

# **SUBMISSION TO THE GARNAUT CLIMATE CHANGE REVIEW ON THE DESIGN OF AN AUSTRALIAN EMISSIONS TRADING SCHEME**

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**Memorandum By:**

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**Submission to the Garnaut Climate Change Review on the design of an  
Australian Emissions Trading Scheme**

Sustainable Forestry Management Limited (“SFM”) was established in 1999 to demonstrate that reversals of tropical and subtropical forest degradation and mitigation of global warming can be accomplished by private sector investment meeting the highest commercial, environmental and social standards. The SFM Group has a rapidly growing global portfolio of carbon forest assets in Africa, the Americas, Asia and Australasia. SFM Australasia Pty Limited (“SFMA”) is an Australian company established in 2002 as a wholly owned subsidiary of SFM. SFMA, with offices in Perth, Melbourne and Sydney, now has investments in South Australia, Western Australia, Victoria and New Zealand. As a developer of projects that generate carbon credits and offsets, the SFM Group is concerned to ensure reliability and integrity in emissions trading and carbon markets.

This submission addresses the main items raised in the Emissions Trading Scheme Discussion Paper, with comments provided against items summarised in the Executive Summary.

Design Decision	Proposal
<p><b>Setting an emissions limit</b></p>	<p>Government should set the emissions limit for Australia. This emissions limit should be expressed as a trajectory of annual emissions targets over time, which define long term budgets.</p> <p><i>Trajectories</i></p> <p>Four trajectories should be specified upon establishment of the ETS. The first up to 2012 will be based on Australia’s Kyoto commitments. The other three for the post-2012 period reflect increasing levels of ambition. Movement between them should be based on determining the comparability of Australia’s response to international effort.</p> <p>The Review will provide advice to government on trajectories and interim targets for an Australian ETS. This will be informed by economic modeling currently underway and further analysis, and presented in the full reports.</p>
<p><b>SFM Comment</b></p>	<p>Agreed, no comment. Post 2012 trajectories should be for minimum 10 year and preferably longer periods as shorter periods discourage investment.</p>
<p><b>Changes to the emissions limit</b></p>	<p>Deciding to move from one trajectory to another should only be made on the basis of international policy developments and/or agreements (which should allow for new information and developments of an economic or scientific kind).</p> <p>Conditions which would lead to a movement from one trajectory to a more stringent trajectory would be specified in advance.</p> <p>Once on one trajectory, Government provides five years notice before movement to another. Any gap between the domestic trajectory and international commitments during this period would be reconciled by the independent authority purchasing international permits.</p>

<b>SFM Comment</b>	Agreed. One way in which emissions targets can be tightened to meet Australia's and the world's climate goals without increasing compliance costs is the inclusion of forestry and land-use credits, including Reduced Emissions from Deforestation and Degradation (REDD), in the international carbon markets. Inclusion of international forest and land use credits will allow Australia to move to a more stringent trajectory at comparatively low cost. Inclusion of Land Use, Land Use Change and Forestry (LULUCF) and REDD credits will provide an incentive for developing world countries to participate in the carbon markets in a meaningful way.
<b>Coverage</b>	<i>Gases:</i> Six greenhouse gases as defined by the Kyoto protocol. <i>Sectors:</i> Stationary energy, industrial processes, fugitives, transport and waste from scheme outset. Agriculture and forestry to be included as soon as practicable.
<b>SFM Comment</b>	SFM agrees with the initial coverage of the scheme and believes that agriculture and forestry should be included when practicable. Offsets generated from agriculture and forestry should, however, be tradable from the outset of the ETS.
<b>Domestic offsets</b>	Domestic offsets should be accepted without limits, but will have a small role, given broad coverage.
<b>SFM Comment</b>	SFM agrees that domestic offsets should be accepted without limits. Putting limits on domestic offsets will not only raise the cost of compliance to those firms in covered sectors, but will slow technological innovation. The economic opportunities afforded by offset potential are a key driver in the development of emission reduction technologies and strategies.
<b>Point of obligation</b>	Set at point of emissions where practical. Where transaction costs are lower than the cost of distortions that may arise, upstream or downstream may be appropriate.
<b>SFM comment</b>	No comment.
<b>Permit issuance (or release)</b>	Permits released according to emissions reduction trajectory. All permits auctioned at regular intervals. (Note, some permits may be used in lieu of cash in providing transitional assistance to traded-exposed, emissions intensive firms at risk.)
<b>SFM comment</b>	SFM agrees that auctioning should occur at regular intervals and should be based on the appropriate long-term emissions reduction trajectories. Regular auctioning will provide stability (and reduce volatility) to the market and provide important price information to all market participants. As a note, annual auctioning has been a feature of the successful US SO <sub>2</sub> market since its inception.
<b>International linkages</b>	Opportunities for international linkage of the Australian ETS should be sought in a judicious and calibrated manner.

<b>SFM Comment</b>	SFM encourages the Australian ETS to pursue international linkages with other ETSs and to allow for the use of international offsets. The use of international offsets will lower compliance costs for Australian firms covered by the ETS and for the Australian Government should it, in the future, take on more stringent emissions targets as is its intention. Australia's current engagement with PNG and Indonesia towards climate partnerships could enhance international linkages, particularly in the area of REDD, LULUCF and agriculture. Both PNG and Indonesia could profit (both environmentally and financially) from credits from these sectors while Australia will likewise benefit from lower compliance costs. Structured properly with best practice methodologies for measurement, monitoring and verification, Australia's use of such credits could allow it to migrate to a tighter emissions trajectory and provide incentives for other countries to adopt a similar approach.
<b>Price controls</b>	Not supported
<b>SFM Comment</b>	SFM agrees that there should be no price cap or floor as either would distort the market, sending false price signals, and lead to suboptimal economic decisions by those companies affected by the trading scheme.
<b>Inter-temporality</b>	Unlimited hoarding allowed. Official lending of permits by the independent authority to the private sector allowed, but may be subject to limits, in terms of quantity and time, determined by the independent authority.
<b>SFM Comment</b>	SFM agrees that permits can be held and "banked" into future commitment periods. This will provide both covered sector participants and other market players greater liquidity and therefore greater flexibility in achieving reductions at the lowest cost. SFM also endorses the concept of borrowing as long as the environmental integrity of the scheme is not undermined. Like banking, borrowing can increase market liquidity and will help develop important price signals on the forward price curve, thus assisting market participants and others in making economically efficient decisions for the deployment of capital.
<b>Treatment of TEEIs</b>	Some industries rely significantly on emissions-intensive production processes, and are substantially unable to pass costs of emissions through to customers because price of commodity or good is determined on international markets. Transitional financial assistance (possibly in the form of free permits) should be provided to account for distortions arising from major trading competitors not adopting emissions limits (or pricing).
<b>SFM Comment</b>	Agreed. SFM believes, however, that any transitional assistance should be scaled down to zero over a period of time (based on adoption of ETSs in other domestic or regional markets and provisions within schemes for financial assistance to affected industries.) Australia should not put itself at a competitive disadvantage vis a vis its major trading partners as this will harm its economy and promote carbon leakage to other areas.
<b>Governance</b>	Policy framework set directly by government.

	Scheme administered by independent authority.
<b>SFM Comment</b>	<p>SFM couldn't agree more strongly with this approach. Both the CDM and the EU ETS suffer from regulatory authority placed in institutional bodies unqualified to regulate what is essentially the combination of a commodity and financial product (the UNFCCC Secretariat through the CDM Executive Board in the CDM's case and DG Environment in the case of the EU ETS). The shortcomings of these inappropriate regulators are now becoming apparent – the length of time for project approval under the CDM is increasing, implying regulatory inefficiency and the European Commission's recent proposed legislation severely restricts incentives to invest in international projects. There is also an inherent conflict of interest in the policy-making body also acting as market regulator.</p> <p>The government's role should be to set the long-term climate goals, negotiate caps and targets and monitor performance. The independent authority should regulate the ETS and offset projects.</p>
<b>Compliance and penalty</b>	<p>Penalty to be set as a compliance mechanism. Penalty does not replace obligation to acquit permits; a 'make-good' provision would apply.</p> <p>Alternatively, the use of revenue from a financial penalty could be used to purchase abatement.</p>
<b>SFM Comment</b>	<p>It may be instructive to structure the penalty provisions similar to that in the US SO<sub>2</sub> market. In the SO<sub>2</sub> market, the financial penalty (\$2,000) was initially set at a price far above where allowances initially traded (the EU has adopted a similar approach in Phase 2 of the EU ETS). The penalty per tonne then increases with the CPI (in 2006 the penalty was \$3,152). For those installations which do not comply, the financial penalty is levied and any free allowances due to the installation in the next year are forfeited. Criminal penalties are also possible for non-compliance. The SO<sub>2</sub> market has had extraordinarily high compliance throughout its history (2006 compliance was 100%).</p>
<b>Use of permit revenue</b>	<p>Auctioning of all permits will be the source of a substantial amount of government revenue. Governments will need to assess competing priorities for this revenue, which may include:</p> <ul style="list-style-type: none"> <li>▪ Payments to TEEIs (to correct for market failures);</li> <li>▪ Payments to households;</li> <li>▪ Structural adjustment to support declining communities;</li> <li>▪ Payments to firms to correct market failures in relation to new technologies;</li> <li>▪ Support for public infrastructure; and</li> <li>▪ Cash reserves to purchase international permits/offsets to reconcile domestic emissions with international commitments.</li> </ul> <p>The political acceptability of the introduction of the ETS would be enhanced by government commitment to transparently return to the community through the</p>

	mechanisms outlined above or in other ways, all of the revenue generated by the sale of permits.
<b>SFM Comment</b>	One area that should be considered as a destination of auctioning revenue is the funding of capacity building including, administration, measurement and monitoring capabilities of carbon stocks and deforestation rates in less developed countries. Given the importance of land use changes to global greenhouse gas emissions, infrastructure and the related capacity building must be developed in order to drive investment into those countries. Funding this capacity would provide the basis for increased private sector flows into these countries by improving governance, transparency and investment certainty.