

Ernst & Young Submission:

**Garnaut Review
Emissions Trading Scheme
Discussion Paper**

April 18 2008

Introduction

The design of an Australian Emissions Trading Scheme (AETS) will have significant impacts on:

- Market demand to increase energy efficiency and reduce emissions intensity
- Market confidence and pricing of risk into market decisions
- The level of uptake of existing low emission technologies
- The confidence of private investors to support R&D of new technologies and their willingness to bring first-of-a-kind technologies to commercial scale in Australia

Ernst & Young works with a wide range of Australian and international businesses – some of which will be liable parties under the AETS and some that will be better equipped to maximise opportunities as a result of the new regulation. Our firm's interest in the design of the AETS is to ensure that it delivers good public policy. In the ETS Discussion Paper, five principles are articulated as being necessary to ensure that market operates smoothly. These are:

- Scarcity aligned with the emissions target
- Tradability
- Credibility
- Simplicity
- Integration with other markets

Ernst & Young supports the review of design elements against these principles. The principle of credibility is particularly important in terms of reliable, steady and transparent operating rules to ensure that business makes timely decisions with some understanding that the rules of the game will not change abruptly. Without this level of confidence, many businesses will be reluctant to invest in Australia.

In our submission, we wish to focus on the key issues of

- Initial allocation of permits
- Revenue recycling from auctions
- Offset opportunities
- Penalty for non-compliance

Initial allocation of permits

While the debate continues as to the most equitable process for the initial distribution of permits, we were pleased that the Garnaut Review clearly stated in the Discussion Paper that *.....the manner of the allocation will not affect the operations of the scheme – the price of the permits or the costs of adjustment to the ETS*. It is important to re-enforce that allocation is not a market efficiency issue in order to focus the debate on distributional impacts.

The two groups of businesses that have specifically argued for an initial free allocation of permits are the energy producers and the trade-exposed, emissions intensive industries (TEIIs). The energy producers, primarily existing power generators, fall into the category of *disproportionately impacted or strongly affected* – terms used by successive Australian Governments. The Discussion Paper notes that *Whilst there is some expectation that existing coal generators are likely to remain competitive on a SRMC basis for some time, the loss in volume will progressively diminish the contribution to fixed costs, with a corresponding impact on the carrying value of the asset. It is this impact that is at the core of some industry arguments for compensation.*

An important consideration in designing the ETS is to consider the orderly transition to a carbon constrained economy. This is particularly important for the energy supply sector as the implications will flow throughout the national economy.

The EU ETS model is quite different to those that have been proposed in Australia. As a result there is little available in terms of lessons learnt with respect to the financial impacts on liable parties, for example power generators given the different levels of exposure under the two schemes. The initial allocation design will have direct impacts on:

- Upfront cash outlay to purchase permits
- Profitability
- Debt funding / refinancing costs
- Asset valuation

Circumstances for each company will vary based on a number of factors, including asset portfolio, balance sheet and current debt financing position.

There are also some issues associated with the accounting treatment of permits allocated or purchased in terms of whether they will be classified as inventory to match liabilities or as fixed assets. The final decision on the accounting treatment will also impact on the working capital of the business.

Liable parties will also need to implement sophisticated forecasting tools to ensure that they can match their compliance risk with commitment to purchase permits and/or credits. Although some companies will decide to trade surplus permits, other businesses will seek to minimise additional cash outlays in any particular compliance period.

The tax implications of permit allocation will also be an important consideration for liable parties. Ernst & Young has recently released a report on the full range of ETS tax implications in conjunction with The Institute of Chartered Accountants in Australia¹.

These issues will collectively impact on the ability of existing generators to continue to operate and for new entrants to enter the market. The objective is to reduce the GHG intensity of the generation mix, so change is necessary. Ernst & Young wish to highlight the need to consider this range of issues alongside the national economic modelling to ensure that transitional arrangements are well managed and energy supply/demand continue to be reasonably well balanced in Australia. The alternative – abrupt shutdown of generating plant could cause excessive pain to a range of stakeholders.

We would be pleased to discuss the financial implications of different allocation methodologies in further detail with the Garnaut Review team.

Auction issues

As highlighted in the Discussion Paper, an auction will have an important role within the allocation process. Ernst & Young notes that there are few international precedents for a high proportion of allowances to be auctioned under a cap and trade model. Within Australian business, there has been minimal discussion about preferred design of an auction process.

¹ Australia's Proposed Emissions Trading Scheme – The Tax Policy Dimension ISBN 978-1-921245-36-7
www.ey.com/au

Getting the auction process right will be a crucial. In the US, five states (Connecticut, Maine, Maryland, Massachusetts and New York) have all indicated that they plan to auction 100 per cent of their permits under Regional Greenhouse Gas Initiative (RGGI). More recently, the European Commission proposed that 60 per cent of permits (including 100 per cent to the powergen sector) would be auctioned in Phase 3 of the EU ETS.

In designing the auction process for RGGI, several key criteria have been nominated as being important:

- Low administrative costs, low transaction costs for bidders
- Perceived as fair, transparent, and understandable to participants and the public
- Economically efficient—that is, getting allowances to those who value them the most
- Avoiding collusive behaviour by bidders and providing good signals about market prices
- Helping to minimise price volatility
- Raising reasonable revenues from the sale of a valuable public asset
- Compatible with existing electricity and energy markets

Ernst & Young would urge the Garnaut Review team to work with Government and industry to develop more detailed thinking around the design options to ensure that the auction process can deliver desired outcomes.

TEEIs

There is strong support across Australian business for short term support for the TEEIs while a limited number of Australia's trade competitors have imposed a carbon regime. The challenge seems to be in establishing transparent rules for sunset clauses, upfront at the beginning of the ETS. Asset owners and investors will need some certainty around the rules for ongoing support; if not, then the value of their asset may be materially impacted or new investors may be deterred from committing to Australia.

There are a number of pros and cons in the consideration of using permits or cash to support TEEIs in the initial phase of the ETS. Some businesses have expressed the view that from both a reputational and transparency perspective, there is a preference to have permits. By establishing a permit allocation, the decision is taken out of the revenue recycling debate and if there is market volatility, then TEEIs would rather have the flexibility of a permit to hedge their position rather than a static cash payment.

Revenue recycling from auctions

As the discussion paper notes, there will be significant demands on the revenue generated from auctions. Ernst & Young acknowledge that there are many worthy recipients of the monies. We recommend that a significant share be used to support complementary policies for research, development, demonstration and first-of-a-kind large-scale commercialisation of technologies.

Reasons for support include:

- Risk sharing to accelerate the availability of breakthrough technologies
- Need to lower the cost of breakthrough technologies at commercial scale
- Creating opportunities to export know-how of proven new energy technologies
- Demonstration will boost confidence of international markets, which in turn will accelerate deployment

Incremental improvements in technology will not by themselves lead to stabilisation; more is required - step-changes in cost, scale and emissions performance - well beyond the usual framework of commercial development. A transformational energy technology strategy is therefore an integral component of international and national climate change response frameworks and will provide value by reducing the costs of meeting future GHG reduction goals.

It will be important for the Australian Government to establish the innovation criteria and be open to a range of technology options, without being fully prescriptive. It is also important to understand that the level of support funding needs to be very high, matched by private investment, to deliver new technologies at commercial scale on an urgent basis.

Offset Opportunities

The inclusion of offsets broadens the scope of the scheme by providing an incentive to undertake projects that would not otherwise have been influenced by a permit price. The inclusion of credits will increase market liquidity, reduce the marginal cost of abatement and reduce the costs of scheme compliance.

Liability parties are keen to hedge their risks and maximise opportunities. One key aspect to meeting both of these objectives is to enter the offset market today – to invest in abatement projects, to develop trading capacity, to better understand their marginal cost of abatement curve and to potentially develop a portfolio of assets that can directly reduce their forward liability.

A real challenge is that the rules for inclusion of credits have not yet been established for the ETS. This has led to a stalling of investments – particularly evident in domestic forestry investment. Ernst & Young see considerable value in the early confirmation of rules for domestic offsets, for example forestry and agricultural projects.

These offsets could play an important role in achieving abatement. There are a number of well-established standards for the recognition of credits from carbon sink forests. This would provide further immediate incentives to this area, building on changes in tax treatment announced in the 2007–08 Budget. The confirmation of approved, rigorous methodologies and governance guidelines in this area should be a priority. Many of the lessons learnt under the NSW GGAS should be incorporated into the ETS rules.

Ernst & Young supports the principle of no limitations on offsets within the ETS, that is, the scheme should recognise a wide range of credible domestic credits and Kyoto Flexible Mechanism units. Domestic offsets will reduce the cost of meeting the scheme cap, and assist in preparing non-covered sectors for eventual inclusion in the scheme. At the global level, the recognition of offsets created in developing countries can be an effective way of promoting their involvement in global efforts to limit emissions and offer least cost abatement opportunities.

In line with Australia ratifying the Kyoto Protocol, it would seem prudent to include the Kyoto Flexible Mechanisms within the framework of the Australian ETS. To date, over 135 million certified emission reductions (CERs) have been issued by the Clean Development Mechanism (CDM) Executive Board through the UNFCCC and this represents over 1000 approved projects. The processes are rigorous and required to meet sustainability goals of host countries. The definition of additionality has been amended over recent years. The criteria are still strict – the change is that the projects no longer need to rely on the CERs for their financial viability but must demonstrate action beyond business-as-usual to qualify.

Governance arrangements have matured significantly since the inception of the Executive Board and will continue to do so. Australia has a strong role to play through CDM investment in the Asia/Pacific region and can reap direct domestic benefits through these investments. Australian companies must have the opportunity to secure the cheapest source of credible abatement worldwide.

Ernst & Young has considerable experience in verification of domestic abatement projects and in CDM project development and it is our opinion that there is value in including CERs within the Australian scheme with no limits on the volume of credits. This approach reflects the global nature of GHG emissions encourages investment in abatement projects and provides a suitable hedging strategy for Australian businesses in conjunction with internal abatement

measures. The inclusion of CERs in the Australian ETS also opens the door for international linkages of carbon regimes. We support a global model that resembles a constellation approach, that is, linking schemes that may have different national characteristics but where overarching rules are aligned through negotiation and agreement between parties.

It is also important that the Australian Government takes an early decision on the inclusion of Joint Implementation within the ETS. There seems no reason to exclude emission reduction units (ERUs) from the scheme, for the reasons articulated above with respect to CERs. There is a separate question as to whether the Australian Government should sanction JI investment in this country. Ernst & Young holds the view that increased investment in abatement projects in Australia should be encouraged. If the concern is that these ERUs will be exported, and hence the domestic task will be made even more challenging, then it would be possible to cap the export of ERUs but this is not our preferred position. There is much to be gained from large scale investment in domestic abatement and therefore local investors would have the opportunity of matching the JI investments for economic and environmental advantage.

The processes to establish the necessary regulatory infrastructure to support JI and CDM will take some time (perhaps 18 months) and therefore it is critical that these efforts are well resourced to ensure that investments are supported.

Penalty for non-compliance

In the event that a liable party cannot acquire sufficient permits to cover its emissions during a compliance period, it will be required to pay a penalty. In setting the penalty consideration should be given to encouraging compliance to ensure the ongoing integrity of the scheme whilst minimising the costs of scheme compliance.

We suggest that the level of penalty must be set at least as high as the future marginal cost of abatement estimated at a point in time. Setting a sufficiently high penalty will be necessary to ensure scheme compliance and will further encourage investment in abatement technologies. It will also improve investment certainty (that is, with a high penalty established from the outset the likelihood of future unplanned increases in the penalty will be reduced).

In setting the penalty, it is also important to ensure that the market is liquid and the scheme is designed to reduce market power issues, otherwise liable parties may face unintended consequences.