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The Garnaut Climate Change Review  
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Our ref 1500045\_1

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Dear Secretariat

**KPMG Submission to the Garnaut Climate Change Review in relation to the Emissions Trading Scheme Discussion Paper**

Thank you for the opportunity to provide a submission to the Garnaut Climate Change Review in relation to the Emissions Trading Scheme (ETS) Discussion Paper released 20 March 2008.

KPMG's submission highlights a number of issues within the Discussion Paper which we believe require further consideration and/or elaboration ahead of the September 2008 release of the Garnaut Climate Change Review's Final Report.

Our submission response to the ETS Discussion Paper has been grouped under two headings:

- Efficiency considerations
- General scheme design comments in relation to transitional issues.

KPMG expresses interest in continuing to play a key role in the development of workable and positive outcomes in relation to the Australian Government's climate change policy. We also expressly seek further involvement and will continue to offer our support in discussions and further consultations held in relation to the Garnaut Review on Climate Change.

KPMG looks forward to contributing to the shape and form of climate change policy and mechanisms across the Australian landscape.

Yours sincerely

Rachael Phelan  
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*Enclosures:*

Submission by KPMG to The Garnaut Climate Change Review in relation to the Emissions Trading Scheme Discussion Paper



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The Garnaut Climate Change Review  
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April 2008  
This report contains 10 pages

## Contents

1	Introduction	1
2	Efficiency considerations	2
2.1.1	Efficiency versus optimality	2
2.1.2	Information asymmetries	3
2.1.3	Incentives	4
2.1.4	Regional/International linkages	4
2.1.5	Emission budgets, trajectory changes	4
2.1.6	Coverage	5
3	General comments	6
3.1.1	Treatment of generators	6
3.1.2	Domestic energy sector regulation	7
3.1.3	Institutional arrangements, geosequestration and biosequestration	7
3.1.4	Linkages with other policy areas	7
3.1.5	Technical considerations for the auction framework	7
3.1.6	Refining the auction framework	7
4	Further consultation	8

# 1 Introduction

KPMG is pleased to make this submission in relation to the "Emissions Trading Scheme Discussion Paper" released by the Garnaut Climate Change Review ("the Review") on 20 March 2008.

In establishing an emissions trading scheme ("ETS" or "the Scheme"), it is appreciated that there will be a myriad of issues around the design, structure and operation of the scheme which will need consideration. The design and implementation of an ETS will have to balance practical and achievable change with what will be acceptable to industry, to certain industry sectors and to the community. It will also need to analyse the full economic consequences and impacts resulting from the introduction of an ETS.

In addition, other objectives such as stimulating investment in low carbon technologies and positioning Australia as a regional trading hub need to be considered. The interaction of these objectives with other key policy initiatives creates a complex picture.

Adding to this complexity is the timing for implementation provided by Government. It is clear that debate and discussion will need to be accelerated considerably to ensure the 2010 deadline for operation of the scheme is met. There will also be a need to bring certainty to the market place to allow for the concerns of stakeholders operating within commercial and competitive environments to be adequately addressed, further supporting a smooth transition to an emissions constrained economy.

KPMG's submission highlights a number of issues within the Discussion Paper which we believe require further consideration and/or elaboration ahead of the September 2008 completion of the Garnaut Climate Change Review's Final Report.

Our submission response to the ETS Discussion Paper has been grouped under two headings:

- Efficiency considerations
- General scheme design comments in relation to transitional issues.

The basis for this division is the Review's use of efficiency as a key objective for an ETS in Australia - that is, the attainment of reductions in emission levels at the least cost to the economy. Efficiency implications are a useful lens through which many proposals within the Discussion Paper can be considered. Subsequent comments are more tangential to the efficiency objective.

## 2 Efficiency considerations

Decisions on the structuring of emission permits (as a property right), the way in which these are allocated and the design of the overarching emissions permit market involve numerous trade-offs, and there are efficiency dimensions to many of these.

The comments in this section seek to highlight particular issues raised in the Discussion Paper. As theoretical considerations underpin many of the proposals for establishing an ETS, some of these comments are more hypothetical in nature than others. Nonetheless, they pertain to matters where we believe further consideration is needed.

### 2.1.1 Efficiency versus optimality

Almost all auction design processes require decisions which trade-off efficiency against optimality (or revenue maximisation).

An efficient allocation is one whereby permits end up with those who value them the most. An optimal allocation is one which generates the most revenue for the seller, in this case the Commonwealth. Trade-offs exist because the people who *value* an item the most are not necessarily the people who can *pay* the most for it.

Where there is a secondary market (as is the intention for the Australian ETS), it is important to secure efficient outcomes at the time of initial allocation because where this is not the case, transfers will subsequently occur with the associated rents accruing to the initial holder of the item in question. That is, it can be optimal to be efficient.

The proposal for participants within the market for emission permits to have an unlimited ability to bank emission permits needs to be considered in the context of overall efficiency. In particular, the impact of permit stockpiling for future use by certain participants may effectively crowd out other participants who have a real need for the same permits. The potential for this should be considered.

KPMG are aware, however, that making provision for some banking of emission permits will play an important role in supporting liquidity and dynamic efficiency over the medium to longer term and this encourages efficient investment. This feature of the market will underpin the emergence of a forward curve to guide permit acquisition/abatement decisions, and encourage investment and the management of risk. That said, the possibility of establishing limits around the level of borrowing activities in particular, could be considered as a means of minimising the efficiency impacts of any banking provisions (as discussed above), the risk associated with future (unexpected) changes to the emissions budget, and additionally support ease of linkage with other international schemes.

KPMG, in its submission response to the Garnaut Climate Change Review – Issues Paper # 2 (February 2008), noted that banking and loaning of permits was not

permitted in the first phase of the European Emissions Trading Scheme (EU ETS), but will be considered in the second phase of the European Scheme.

## 2.1.2 Information asymmetries

The value participants may attach to emission permits in an ETS, will be informed to a large extent, by information about the costs of abatement opportunities. There are currently some strong information asymmetries regarding the cost of abatement activities on the (future) demand side of an emissions trading market. Further consideration and discussion regarding the impact of information asymmetries on the allocation of emission permits and the operation of the market would be useful to the development of the ETS.

There are strong information asymmetries about the true nature of abatement costs, and the interaction of existing market dynamics. Given this, the costs of reducing emissions will increase if (a) new technologies do not come on as quickly as expected or (b) improved scientific data results in changes in trajectories or scheme design.

Conversely, if some low cost options for emission abatement are facilitated through the advent of major technological advances or the establishment of regional or international trading schemes, the price of emission permits could fall.

Each of these outcomes has the potential to impact on the efficiency of the ETS. If participants are too complacent about the costs of reducing emissions, and possibly borrow against future emissions, there is a risk that some fairly rapid adjustment may be needed in a relatively short period of time, and this could be costly to the economy. The risk that participants over-pay for their permits is also a concern because the 'premium' aspect may not be able to be recovered through a competitive marketplace, leading to adverse effects on economic growth.

These issues could arise regardless of the scheme design. The important point is that there is a competitive underlying market structure which supports the objectives of the Government to reduce emissions in the long run. Key to this is the emergence of forward investment signals which support the capital markets in providing efficient investment.

### **2.1.3 Incentives**

KPMG believes that the role and nature of incentives in an ETS would benefit from further discussion in relation to how they might be harnessed to bring about the desired outcomes.

In relation to fugitive losses from transmission and distribution systems, these could be reduced if the owners of these systems had the incentive to do so (i.e. competitive pressures as a result of responsibility for fugitive losses being apportioned to infrastructure owners under operating rules of the National Electricity Market).

### **2.1.4 Regional/International linkages**

KPMG agrees with the discussion of principle 5 (Integration with other markets) on page 13 of the Discussion Paper – however, as highlighted above, there is a need to ensure in the first instance that the ETS does not create distortions to input markets in Australia.

Whilst the Discussion Paper asserts that international linkages have been limited in scope to date, it is reasonable to assume this may not be the case in the future. Discussion of the pre-requisites for linkages and the expected implications of any linkages may be appropriate.

The Discussion Paper suggests (on page 35) that Australia should consider deep integration with (emissions) markets in PNG and New Zealand. KPMG agrees that there is merit in this being pursued. KPMG also believes integration with larger and deeper markets such as the European Union (EU) and US would complement such linkages, and these should be pursued accordingly with equal effort.

KPMG agrees with the discussion on pages 35-36 of the Discussion Paper regarding the need to certify the relative quality of emission trading schemes to which Australia may link itself. However, we were not so certain about the suggestion (page 35) that the international purchase of permits and offsets be limited to ensure credible domestic action on the emission reduction front. It is believed any such limit would reduce the overall efficiency of an international emissions trading framework.

### **2.1.5 Emission budgets, trajectory changes**

KPMG agrees with the need to ensure that there is a provision for reviewing the emissions budget. The trajectory approach outlined in the Discussion Paper is a useful construct for indicating how the budget may change over time in response to developments in science and/or commitments made by the international community.

It may be necessary, however, for Australia's emissions budget to be more responsive to developments in the international community, than is suggested by the 'four trajectory-scenario'. For example, abatement activity may be greater than

expected in the early years of the ETS, which may lead to an over-supply of permits in later years if the trajectory system is strictly adhered to. A discussion on options for increasing the responsiveness of the trajectory framework to market developments would be useful.

It will also be important that the permit release schedule (as dictated by the current emissions budget and impending trajectory changes) is structured in a way that is amenable to the current functioning of debt markets, particularly with respect to the forward release schedule for permits. Further consideration and specialist advice should be sought on this issue.

### **2.1.6 Coverage**

Ensuring the ETS has the broadest possible domestic coverage is important for achieving a reduction in emission levels efficiently.

In relation to the issue of coverage, the following observations are made:

- the value of regional/international linkages will be reduced if coverage (both here and overseas) is not as broad as it might be
- the proposed treatment of trade exposed emission intensive industries needs to be considered in the context of scheme efficiency and leakages which could occur
- arrangements for civil aviation and sea transport to be included in the ETS need to be made clearer. Presumably these arrangements will need to be compatible with those in other jurisdictions.

## **3 General comments**

### **3.1.1 Treatment of generators**

The treatment of generators under an ETS is one area where KPMG believes further analysis is needed, given their central role in the supply of electricity.

The concern is that the analysis to date does not properly take account of the significant financing considerations associated with generator assets or the fact that individual generator experiences will differ due to differences in the emissions intensity of their generation activities.

It is acknowledged that it is important for reasons of efficiency to include generators in the coverage of an ETS, but questions remain as to how this should be facilitated. The material within the Discussion Paper around free allocation of permits for the generation sector focuses on the perceived difficulties of this approach (page 33), not the key issue of what the implications of an ETS might be for the sector in the absence of any assistance or compensation measures.

If the sector was required to acquire permits via a competitive market place, there is a possibility that one or more generators may be forced to exit the industry, creating a shortage of baseload capacity, which would clearly have adverse knock-on effects for the economy.

This area provides scope for innovative thinking regarding how the transition to low-emission generation technologies can be facilitated. There could, for example, be a competitive tender for the exit of the least efficient generator(s) (above a certain output threshold) which would, in the short term, sure up the demand outlook for the remaining generators. Examples of areas where government has facilitated industry exits in recent years include dairy and commercial fishing.

Alternatively incentives for the early or accelerated retirement of emission intensive generation assets could be built into the corporate tax system and funded by revenues from the auctioning of emission permits. These are only initial suggestions, but are included to illustrate how public resources may be used to help facilitate the transition to low-emission generation technologies whilst ensuring the continuity of baseload supplies over the short term.

There are also other issues which require consideration in the context of the Australian energy industry; such as upstream gas market in the context of future generation sources (page 50) in addition to the concerns about market power.

The underlying structure of the energy market will have a large impact on, and be affected by, the outcome of the ETS design and implementation. KPMG believe that these discussions need to be elevated and accelerated in light of the impact to ongoing investment in the industry.

### **3.1.2 Domestic energy sector regulation**

Issues around the inclusion of a carbon cost in energy prices when regulation of some energy prices at the retail level exists in some states will require further consideration.

NSW has already announced that it is intending to extend its retail price regulation until at least 2013, and there is no real clarity around how the introduction of an ETS or the 20 per cent renewables by 2020 requirements) will be passed to consumers. It is important that regulatory frameworks have the flexibility to provide for these costs to be passed through. It may be the case that legislation overriding NSW and other states' retail price regulations is required to ensure that the Scheme has maximum effectiveness.

### **3.1.3 Institutional arrangements, geosequestration and biosequestration**

Discussion regarding the need or appropriate form for robust institutional arrangements in relation to some of the expected large-scale abatement options, namely geosequestration and biosequestration, is required. KPMG believes the needs to be credible arrangements, including provisions in relation to eligibility, verification and accreditation, in these areas so abatement activities are appropriately accounted for.

### **3.1.4 Linkages with other policy areas**

It is important that linkages between an ETS and related policy areas such as the mandatory renewable energy targets and future domestic offset arrangements are explored. More generally, the existing international carbon and renewable markets should naturally continue to be a key reference point for the design of Australia's ETS.

### **3.1.5 Technical considerations for the auction framework**

Further consideration and discussion will be required in relation to the technical considerations associated with the (likely) allocation of over 500 million permits per annum, and the simultaneous allocation of over 125 million permits, if auctions under an ETS are quarterly. If there is to be provision for any bundling of permits by market participants (for example, a bid for bundle of 1000 permits) the technical complexity of the IT infrastructure supporting the auction framework will increase again.

Whilst there is an understanding that IT technologies to support allocative events of this size exist, it is believed that the issue should be addressed explicitly within the final report.

### **3.1.6 Refining the auction framework**

The Discussion Paper does not address the use of expert economic (technical) expertise in the design of the ETS or the scope to employ experimental techniques to test out different auction designs in a laboratory setting before final recommendations are made. Given this testing capacity exists in Australia, KPMG believes that it should be utilised.

## **4 Further consultation**

KPMG expresses interest in continuing to play a key role in the development of workable and positive outcomes in relation to the Australian Government's climate change policy. We would welcome any opportunities to further discuss the contents of our submission or broader climate change matters being addressed by the Review. KPMG continues to offer our support in discussion and further consultations held in relation to the Garnaut Climate Change Review.

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