



# Submission on Emissions Trading Scheme Discussion Paper

28 April 2008

## Table of Contents

---

1.	Introduction .....	1
2.	Specific comments .....	2
2.1	Objective of the ETS .....	2
2.2	Principles guiding the design of the ETS.....	3
2.3	Setting an emissions limit .....	4
2.4	Changes to the emissions limit .....	4
2.5	Coverage of the ETS .....	4
2.6	Points of obligation.....	4
2.7	Offsets .....	5
2.8	Permit allocation .....	5
2.9	International linkages .....	6
2.10	Price controls .....	6
2.11	Inter-temporality – banking and borrowing.....	7
2.12	Treatment of TEEIs .....	7
2.13	Governance .....	7
2.14	Compliance.....	8
2.15	Use of permit revenue .....	8
2.16	Market failures.....	8
2.17	Other issues .....	8
3.	Conclusion .....	9

# **Submission on Emissions Trading Scheme Discussion Paper**

---

## **1. Introduction**

Climate change is a global problem that requires a global solution. The ABA believes that it is important to encourage the development of a global carbon market, initially through the introduction of an Emissions Trading Scheme (ETS) for Australia.

The ABA supports introducing a national scheme administered and regulated by the Federal Government. It is in the long-term interests of the Australian economy, society and environment to take early action so that Australia can make a smooth transition to a lower carbon economy as well as address the vulnerabilities and take advantage of the opportunities presented by climate change.

The ETS should provide a transactional space that allows price discovery to occur due to the exchange of permits for value. Trading rules and operational arrangements will be required to ensure the exchange of permits takes place in a manner which is economically efficient.

It is the ABA's view that a national ETS should:

- Be established around a clearly articulated objective to mitigate the adverse effects of climate change by limiting and reducing the release of greenhouse gas (GHG) emissions into the atmosphere through a market-based mechanism which places a price on carbon.
- Be developed around a flexible, yet consistent framework, minimising market and policy changes over time, reducing regulatory uncertainty, managing transaction costs, and thereby encouraging confidence by participants.
- Be bound by uniform rules and able to facilitate efficient and simple participation. Market efficiency must be supported by solid financial market conventions, trading and operating rules and regulatory and governance arrangements.
- Improve investment and operational certainty while minimising artificial distortions on the economy and adverse impacts on the environment.

The ETS should be part of a portfolio of policy responses to address climate change and achieve sustainable reductions in GHG emissions, along with practical strategies to develop and deploy low to zero emissions technologies, renewable energy technologies and adaptation responses to assist businesses and the community transition to a future carbon constrained economy.

Participation by the banking and finance sector will be critical to the successful design and implementation of a national ETS. Banks and financial institutions are well placed to develop and deliver the necessary infrastructure, products and services to support the ETS and assist businesses and individuals understand their exposures and take appropriate actions.

The banking and finance sector has an important role to play in a number of crucial areas, including:

- Facilitating the trade of carbon assets on the ETS, including financing the creation and trade of carbon assets;
- Intermediating between private sector participant buyers and sellers and making secondary and forward markets;

- Advising private sector participants on commercial risks and opportunities, including carbon risk management techniques and reduction strategies;
- Investing and providing capital funding for the development of low to zero emissions and renewable energy technologies;
- Lending to private sector participants and individuals; and
- Developing products, services and incentives to support other climate change policies and mitigation and adaptation strategies, including retail products and services.

It is the ABA's view that the Government also has an important role to play in a number of crucial areas, including:

- Developing the legal and documentation frameworks, including a national registry and legislative tools for other interoperable Kyoto market mechanisms;
- Developing the governance framework and independent authority to oversee the design and function of the ETS, including transitional arrangements and the initial allocation and auction of permits;
- Educating and building capacity across private sector participants covered by the ETS and individuals, including a national information campaign for businesses, individuals and communities<sup>1</sup> and reporting requirements for companies;
- Acknowledging the tight timeframes within which participants will have to comply and meet the requirements of the ETS and potential capacity constraints in Australian service providers to meet accompanying deadlines; and
- Developing complementary measures to support the development of low to zero emissions and renewable energy technologies.

## **2. Specific comments**

### **2.1 Objective of the ETS**

The ABA supports the objective of the ETS to *“provide a transactional space that enables the transmission of permits to economic agents for whom they represent the greatest economic value.”* It is vital that the ETS framework promotes the efficient exchange of permits with low transaction costs.

The ETS should form part of a comprehensive and multifaceted policy response to control (limit and reduce) GHG emissions, facilitate innovation and investment and adapt to changed market conditions.

The ETS should enable price signals to reflect the market forces of supply and demand. Mechanisms which enable businesses and individuals to identify a carbon price will provide investment and operational certainty.

---

<sup>1</sup> The ABA believes that the Federal Government and the banking and finance sector have a role to play in raising awareness and educating participants. A “Behavioural Change Agenda” must be identified and articulated to businesses, individuals and communities to empower Australians to understand the impacts of unavoidable climate change and the actions they can take to reduce the effects and manage their exposure to climate change.

The ABA recognises that determining the core objectives and design of the ETS will drive complementary policy responses and other instruments to achieve the broader economic, environmental and social objectives.

## 2.2 Principles guiding the design of the ETS

The ABA supports the principles identified to define a solid framework and design an efficient market including:

- **Scarcity:** Permits must be limited to ensure the value and demand for those permits. Allocation must be certain, otherwise, market participants will factor risk into the price (premium or discount).
- **Tradability:** ETS must be accessible for market participants and permits must be tradable quickly, at minimal cost, and with transparent bid and offer prices. Carbon assets with distinguishable and tradeable rights will be a key to establishing a secondary market and promoting the efficient operation of the forward market. Carbon assets will improve the efficiency and function of the ETS, by reducing transaction costs, facilitating price discovery and transferring risk and minimising counterparty and settlement default. Carbon assets should be underpinned by strong governance. Carbon assets with distinguishable and tradeable rights will better assist financial institutions to extend credit against the value of the underlying asset, and include its value in cashflow and balance sheet projections.
- **Credibility:** Operating rules must be steady and reliable. Disclosure of high quality, validated data will be crucial to the effective function of the ETS and management of price volatility.
- **Simplicity:** Operating rules must be easily explained and implemented. Rules should apply consistently and ongoing 'special' rules, concessions and exemptions should be avoided.
- **Integration:** ETS must be able to integrate with other financial, commodity and product markets in the domestic and international economies as well as global emissions markets. The inter-relationship between the primary and secondary markets and the spot and forward markets needs to be reflected in the design of the ETS. A secondary market will provide the primary market with credibility and certainty and allow trading of permits by carbon emitters prior to them entering the primary market. Forward and derivative markets will be essential to provide investment certainty for new entrants as well as existing carbon emitters. Forward markets have the ability to stabilise otherwise unstable spot markets, by providing market participants with the ability to predict to some extent the cost of participating in the primary market. However, global linkages are very different to inter-relationships with other domestic markets – it will take some time to facilitate the integration of global emissions markets. Notwithstanding, actions should be taken to position the ETS with comparable overseas schemes.

The ABA also believes that another guiding principle should be recognised – "Leadership". Climate change has considerable economic, social, environmental and business risks that require significant and immediate action to limit and reduce GHG emissions, minimise adverse impacts and adjust to the effects of climate change. Early action to limit and reduce GHG emissions will increase the effectiveness of our response and reduce the costs of actions over the long-term. It is important for Australia to take action now and take advantage of the opportunity to position itself as a leader within the Asia-Pacific region ('carbon hub') and influence our Asia-Pacific neighbours into the carbon market.

### **2.3 Setting an emissions limit**

The ABA agrees that the Federal Government should set the emissions limit and trajectories for Australia. While the decision regarding the emissions limit should be made outside the ETS framework, greater certainty is required over key market signals, such as thresholds, targets and free allocation versus auctioning.

### **2.4 Changes to the emissions limit**

The ABA agrees that the Federal Government should make decisions regarding moving from one trajectory to another. Changes should be made on the basis of international policy developments and agreements and based on economic and/or scientific data. Conditions for changes to the emissions limit should be identified and disclosed in advance.

### **2.5 Coverage of the ETS**

The ABA supports broad coverage of all emissions and industry sectors being covered by the ETS. Ideally, the ETS should commence with all emissions and sectors, as changes to emission types and sectors covered later will impact the supply and demand for permits or credits and impact on the efficiency of the market (including the forward market).

Six greenhouse gases<sup>2</sup> as defined by the UNFCCC Kyoto Protocol should be included.

Due to ongoing inconsistencies in assessing emissions from agriculture, land use and forestry, these sectors should be excluded from the ETS for a transitional period, but should be able to access offsets (carbon compensation) where emissions reductions and early abatement activities can be clearly quantified. Agriculture, land use and forestry should be included as soon as practicable.

A timetable and process should be identified for those sectors excluded from the ETS in the transitional period and disclosed in advance. This should be articulated at the commencement of the ETS, so that uncertainty, future shocks and changes can be minimised.

### **2.6 Points of obligation**

The ABA supports the point of obligation (liability) being the point in the supply chain that involves the release of GHG emissions into the atmosphere (carbon emitter), where practicable and appropriate.

Permits must be acquitted by the carbon emitter reflecting these GHG emissions.

Liability for GHG emissions should be levied directly on the carbon emitter, however, there should be mechanisms for voluntary 'opting-in' to take on indirect liability.

Where the asset or utility is jointly-owned, carbon reporting frameworks should allow consistent reporting, so as to not reflect the operator as having 'whole liability' and to ensure 'equity exposure'.

---

<sup>2</sup> Carbon dioxide (CO<sub>2</sub>), methane (CH<sub>4</sub>), nitrous oxide (N<sub>2</sub>O), sulphur hexafluoride (SF<sub>6</sub>), perfluorocarbons (PFCs), and hydrofluorocarbons (HFCs).

## 2.7 Offsets

The ABA supports acceptance of domestic offsets without limit, where activities are quantified. A reduction or removal of emissions from activities in one area of the economy can be used to offset emissions in other sectors of the economy. Reductions in sectors not initially covered by the scheme (agriculture, land use and forestry) could be eligible to create offset credits. Carbon sinks could also generate offset opportunities.

The ETS should be able to link to Kyoto market mechanisms. For example, consideration could be given to including a level of Certified Emission Reduction certificates (CERs) into the ETS to encourage least cost abatement, to provide access to additional liquidity, to provide opportunities to assist our Asia-Pacific neighbours, and to encourage building international linkages.

Transparent and consistent recognition of assets eligible for carbon compensation should be accompanied by the introduction of 'early action credits' and 'offset credits' for abatement efforts and activities that have actually occurred within a specific time period, are additional (i.e. beyond business as usual), and are permanent, measurable and verifiable. For example, consideration could be given to including bio diversity and energy efficiency credits as a way of generating offsets.

## 2.8 Permit allocation

The ABA supports an ETS that combines permit allocation types, including a proportion of free allocation and auctioning in the beginning years of the scheme.

Permit allocation has the potential to unduly influence the evolution of the carbon market. It is essential that permit allocation is transparent and efficient and results in minimal costs to abatement activities and distortions to the economy. Permit allocation should minimise the need for other structural adjustments to the ETS, such as price controls.

'Grandfathering' or free allocation of permits or credits; where participants receive an initial allocation of permits or credits based on their historical emissions profile; should be only for a discrete, transitional period to assist industry sectors vulnerable to negative impacts on international competitiveness. Free allocations should not continue in perpetuity, as this would generate an artificial carbon price, transfer carbon assets to major carbon emitters and have adverse impacts on the economy. Permit allocation should not inadvertently create artificial constraints on the ETS.

'Auctioning' should be the primary source of allocation as it provides a level playing field, especially for new businesses or entrants, and allows the market to determine the carbon price with minimal external or artificial influence. Over time, auctioning should be the only source of allocation. Permits should be released according to the emissions limit and trajectories.

Auctioning should take place via issuance of small parcels of permits at regular intervals, say monthly or quarterly (or at intervals identified as suitable to market participants). Auctioning should take place via mechanisms already known to market participants, for example, a tender process similar to that used for Commonwealth Government Securities (CGSs). The ABA looks forward to receiving further information about auctioning and associated issues, such as compliance costs and price shocks.

Permit allocation should commence as soon as possible after the initial ETS is designed, and in advance of the full ETS being operational, where practicable.

Permit allocation should encourage the market forces of supply and demand, where permits are limited, the value of permits is enhanced, and companies are provided with an incentive to cut down on their need for permits with the excess available to 'trade'.

Permit allocation should be equitable and linked to the economic activity of the carbon emitter. Permit allocation should not discriminate between sectors or new entrants or undermine the incentive to reduce GHG emissions. Compensation for trade-exposed energy intensive industries (TEEIIIs) will allow companies that are disproportionately impacted to adjust to the ETS. It will also assist in balancing environmental gains with potential detrimental economic impacts.

Uniformity of permits will be essential to ensure that carbon credits can be compared like-with-like and 'banked'.

Permit allocation should focus on meeting the objective of the emissions limit, and not be viewed as a source of government revenue. Over allocation of permits will discredit the ETS, create investor uncertainty and render the ETS ineffective in achieving its objective.

A single, national registry must be established to manage the administration of the permits or credits. Tracking of permits or credits should take place from creation to retirement. Permits or credits should be managed like other tradeable instruments or commodities, recognising third parties' rights and interests.

## **2.9 International linkages**

The ABA believes the ETS should be developed so that it has opportunities to link to global emissions markets. This will deepen the market and address concerns with liquidity. However, interoperability must be balanced with encouraging the evolution of an Australian market of sufficient scale.

The global nature of finance markets and the multinational operations of businesses require seamless transition between jurisdictions. Companies, investors, intermediaries and participants need to be confident that the permits and credits they trade now and in the future in the ETS have the broader potential to be tradeable across marketplaces. Therefore, in line with financial markets, the ETS needs to be consistent and compatible with other schemes in operation internationally.

While in the long-term international linkages are desirable, it will take some time to facilitate the integration of global emissions markets. Importantly, integration should be undertaken in a manner that does not undermine the credibility of the ETS. In the short-term, actions should be taken to position the ETS with comparable overseas schemes. In the long-term, given our close economic relations with New Zealand, linkages between the Australian ETS and the New Zealand ETS could be explored (recognising that our different emissions profiles will present a challenge).

The ABA supports fungibility of the permits or credits so that the ETS may be linked and integrated with other schemes to form a truly global carbon market. It is in Australia's interests that carbon permits and credits can be eventually recognised internationally. Fungibility will ensure that permits or credits can be traded, but will require consistent carbon accounting standards and rules, especially measures for unitary value and creation/retirement of permits or credits.

## **2.10 Price controls**

The ABA does not support price controls. Intervention by setting price 'ceilings' and 'floors' will be arbitrary and at odds with enabling the market forces of supply and demand to establish a carbon price. Price ceilings and floors will undermine the functioning of the market and are a disincentive for the development of a secondary market. Price shocks or price volatility can be managed through auctioning of permits (release and timing) as well as purchasing of CERs or other recognised offsets.

## 2.11 Inter-temporality – banking and borrowing

The ABA believes 'banking' of unused permits and 'synthetic borrowing' should be allowed, but 'borrowing' from the future to cover current emissions should not be allowed (other than a small shortfall buffer, say 5-10% of liability, that can be carried forward to the following compliance period). Inter-temporal flexibility is an incentive for participants to reduce emissions below the emissions limit and trajectories.

'Banking' of permits 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.

However, 'borrowing' brings with it risks to meeting the objective of the emissions limit. The concern is that it may provide an incentive to borrow from the future to cover current emissions in the hope that any serious shortfall between available permits and underlying emissions will be offset by intervention. Such behavior would weaken the credibility of the ETS and could also potentially undermine the integrity of the ETS by removing scarcity and weakening the price signal.

## 2.12 Treatment of TEEIs

The ABA believes that compensation for existing companies and industrial sectors identified as likely to face threats to their competitiveness with the introduction the ETS and a carbon price, should be accommodated in the ETS. Transitional financial assistance (possibly through free allocation of permits or credits to TEEIs) should be provided to address distortions. Permits or credits allocated to TEEIs should be monitored by the independent authority/market regulator to ensure a fair and efficient market.

## 2.13 Governance

The ABA supports the Federal Government establishing the policy framework for the ETS, including the design of the ETS. Sound governance arrangements are necessary to ensure that permits are acquitted in line with the emissions limit and trajectories.

The Federal Government will have a number of roles to play within the ETS framework, including establishing the rules for the ETS, administering the ETS, issuing permits, certifying credits (offsets) and possibly purchasing permits and credits for national compliance purposes. A clear delineation between the responsibilities of the Government and the independent authority/market regulator will be required.

The ABA supports establishing a legal and regulatory framework accompanied by an independent authority/market regulator with a mandate to administer the legislation as well as monitor the operation of the market. An independent authority/market regulator will ensure that legal, regulatory and governance arrangements are maintained and monitored as well as review the effectiveness of the ETS in meeting its objective. It is essential that the authority/regulator be independent, adequately resourced and with appropriate expertise.

The ABA notes the discussion paper proposes the "Independent Carbon Bank" (ICB), which would have similar responsibility as the Reserve Bank of Australia (RBA), but in the context of the carbon market. The ABA agrees that the powers and responsibilities of the ICB would need to be established by legislation. The ABA looks forward to receiving further information about the proposed ICB and how its responsibilities will contribute to the efficiency and effectiveness of the ETS.

The ABA supports a governance framework that allows banks and financial institutions to operate the ETS, subject to trading and operating rules sufficient to support the emergence of an efficient market. Over-regulation of the ETS will stifle participants, unnecessarily increase transaction costs and lead to unintended consequences for the ETS and other domestic markets.

The ABA believes that the ETS framework should contain consultation mechanisms to ensure that the Government engages with the banking and finance sector prior to any review or revision of the policy, technical and administrative settings for the ETS.

The ABA supports the summary of governance roles and responsibilities contained in the submission made by the Australian Financial Markets Association (AFMA).

## **2.14 Compliance**

The ABA believes that penalties should be part of the compliance mechanism. Private sector participants that fail to surrender permits equal to their emissions during the compliance period should be subject to penalty. The penalty would not replace the obligation to acquit permits, but be imposed to cover the cost of making good the abatement as well as provide a disincentive for non-compliance.

## **2.15 Use of permit revenue**

The ABA believes that government revenue from auctioning of permits should be used to subsidise disadvantaged Australians (for example, provide assistance to households to counterbalance increases in energy prices), support developments and protections of public infrastructure, support payments to businesses to correct market failures in relation to new technologies and fund clean technology research and development. The ABA looks forward to receiving further information about how government revenue from auctioning of permits can assist structural adjustment and compensation strategies for businesses, individuals and communities.

## **2.16 Market failures**

The ABA believes that while the introduction of a carbon price is critical, it is unlikely to be sufficient to advance the development of, and investment in, low carbon technologies and clean development initiatives.

The ABA supports the Federal Government taking action to correct ongoing market failures associated with research and development and commercialisation of low and zero emissions technology, extended electricity transmission infrastructure, public transport efficiency and energy efficiency initiatives.

A comprehensive and multifaceted policy response will be critical to ensure that economic, environmental and social objectives are met. Effective policies in these areas can reduce the price of permits and the price of emissions-intensive products.

## **2.17 Other issues**

The ETS framework will need to be cognisant of other climate change policy responses and instruments. For example, the ETS should facilitate the rationalisation and smooth transition from various state-based schemes to the national scheme. The ETS should also ensure that NGRS information is supplied in a manner that does not generate an artificial carbon price, and thereby contributes to the emergence of an efficient market.

### **3. Conclusion**

The ABA believes that the banking and finance sector must be involved in the design of the ETS to ensure maximum market liquidity, viability and efficiency. The successful design and implementation of the ETS will enable low cost transactions, price discoverability, emergence of secondary, forward and derivative markets, investor confidence and low cost abatement.