



Submission by Westpac Banking Corporation

Garnaut Climate Change Review

Emissions Trading Scheme Discussion Paper

22 April 2008

Background

Westpac is an active participant in public policy dialogue on the design and operation of an Australian Emissions Trading Scheme (AETS), and welcomes the opportunity to provide feedback on the Emissions Trading Scheme Discussion Paper, released by the Garnaut Review in March 2008.

This is the second submission Westpac has provided to the Garnaut Review, having also provided comments on 'Issues Paper 2: Financial Services for Managing Risk - Climate Change and Carbon Trading' in February 2008.

Westpac strongly supports the involvement of financial markets participants in discussions around the implementation of emissions trading in Australia for the following reasons:

1. Financial institutions have the pre-requisite knowledge and direct experience of trading in financial markets to comment on the practical implications of various design elements and transitional arrangements as Australian organisations move into a carbon constrained economy;
2. Many of the practical aspects of the AETS will follow the same or similar behavioural and price patterns of existing financial markets, thereby putting financial institutions in an excellent position to provide commentary on how the AETS is likely to develop in practice following the implementation of different design proposals; and
3. It is financial markets participants who will develop the financial products and services which will facilitate greenhouse gas mitigation at the least cost for organisations covered by the AETS.

Westpac's submission to the Garnaut Review draws upon the bank's considerable experience in factoring environmental considerations into business policies, systems, and procedures as well as our practical participation in environmental markets to date. Westpac has been trading in the EU ETS since late 2006.

Comments on the proposed Australian Emissions Trading Scheme (AETS)

Westpac has sought to comment on the following aspects of the proposed AETS:

1. Setting emissions limits;
2. Coverage;
3. Domestic offsets;
4. Point of obligation;
5. Permit release;
6. Price ceilings;
7. International linkages;
8. Inter-temporality;
9. Governance; and
10. Compliance mechanisms.

This is followed by some additional comments on social equity considerations, particularly in relation to indigenous communities, and complementary policy recommendations.

1. Setting emissions limits

Westpac has adopted a prominent position in advocating for greater regulatory certainty in both Australia and New Zealand. We have done so because we recognise that a strong policy framework is required to determine future climate policy impacts. Such a framework would assist business in making decisions and investments using established business models to manage climate risks and leverage opportunities.

Uncertainty increases risk, thereby reducing and delaying investment which is critically required to maintain and grow infrastructure. Without a clear policy framework that matches investment horizons, business has little incentive to invest now in newer, cleaner technologies and limited ability to accurately price climate risk.

To maintain global economic competitiveness, business needs to work with government to agree on a practical framework for reducing greenhouse gas emissions.

One of the key distinguishing features of an emissions trading scheme, is the role that policy signals play in influencing price fluctuations. Within the EU ETS, ongoing uncertainty around policy frameworks over longer-term horizons continues to create volatility and uncertainty within the market into Phase Three pricing.

The ‘trajectories’ approach outlined in the discussion paper, appears to address these concerns while retaining sufficient flexibility to address the changing regulatory landscape and emerging scientific consensus.

2. Coverage

Westpac supports the proposal to make the scheme as broad as possible, incorporating all six greenhouse gases specified under the Kyoto Protocol and across key contributing industry sectors.

This will benefit the functioning of the market by creating additional depth and liquidity in trading activity, thereby providing more opportunities to identify lower cost mitigation. Experience from the EU scheme indicates that engendering a critical mass of industry coverage is necessary to encourage companies to actively engage in the market, rather than passively meeting minimum compliance obligations on an annual basis.

Without genuine opportunities to manage their carbon risks in a competitive fashion, companies are more likely to hold onto their permit allocations to meet compliance requirements without realising the benefits of the market to achieve lowest cost abatement.

To support the inclusion of a broad range of industry sectors, more research and support is needed, focusing on ensuring that robust measurement methodologies and accounting systems underpin industry coverage. Westpac would specifically support an increased focus on research for the agricultural sector to assist property owners understand future liabilities and opportunities embedded within their farming practices.

3. Domestic offsets

Westpac supports the unlimited use of domestic offsets for two reasons:

- This will assist with transitional and adjustment costs for industry sectors covered in the first phases of the AETS; and
- It will promote additional investment and activity in greenhouse abatement and sequestration across industry sectors not covered by the AETS, but which are likely to be covered in the near term (for example forestry and agriculture).

Concerns that a delayed introduction date may disincentivise early abatement activities could be addressed with appropriate policy signals that forestry and agriculture will be included within the AETS by a certain date for example, along with overt incentives for 'early action' to promote innovation and reward first movers.

Any discussion of the use of domestic offsets also needs to address the applicability of international credit offsets for use within the AETS.

Westpac strongly supports the use of international offset credits through the market mechanisms set out in the Kyoto Protocol.

While there is general recognition a global carbon market would provide maximum efficacy, the reality is that a patchwork series of schemes is likely to develop in the interim, linked by the overarching framework of the Kyoto protocol. It is the use of offset credits generated through the Clean Development Mechanisms (CDM) and Joint Implementation (JI) which will create the bridge to a global market.

Westpac does not necessarily have a position as to whether the use of international offsets should be unlimited or limited to a prescribed percentage amount of permit acquittal on an annual basis.

However there is no doubt that CERs, the Certified Emission Reduction certificates generated through the CDM framework, have a price and are generated and traded today to benchmarked standards of credibility. The issues raised in the discussion paper around additionality, credibility, sovereign risk, project and delivery risk considerations are factored in to the pricing of 'primary CERs' and smoothed out in the bulk of subsequent trading through 'secondary CERs'.

Allowing the use of CER offsets from the start would also provide an additional tool to allow companies to transition into the market, providing additional liquidity to respond to any unintended miscalculations on carbon exposure.

Westpac promotes the rapid establishment of supporting infrastructure, to support the holding and trade of international offset credits through these mechanisms as a priority for Government, and strongly supports providing access to international offset credits.

4. Point of obligation

Westpac supports the approach that the point of obligations should sit at the point in the supply chain where it is most practical and appropriate. This will vary across industry

sectors to some extent, in terms of determining whether the best point of obligation should rest at the source of emissions, upstream or downstream.

The point of obligation should be agreed in consultation with industry sectors covered under the AETS.

5. Permit release

There are a number of relevant issues around permit release which need to be addressed from the outset in designing the AETS. These include:

- Permit design;
- Method of permit issuance (auctioning versus free allocation); and
- Rate of issuance.

It should be noted that Westpac's comments on permit release are based on the presumption that all these factors work together and are not 'cherry picked' to assemble a composite framework. Certain approaches work together more effectively than others and should not be considered as independent components which can 'mix and match'.

Permit design

Westpac supports the development of a tradeable carbon permit based on the creation and existence of secure property rights. Permits with distinguishable and tradeable rights will be key to establishing a secondary market and promoting the efficient operation of the forward market. They will also better assist financial institutions to extend credit against the value of the underlying asset, and include value of the permit in cashflow and balance sheet projections.

It is also important that permits are date stamped, and subsequently eligible for acquittal on or any time after the market date – but not before. This approach would allow for the issuance of future-dated permits, thereby supporting greater liquidity, certainty for abatement investment and the more rapid development of an efficient forward market.

Method of permit issuance

As discussed in Westpac's previous submission to the Garnaut Review, ultimately, auctioning is the most effective means of driving price discovery, both in the early stages of market development and in terms of the market's ongoing functionality. Additional issues relating the auctioning of permits are discussed below.

Permit issuance mechanisms aimed at assisting industry sectors transition into the ETS, such as the free allocation of a portion of permits, should therefore be dealt with separately as a specific facet of first phase scheme design – and not as a core operational element.

However, Westpac also recognises that the AETS will need to ensure that trade-exposed sectors (import and export) are not severely impacted as Australia transitions to a low-carbon economy.

Should this be pursued, Westpac would advocate an approach whereby permit allocation volumes are telegraphed in advance for abatement investment certainty, however the physical transferral of permits into the receiving company's registry account should be

undertaken at the start of the relevant compliance year to ensure that allocations of free permits are only made to ongoing concerns.

A mechanism for allocating permits and transferring carbon assets – and potential liabilities – to the balance sheet of significant emitters operating in trade exposed sectors will need to be considered. This must necessarily take into account cost pass through ability and not artificially constrain the growth or liquidity of the AETS.

Rate of issuance

Westpac supports the frequent auctioning of small parcels of permits (monthly or quarterly) to promote greater price transparency in the market and to smooth out potential price shocks in the early stages arising from the release of data to the market.

If permits are date stamped (as discussed above) auctions could also include a package of permits dated a number of years into the future to support an efficient, transparent and accessible forward market.

In addition, as a method of ensuring sufficient liquidity in the early stage of the scheme when some hoarding is likely to occur, consideration should also be given to weighting the volume of permits auctioned in the first two compliance years in favour of the first year. By way of illustration, given an anticipated trajectory of 110-90-70-50 units over four years (320 in total), a means of addressing liquidity concerns in the early stages could be to alter the balance to 130-70-70-50 units (320 in total).

Westpac also supports the commencement of auctioning of permits ahead of the formal start date of the AETS, to promote price discovery and allow organisations covered under the ETS obtain permits in advance and lessen the short term cost impost of first year compliance.

As discussed within the section on price ceilings, it is important the rules for the AETS as it is intended to operate be set first, before giving consideration to transitional concerns.

6. International linkages

As discussed above, creating a functioning global market will involve a step-change process, ensuring that at every stage of domestic market development and international policy negotiation decisions are made with a view to ensuring seamless transition between jurisdictions and genuine global greenhouse gas emission reductions.

These considerations must be embedded in permit design, overall scheme design and in establishing effective linkages with existing markets through the Kyoto market mechanisms.

As discussed above, providing market access to existing Kyoto compliant carbon credits, such as CERs for example, will provide the pivotal foundation stones and early links to establishing a genuinely global market in carbon assets and provide market access to the EU ETS and any future North American ETS.

This should negate the need to establish specific ‘regional markets’ with Papua New Guinea or Indonesia for example, as offset credits generated within these jurisdictions,

once properly certified to existing international frameworks, will meet the intent of this proposal from a financial markets perspective. However, Westpac does recognise the value of establishing bilateral arrangements for the purposes of meeting Australia's national emission reduction targets under the Kyoto Protocol, and in supporting inter-governmental emissions trading through these market mechanisms.

Westpac supports the goal of longer-term alignment between the Australian ETS and the New Zealand ETS, while recognising that there will be challenges in addressing the needs of the different emissions profiles.

Ongoing decisions around linking mechanisms and how these feed into Governmental compliance requirements will need to be explored in more detail.

7. Price ceilings

It is worth noting that any discussion around the use of price ceilings within the AETS is aimed at avoiding short term price shocks in the early stages of the scheme. Westpac would strongly re-iterate at this point that the fundamentals of scheme design should be based solely on considerations of how the market will function when fully operational, while transitional issues should be considered subsequently. Essentially, the scheme should be designed, then transition addressed within that framework.

Designing an ETS with price ceilings or floors built in fundamentally undermines the trust in and functioning of the market by weakening incentives for market participants to pursue responsible and efficient trading behaviour. As such Westpac does not support the imposition of price controls onto the market.

Short term price shocks or price volatility can be managed through a number of measures already outlined, including frequent auctioning of small parcels of permits, managing the release timing of future dated permits, purchasing CERs or other recognised offset credits and by providing a government 'lender of last resort' facility (discussed below).

8. Inter-temporality

Inter-temporality needs to be differentiated between the design and practical application of different 'banking' and 'borrowing' provisions.

As stated in Westpac's previous submission to this inquiry, we support the use of banking within the AETS. Banking provides compliance flexibility, encourages early emission reductions and reduces compliance costs. It also allows firms to manage emissions profiles more smoothly from year to year to reflect production variations and the business cycle.

The ability to bank carbon permits for use in future years would also serve to smooth out price volatility, helping to avoid situations where an excess of permits at any given time might depress the carbon price.

As discussed above, Westpac supports date stamped permits which will subsequently be eligible for acquittal on or any time after the market date – but not before. This approach

would allow for the issuance of future-dated permits, thereby supporting greater liquidity and the development of a forward market without exceeding carbon budget restrictions.

The practice of 'borrowing' needs to be differentiated between private sector borrowing as a function of the market (for example through synthetic borrowing - the purchase of one vintage and simultaneous sale of a future vintage), and government lending, where organisations covered by the scheme can borrow permits from a government body to meet their compliance requirements.

In previous submissions, Westpac has raised some concerns about allowing emitters to 'borrow' from their future allocations of permits, in the expectation that it would weaken the price signal and undermine the need for active participation in the market, as well as potentially distort market behaviour to the detriment of the stated intent of the ETS to reduce overall greenhouse gas emissions. This remains our position.

However, the option of 'borrowing' from government as introduced in the Discussion Paper, could potentially operate as a 'lender of last resort' with accompanying financial penalties and costs to discourage organisations covered by the scheme from accessing this option unless absolutely necessary. Provided it were only undertaken within strict parameters, this may provide some limited flexibility for organisations meeting annual emission caps, without distorting or undermining the effective functioning of the market.

9. Governance

Experience of the EU ETS indicates that carbon markets continue to be very sensitive to policy signals, changes in process or technical administration and new developments in international policy.

There is no doubt that the Government will have a number of roles to play within the AETS, including establishing the rules and the ETS framework, administering the ETS, issuing permits, certifying offset credits and potentially purchasing credits for national compliance purposes. Therefore the delineation of responsibilities between different entities responsible for the various roles must be open and transparent from the outset.

It is vital that administrative decisions affecting the operational functioning of the market be undertaken in an environment as free from political sensitivities or representation from impacted industry sectors as is possible.

Therefore, Westpac supports the proposal mooted in the discussion paper, that an independent body oversee the administrative functions of the market, analogous to the Reserve Bank of Australia (RBA). Furthermore, Westpac supports the summary of administrative and government functions, as set out in the submission by the Australian Financial Markets Association (AFMA) on this discussion paper.

10. Compliance mechanisms

Westpac supports the use of compliance and penalty provisions to ensure market participants meet their acquittal obligations. It is important that these provisions not be considered an attractive alternative to engaging with the market to meet compliance requirements.

Social equity considerations and indigenous communities

It is now generally recognized that the economic impacts of climate change will be distributed disproportionately across and within economies. Of particular concern are the social justice implications for socially disadvantaged groups such as low income earners and Indigenous communities.

These can include arbitrary effects on income distribution from the introduction of carbon price signals, structural reform impacts in the shift to a low carbon economy and assistance to impacted communities adjusting to the physical impacts of climate change.

Climate change also has several unique social and human rights implications for Indigenous communities. These include both the cultural impacts and the direct environmental impacts of climate change on the health and wellbeing of Indigenous communities, particularly in remote areas of Australia.

There are economic opportunities and implications for Indigenous peoples as a result of policy response to climate change. Climate change is expected to adversely impact the tourism industry in Australia, a source of income for many Aboriginal communities in remote areas. However, there may also be significant new commercial opportunities from accessing emerging carbon markets around land based and forestry carbon sequestration opportunities for many Indigenous Land Councils.

Active consideration should therefore be given to the role of Indigenous communities in designing and implementing a policy response to climate change and in particular the administration of forestry and land use under the AETS.

The role of complementary policy measures

Westpac strongly supports and promotes flexible, market-based policy instruments that facilitate reductions in greenhouse gas emissions while maintaining economic competitiveness.

However, we also believe that emissions trading alone will not deliver substantial greenhouse gas reductions. To achieve the environmental outcomes required without unduly compromising national economic competitiveness, Westpac supports a suite of complementary policy responses within a clearly articulated framework.

This essentially requires five core elements:

1. The establishment of a long-term aspirational goal to reduce greenhouse gas emissions, supported by a short term binding target aligned to international policy requirements.
2. A national emissions trading scheme, incorporating appropriate international linkages.
3. A practical strategy supporting the investment in the development and deployment of low-emission technology.
4. Demand management and behavioural change, facilitated through appropriate education and awareness raising across the community.
5. A strategic response to adaptation requirements across impacted communities, natural habitats and industry sectors.

Concluding comments

Westpac welcomes the opportunity to provide feedback on the proposed framework for emissions trading in Australia and would be happy to discuss further any issue or comment raised in this submission.