

Garnaut Review Issues Paper 2 – Financial Services for Managing Risk: Climate Change and Carbon Trading

NSW Government Submission

The New South Wales Government welcomes the opportunity to participate in the Garnaut Review consultation process, to provide input to the design of medium to long-term policies to ameliorate the impacts of climate change on the Australian economy.

The NSW Government is committed to working collaboratively with the Garnaut Review process, and with the Commonwealth Government to ensure a coherent national policy response to climate change.

In response to some of the questions raised for consideration by the Issues Paper, the NSW Government submits comments and recommendations on: i) insurance issues; and ii) how Governments can help facilitate Australia becoming a regional hub in the Asia-Pacific carbon markets.

Insurance Issues

Are there any market failures associated with the provision of insurance that are specifically related to climate change risk?

What are the key insurance gaps relating to climate change?

The NSW Government agrees that the insurance industry is best-placed to deal with increased risks of weather events as a result of climate change, particularly through the development of innovative insurance services and financial mechanisms.

The Issues Paper notes that a key role for government is the identification of market failures associated with the management of risk. The NSW Government agrees that:

...government intervention needs to be considered in the context of the potential perverse incentives it may create. For example, the expectation of government rescue may increase incentives for risky private behaviour, or poor risk management practices. Government's role should be primarily focussed on assisting individuals make informed decisions and on ensuring there are no impediments or restrictions to accessing private insurance (p5).

Some pre-existing issues in the insurance market, such as under-insurance and a shortage of flood cover, may be exacerbated by climate change. However, the existing policy responses to these issues – focussing primarily on informing households about risks and available products – remain appropriate. We note in this context the National Insurance Law Service offered at the Consumer Credit Legal Centre, which is a national service predominantly funded by the NSW Government. The Government has recently expanded this service from a three day per week to a five day per week service.

In this regard, there may be scope for cooperation between government and the insurance industry on climate change impacts, such as storm frequency and intensity, flooding and coastal processes.

The Insurance Council of Australia has recently advised the NSW Government of its Residential Flood Project. As part of this project, the Insurance Council, on behalf of the general insurance industry, is developing a common industry definition of flood and a National Flood Risk Database.

Insurance issues for the natural resource management sector

While the discussion paper refers primarily to the built environment, climate change will also have impacts on primary industries, including forestry and agriculture. Some insurance and risk management issues to consider in this context follow:

- For primary industry and natural resource managers, production failure, for example due to ongoing drought (which may or may not be attributable to climate change), can present additional financial burden which may contribute the likelihood of non-insurance or under-insurance. While insurance can manage the risks of the 'boom-and-bust' cycles associated with primary industries, it is not comprehensively available for all aspects of these industries.
- One challenge for the insurance industry will be to differentiate 'climate extremes' from climatic events and to identify insurance gaps associated with natural resource management or primary industries.
- While plantation forests are increasingly being promoted as viable options for diversifying income (e.g. on farms) and generating environmental outcomes, they may face disproportionately high risks in terms of the impacts of climate change. The perception of an increased risk in this regard (e.g. bushfires), and possible difficulties in accessing insurance services (or the high cost of insurance), may affect investment decisions regarding long-term assets such as plantation forests for timber, carbon offsets or other environmental benefits attracting market value.
- The design of offset arrangements under the national emissions trading scheme may help to reduce this risk. For example, under the NSW Greenhouse Gas Reduction Scheme, risk to investors in long-term forest offsets is moderated in the following ways:
 1. Risk assessment of individual projects occurs prior to accreditation and minimum qualification standards apply.
 2. The scheme adopts a conservative approach to carbon accounting (70% Rule, carbon trade is limited to the minimum amount of carbon than can be maintained over the 100 year life of the project).

Building Effective Carbon Trading Markets

Are there any institutional inhibitors to the emergence of an Australian emissions trading scheme?

The NSW Government agrees that Australia, especially New South Wales, has the necessary market infrastructure and financial institutions to support an emissions trading scheme and permit price discovery.

However, new regulatory and administrative institutions to support an emissions trading scheme will need to be established, including the formation of an independent scheme regulator and administrator.

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

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

What features of an emissions trading scheme might impede the emergence of forward markets?

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

The NSW Government understands that an Emissions Trading Scheme Discussion Paper is to be released by the Garnaut Review for consultation in early March, with submissions due by 11 April 2007. The NSW Government will take the opportunity to provide comments on emissions trading scheme design issues through that consultation process.

Positioning Australia as a Regional Hub in the Asia Pacific Carbon Markets

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

The NSW Government agrees that Australia has the potential to become a leader in many aspects of the emerging carbon markets, though swift action is required to capitalise on these opportunities.

London is currently the world's leading centre. New York and Chicago are actively competing to be the leading centre in the Americas. It is not yet determined which country or city will be the leading trading hub in the Asia-Pacific. There are several contenders for the position – at present Singapore appears to be leading followed by Hong Kong, Beijing, Tokyo and Australia.

The Commonwealth Government's ratification of the Kyoto Protocol has removed a significant constraint to Australia's participation in the multi-billion dollar international emissions trading market. Australia has some significant competitive

strengths that could be built on in developing Australia as a key hub for emissions trading and related services in the Asia-Pacific region.

These strengths include:

- Australia's proven capacity as a financial and commercial trading centre, with its world leading financial institutions, highly developed capital markets, robust banking system, strong legal frameworks, political stability, advanced communication systems and skilled workforce. Australia's high standards of corporate, financial and regulatory governance make it a model in the region. Australia is already the major regional hub in a number of financial niche markets. For example Australia has both the largest pool of investment funds assets and the largest hedged fund industry in Asia. The majority of these Australian financial market activities are managed in Sydney.
- Practical experience and expertise in developing, implementing and administering the NSW Greenhouse Gas Reduction Scheme (one of the world's first mandatory greenhouse gas reduction schemes and still the world's second largest) and our comprehensive environment protection licensing system. Consequently, NSW has significant expertise in developing and operating a successful compliance assurance framework for emissions trading.

Further action by governments now could help to develop these capacities in a way that promotes Australia's position as the first choice for the supply of financial, legal and ancillary services within the burgeoning emissions trading market.

In this regard, the NSW Government submits that the key issue is to provide industry with early certainty as to the key design parameters of the emissions trading scheme, and the management of regulatory risk. The latter is of particular importance because the uncertainties associated with climate change, including the uncertain related costs and benefits of mitigation, raise the spectre of unpredictable changes to related regulatory arrangements. In the extreme, the market's perception of this risk could have consequences for the setting of permit prices in the forward market. Permit allocations provide an instrument to help insulate participants from the consequences of the perceived risk. Therefore, managing this regulatory risk issue is fundamental to the scheme design. Setting the NETS design parameters early and dealing with the regulatory risk, will encourage the forward development of the necessary institutions and services to facilitate carbon trading.

Other issues for policy-makers to consider to facilitate Australia's ascension as a regional hub in Asia-Pacific carbon markets are discussed below.

Kyoto Protocol

On 6 February 2008, the Commonwealth Minister for Climate Change Senator, the Hon. Penny Wong, stated publicly that the emissions trading scheme being developed by the Commonwealth Government will be designed to enable international linkages, while ensuring it suits Australian economic conditions.

The capacity to trade emissions internationally would moderate the cost of the emissions trading scheme domestically, while also providing significant trading opportunities for Australian companies. As such, consideration could be given to compatibility with Kyoto Protocol trading mechanisms, including the Clean Development Mechanism (CDM) and Joint Implementation (JI). The capacity of the Australian companies to establish trading links through the European Union Emissions Trading Scheme (EU ETS) could also be explored. It is understood that many Asian companies are already actively engaged in projects utilising the CDM, while only a small number of Australian companies have engaged in this process.

Specifically, consideration could be given to finalising the following measures to facilitate greater international compatibility, and boost Australia's competitiveness in relation to international emissions trading:

- Establishing a national emission unit register to facilitate emissions trading with other Kyoto participants. Japan, New Zealand and others in the region are establishing national registries that will be linked to the International Transaction Log.
- Nominating a Designated National Authority (DNA) under the Kyoto Protocol to help facilitate the involvement of Australian companies and agencies in the CDM. A number of developed and developing countries in the Asia-Pacific region have already established DNAs.

Further, NSW suggests that it would be desirable to:

- develop a clear CDM and international purchases strategy for Australia. Many Annex 1 countries under the Kyoto Protocol still lack a clear CDM strategy which can be a disadvantage to their companies' participation in the international mechanisms; and
- examine and consider establishing a Carbon Fund jointly with the World Bank, to facilitate Australian participation in the CDM and the JI, and Australian national purchases of Certified Emission Reduction (CER) units. A Carbon Fund invests contributions made by companies, government and the World Bank in CDM and JI projects. Contributors then receive a pro-rata share of the CERs generated by the project. A number of developed countries are seriously considering this approach, and the Netherlands government has already set up two such funds.

The national emissions trading scheme and international carbon markets

The Commonwealth's commitment to design the national emissions trading scheme in a way that enables international linkages should stimulate the establishment of a range of public and private institutions and agencies to service investment, carbon crediting and trading needs in the Asia-Pacific region.

It appears unlikely that a single global emissions trading scheme will emerge, at least in the short-term. A possible scenario is that global emissions trading will evolve through the linking of different and emerging regional and national emissions trading

schemes, together with the Kyoto Protocol's existing CDM and JI mechanisms, until an international consensus on reducing greenhouse gas emissions emerges. Therefore it is desirable that the architecture of the national emissions trading scheme allows for transitions to ever broader markets with a minimum of redesign. For example, whilst the EU ETS is currently the most obvious candidate for linking to an Australian emissions trading scheme, emerging schemes in the United States and New Zealand should also be considered.

It is recognised that, in the first instance, an Australian emissions trading scheme needs to be designed to meet Australian environmental objectives and to suit the needs of the Australian market. Irrespective of the imperatives for international linkages, regulatory uncertainty should be minimised as much as possible, in order to encourage adequate investment in facilities and projects whose value is influenced by the scheme and other greenhouse policies.

Key design issues to be scoped include:

- the most appropriate way of linking the national emissions trading scheme with similar schemes overseas, including consideration of unilateral and bilateral linkages;
- compatibility with the International Emissions Trading (IET) provisions of Article 17 of the Kyoto Protocol including baselines, additionality and standardized reporting protocols of emissions data, as well as general international compatibility issues;
- whether to allow the use of international offset credits created under the CDM and JI mechanisms for domestic compliance, along with other approved international offset credits where the scheme administrator is satisfied as to their integrity, acknowledging that this will have to be balanced against domestic greenhouse policies;
- whether there should be limits on the use of international offset credits allowed to offset domestic compliance obligations - "generous" limits could support the development of Australia as an Asia-Pacific regional hub, but this would have to be balanced against domestic emissions reduction requirements;
- closely involving the financial industry in the design of an emissions trading scheme to ensure that the industry has an early opportunity to develop market trading systems to handle trade in emissions permits; and
- policies that improve the efficiency of Australian markets, including the minimising transaction costs.

Addressing competitive disadvantages

To best realise Australia's potential as a regional hub in the Asia-Pacific carbon market, the international competitiveness of Australian financial services policies may need to be examined.

For example, financial competitors such as Singapore have made the development of international trading institutions and services, including carbon trading, a national priority. Initiatives to support this include tax concessions under Singapore's Global Trader Programme and the establishment of an International Trading Institute to build up knowledge and capabilities in the international trading sector.

It is important to note that carbon markets are a creature of government and rely on government for their continued existence. Consequently, the carbon markets are, and will remain, extraordinarily vulnerable and sensitive to government policy changes. It is therefore crucial that government operates in a consultative and open manner in developing the emissions trading scheme, and continues to work with the financial sector (and other relevant sectors of the economy) in the ongoing administration of the scheme.

Fundamental to the successful development of international financial markets is the preparedness of the relevant authorities to work through issues with the industry to develop a simple and clear regime that minimises compliance costs. The NSW Government supports the development of mechanisms for dialogue between industry and government so that issues are appropriately addressed on an ongoing basis. The Garnaut Review consultation process is a clear example of this industry-government dialogue. It is important that government signals to the market that attention is, and will continue to be, given to creating and maintaining a competitive, sound and flexible regulatory and operating framework which will provide investors with certainty and confidence in the integrity and efficiency of the system.

The NSW Government applauds the decision to give Assistant Treasurer and Minister for Competition Policy and Consumer Affairs, The Hon. Chris Bowen MP responsibility for growing Australia as a funds management centre. It is suggested that similar consideration be given to including carbon markets as part of an overall Ministerial responsibility to help to secure Australia's future as a global financial centre.

Leadership

The NSW Government has shown itself to be a leader on climate change, as demonstrated by its pioneering Greenhouse Gas Reduction Scheme. NSW welcomes the Commonwealth Government's commitment to introduce a national emissions trading scheme in 2010.

It is important that Australian governments take a proactive approach to emerging carbon markets and the opportunities those markets present for the Australian economy. To continue this tradition of leadership, consideration could be given to developing an overarching national strategy for positioning Australia as a regional hub in the Asia-Pacific carbon markets.

In the formulation of such a strategy, it may be prudent for the Commonwealth Government to commission an in-depth study of carbon markets and the opportunities for Australia. Issues to examine might include:

- The potential size of the regional market, and the services that will be required. A well developed emissions market will require a wide range of services including accounting, carbon management, risk management and insurance, financial and legal services, monitoring, verification and validation, trading and broking services, market analysis and advisory services, IT and registry services, training and communications.
- The relative strengths and weaknesses of competitors in the regional market, and the various government programs offered in support of those competitors.
- Identification of market opportunities and the barriers to realising those opportunities such as skills shortages.
- Locating gaps in existing resources, structures and institutions and developing strategies to address them.
- Learning from the experiences of other Governments in developing emissions trading policies. For example, London is currently the world leader in carbon banking and carbon markets. This leadership is in part built on innovative measures such as the London Accord, described on its website as a “co-operative research initiative that brings together the latest thinking of leading investment banks to provide a comprehensive overview of the state of the art - to provide greater clarity, better measurement and management - in bringing the effects of climate change into rigorous financial decision making analysis.” It is suggested that a similar co-operative approach, tailored to the structure and characteristics of the Australian markets, be considered as a further leadership initiative by governments. More information on the London Accord can be found at www.london-accord.co.uk

Conclusion

The significant environmental and economic opportunities that emissions trading presents for Australia should be harnessed as a matter of priority. The NSW Government appreciates this opportunity to provide comments on some of the insurance issues that arise in relation to climate change, and on developing the role of Australia in emerging carbon trading markets.

NSW looks forward to the Garnaut Review’s upcoming discussion paper on the emissions trading scheme, and will take the opportunity to provide comments on relevant issues through that process.