Submission by the Australian Climate Exchange to the Garnaut Climate Change Review Issues Paper 2 - Financial Services for Managing Risk: Climate Change and Carbon Trading

Introduction

This submission to the Garnaut Climate Change Review is made by the Australian Climate Exchange Limited (ACX), the developer and operator of Australia’s first exchange traded greenhouse gas (GHG) emissions market.

The emergence of an Australian ETS may be hindered by a lack of accredited personnel required to undertake assessment and approval of suitable GHG abatement projects and the correct consolidation, reporting and auditing of organisational GHG emissions according to Australian Standards. In addition, the delayed establishment of a Designated National Authority (DNA) would disadvantage Australian industry and reduce options to meet their liabilities under an ETS.

For markets to function smoothly, participants need to have trust and be able to limit counter party risk where possible. Having a fully operational national Registry is vital in this respect. The Registry needs to balance both compliance and trading needs. It needs to facilitate settlement & delivery and possibly even report to the market daily acquitted and open credit volumes.

ACX is a strong advocate of auctioning permits in order to distribute them in an equitable and efficient manner, while also providing an early carbon price signal. An additional or alternative method of determining an early price would be to increase the liquidity of the current voluntary offset market by recognising some existing instruments as legitimate for use in the upcoming ETS. Having a liquid voluntary market would also provide early exposure for industry to the range of emission trading issues.

ACX favours policies that have as little artificial market distortions as possible. A forward market should develop regardless of whether banking and borrowing is accepted under an ETS. However, where borrowing is facilitated rules are necessary in order to reduce the unfavourable effects, including
interest payable on borrowed permits based on the time cost of carbon. Stringent risk assessment will be necessary for those seeking to use the borrowing facility. Borrowing has to be accompanied by clear signals from Government that defaulting on borrowed permits is not an option for any organisation.

To support a forwards market there needs to be clear and sufficient abatement targets that keep adequate tension on permit/offset demand into the medium to long term.

**Building Effective Carbon Trading Markets**

“*are there any institutional inhibitors to an Australian ETS?”*

There is currently a lack of suitably accredited personnel to undertake the tasks necessary to support a robust ETS. These tasks include the assessment and approval of suitable GHG abatement projects and the correct consolidation, reporting and auditing of organisational GHG emissions according to Australian Standards.

In addition, the delayed establishment of a Designated National Authority (DNA) to facilitate Australian participation in CDM project development and the generation of Certified Emission Reductions (CERs) would disadvantage Australian industry and reduce options to meet their liabilities under an ETS.

ACX also observes that in order for the markets to function smoothly, participants need to have trust and be able to limit counter party risk where possible. Having a fully operational national registry is vital in this respect.

Other than the Australian Climate Exchange Registry, existing Registries in Australia have been conceived from a compliance perspective more so than from a trading perspective.

The Registry needs to balance both compliance and trading needs. It needs to facilitate settlement & delivery and possibly even report to the market daily acquitted and open credit volumes.

“*is permit price realisation and discovery best facilitated through the use of auctioning under an ETS ?”*

Firstly, if the purpose of this question is to distinguish between auctioning and grandfathering, ACX supports auctioning. Setting a fixed price on credits, rather than a free auction, is really just another form of auction. We won’t be distinguishing between the different auction types or preferences.
ACX views auctioning as an effective way of distributing permits to industries that can derive the greatest value from using permits from the national emissions permit pool as well as being a good instrument to use in order to derive early permit price discovery for the ETS.

Secondly, for price realisation and discovery purposes, auctioning relies on all market participants doing their sums and coming up with a price which will best reflect what they see as the value of the credits. Compared with any price or allocation calculations done by one single government agency, more limited at best and subjective at worst, it seems preferable to let the market set the price of carbon.

As an alternative price discovery mechanism there might be merit in increasing the liquidity of the current voluntary offset market by recognising some existing offset instruments as legitimate offsets to be used in the upcoming ETS (such as Greenhouse Friendly™ and the NSW GGAS). Trading these offsets on a voluntary basis would not only be a price indicator for offsets and permits under an ETS, but it would also allow business to hedge against the future price of carbon under a mandatory scheme and facilitate companies to become familiar with emissions offset trading including the pricing of offset risk, quality, transparency, etc.

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

Grandfathering is at best an administratively complex system and at worst subjective i.e. unfair. The problem here is that it is difficult to objectively define “significant”. Every industry and company can and will, rightly, argue that they are significant and have just as much right to be supported as the next industry or company. Furthermore one can argue that if an industry or company cannot either buy the necessary permits or invest in modern production technology, it may not be beneficial for the country to further support such activities, both from a financial efficiency and an ecological point of view. After all we no longer allow lead-based paints, dynamite fishing, DDT insecticides, or CFC-based refrigerators either.

If a player can only survive by being given permits, it is not an efficient player and we should not waste tax-payers’ money trying to save them. In the light of what has recently happened at Mitsubishi in the South Australia and Northern Rock in the UK, this must certainly be the last road the government wishes to take.
Facilitating Forward Trading Markets – Banking and Borrowing of Permits

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

Not only it is necessary to have short-medium and long term targets i.e. an emissions target trajectory but these targets need to be reviewed annually so as to maintain a certain tension between compliance and the number of permits/offsets available in the market (see also the Registry’s reporting role mentioned above). An imbalance of either might distort the market and create unnecessary price volatility or liquidity issues.

The National Greenhouse and Energy Regulations System (NGERS) supports the ETS through the compilation of emissions data. This data provides the foundation to decisions concerning market tension i.e. adjustments to permit/offset supply, compliance and subsequently the development of a forwards market. A combination of incorrect GHG reporting management by corporations resulting from a lack of suitably qualified personnel can lead to an incorrect allocation of permits or compliance measures and ultimately create market volatility. Correct corporate reporting standards need to be developed by Australian industry in association with efforts to increase competence in the area of GHG and energy auditing and reporting.

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

Whereas banking is generally accepted as a concept in carbon trading, borrowing seems to be more contentious.

Unless there are strong reasons to prohibit it, ACX favours policies that have as little artificial market distortions as possible. It should be possible to allow banking and have some limits on borrowing to rule out its more unfavourable effects.

In order to recognise the “Social Cost of Carbon” inherent in borrowing, an interest should be applied when borrowing permits. The interest rate charged must be sufficient to counteract the discounting effect of the time cost of money.

---

1 Stern Review on the Economics of Climate Change, Nicholas Stern, 2006
Where borrowing is requested, borrowers would need to be assessed as to their capacity and prospect for making good with dramatically lower emissions in the future (i.e. estimated time to roll out abatement technology, etc) plus additional permits accrued.

It may be beneficial and efficient to have borrowers attach an AAA rating (or equivalent) to determine the covenants and default provisions as well as the interest that will be charged on the permits attached.

Escalating penalty rates for late payments and the standard consequences for defaulting on your loans should be sufficient deterrent for organisations defaulting by intent.

An interesting concept in this respect is the question of who will be the lender of last resort. Should a central carbon bank be established and should it be able to bail out failing companies when it deems this is necessary. What “currency” will they be using in case of market failures? Could they use the revenues raised from the permit auctions to fund offset and origination activities? Will they be setting the “interest rate” independently or should we leave this to the market?