are disproportionately affected by the introduction of emissions trading (e.g. Low income households) and through programs that are targeted to assisting these parties (e.g. Structured programs to alleviate energy poverty and concurrently significantly decrease emissions).

- International competitiveness

While the international community is divergent in respect to climate policies potential exists for Australian businesses to be competitively disadvantaged by the introduction of an ETS. Careful consideration must be given to the actual potential impact in regards to Australian businesses, such that they are not overplayed in an attempt to gain permit concessions. Tietenberg (p65) notes that various studies in relation to this have found in main that effects from a ‘race to the bottom’ are inconclusive, from ‘no effect’ to ‘significant relocation’ due to the incomplete coverage of the Kyoto

Protocol. To minimise the potential decrease in international competitiveness a minimal element of free allocation could be justified.

What features of an ETS might impede the emergence of forward markets

It is my belief that forward markets will adapt to the applicable regulatory framework. However, the following issues could impede the emergence of forward markets:

- Inadequate regulatory certainty: A key element to allowing forward markets to operate efficiently is information symmetry. With the post-Kyoto environment unresolved forward markets will be hampered until such time as clarity and direction is provided. However, in relation to this point the EU ETS will allow banking of permits from Phase 2 to Phase 3, thereby allowing firms to better plan their permit inventory and potential forward exposure.
- Inadequate market information: Regular reporting, of permits retired, permits held and permits to be allocated, is essential to allowing forward markets to transparently price forward demand and supply. The European Round Table of Industrialists propose yearly reporting for large facilities. Quite clearly to enable a well functioning forward market participants should be appropriately informed of the available inventory. It is recommended that at a minimum six monthly reporting be completed, however ideally this would be quarterly (perhaps not coinciding with other administrative tasks such as GST). This would lower overall costs as firms would not have to bid up prices to reflect an information gap in relation to future supply.

Is it possible to have strong and efficient forward markets with restrictions on the use of permits, such as limited banking and borrowing?

As noted above it is my belief that the forward markets will adapt to any restrictions placed, albeit there will be an impact on the efficiency of the forward markets. However, the impact of this efficiency must be considered in light of the overriding aim, being to reduce harmful emissions.

Banking of credits, which are in fact an explicit emission reduction within a finite period, should potentially be rewarded by way of a transfer credit between phases (set at such a level that the holding cost of the permit still outways any transfer credit), for example each banked permit from the 2010-2012 phase could be equal to 1.05 (arbitrary multiple) permits in Phase 2. This would have the dual benefit of rewarding emission reduction leaders (who for commercial reasons may have exhausted their easy emission reductions but expect emission increases from commercial growth) and ensuring that the transition between phases is orderly and does not enable opportunistic profit making.

It may be preferred to enable the borrowing of credits, within reasonable restrictions. For example the borrowing of credits (say up to a total of 5% of a firm's total emissions), with appropriate market disclosure, would be a better solution than either a requirement to pay a penalty on permit shortfalls. This would enable participants to borrow from forward permits (preferably fixed term permits to prevent a perpetual borrowing cycle) and create a more orderly transition between years and phases (as the number of tradeable instruments would increase to include current year, future year and non-fixed term permits).

How can governments help facilitate Australia becoming a regional hub in the Asia-Pacific Carbon Markets?

As acknowledged in the Issues Paper Australia has the appropriate technical, personnel and infrastructure capabilities to operate a robust ETS and a significant opportunity to capitalise on these strengths, both within the Asia-Pacific region. However, I think more importantly that Australia has an opportunity within any global ETS harmonisation that may rapidly occur.

Key issues to ensure meaningful alignment include:

- Consistent ETS periods.

The European Union ETS Phase 2 will run from 1 January 2008 to 31 December 2012. Any Australian ETS should have a similar phased approach, while limiting the 'learning by doing' elements of the EU Phase 1, with a natural conclusion at the expiration of the Kyoto Protocol in 2012.

- Consistent policies

Whilst too numerous, and out of scope, to detail all instances, the ability to develop consistent policies with the EU ETS will ensure an Australian ETS has cross-border applicability. Appropriately devised protocols could entail multi-national organisations seeking to utilise the Australian ETS in respect of EU obligations, thereby increasing the ability for the market to be transparent with respect of the international cost/value that Australian emissions and emissions reductions have. The resultant increased activity, and international comparability, would similarly enable better functioning Forward Trading Markets.

- Land Use, Land-Use Change and Forestry

Of particular relevance to Australia, and a likely issue in respect of international ETS harmonisation, is the applicability of land use, land-use change and forestry ('LULUCF') for credit generation/emission reduction.

The EU has noted that it will not be possible to obtain credits from carbon sinks as 'doing so could undermine the environmental integrity of the EU ETS'. While the EU rationalise this decision on the basis that LULUCF projects cannot physically deliver permanent emissions reductions, a point on which I concur, the fundamental issue that Carbon Trading should focus on is emission levels.

As carbon is recognised as a cumulative pollutants concentration on the level of emissions is paramount. Obtaining credit for LULUCF activities would provide incentives for emitters to concentrate on 'offsetting' or 'balancing' their emissions, not on the fundamental requirement to decrease emissions. Simply put, an emission foregone is significantly more valuable than an emission offset.

LULUCF activities can be better handled outside of an ETS environment, either through the proceeds of auction revenue (as envisaged by the EU Commission), voluntary credit markets built to provide carbon neutrality or Government/NGO/public interest group involvement.

Given that Australia's emissions, excluding LULUCF, were reported by the UN to have increased by 25.1% from 1990 – 2004, it is of particular importance that Australia accepts that it too must cut emissions, not just rely on LULUCF activities to 'meet' its international obligations.

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