

SUBMISSION TO THE GARNAUT CLIMATE CHANGE REVIEW

RESPONSE TO EMISSIONS TRADING SCHEME DISCUSSION PAPER

A personal submission from Mr Jeremy Burke (London, United Kingdom)

Introduction

With the release by the Garnaut Climate Change Review ('The Review') of the Emissions Trading Scheme ('ETS') Discussion Paper ('The Paper') and the Interim Report it is clear that the Review is aware of the major issues that the forthcoming implementation of an ETS will have on Australia, our communities, businesses and international relationships.

In light of the Paper and the Interim Reports coverage of the major issues I have concentrated my submission on areas that I believe could cause distortion in the ETS design and implementation, which may result in inequitable outcomes that are in conflict with the over-riding goal of reducing harmful emissions.

It is with this over-riding goal in mind that I call on the Garnaut Review to support the following key points in its final report:

- Australia must reduce its emissions level, both on a gross emissions and net emissions basis. We should not introduce a system that allows anything less than meaningful emission reductions;
- Australia can lead the world in the areas of meaningful emission reduction as well as Emissions Trading Scheme ('ETS') design. We do not have to wait for world opinion and consensus;
- The ETS be as free from distortion as possible (free from compensation to incumbents, free from debatable offsets, free from the capability to 'create' net emission reductions through paying for offsets);
- That Land Use, Land Use Change and Forestry be recognised as a source of emissions, but that Australia's history of hiding behind dubious emission reduction accounting is over; and
- That inter-temporality be limited to hoarding (or banking) so that appropriate recognition is given to the requirement to cut, and limit, emissions immediately.

Australia's Emissions Target

In your interim report you note that "The direct effects of Australia's emissions reduction efforts are of secondary importance" and in the Paper that 'It is not in Australia's interest to act in isolation'. However, I do not believe this adequately nor appropriately reflects Australia's position in relation to either the impacts or causes of climate change. Being in a position where the effects of climate change will disproportionately affect Australia, relative to our global emission output, means that Australia has a vested interest in climate change mitigation. Acting in a degree of isolation and becoming a leader in climate change mitigation is without question within Australia's best interest. Rather than just setting a goal that gives 'reassurance and encouragement to others' let's aim to lead the international community, both in ETS design as well as emissions reduction targets.

Consequently I see the capacity for Australia to 'punch above its weight' in regional, emissions reduction, and world wide capacities, as being one of the only reasons for the climate change debate occurring at all. If we don't accept that utilising this capacity to have a significant and immediate impact is paramount to our livelihoods, and that of our close regional neighbours, then with our emissions profile we have no reason to

enter the debate. The opportunity to lead the world, and our region, is presently available and the Review and Australian Governments should openly acknowledge this and devise an ETS and emissions reduction goals that are appropriately world leading and best of breed.

These aims may include setting an emissions reduction goal that is more ambitious than presently mooted world emission targets. The advantages of which would be significant in terms of leading public debate, and providing business and the community with a genuine indication of the shape of Australia's future. This in turn will lead to technological development and support that could position Australia as a world leader in emissions reduction technology.

Permit Allocation

The Report asserts that the manner of allocation will not 'affect the operations of the scheme –the price of permits or the costs of adjustment to the ETS'. While in theory this should be the case related design issues could lead to permit issuance affecting the operations of the scheme, both from a pricing and cost perspective. Specifically the issue of permits to Trade-exposed, emissions intensive ('TEEI') firms could affect the auction price of permits. If a firm is aware they will receive an allocation of permits in lieu of cash assistance they are incentivised to decrease their permit auction participation. This decreased demand would therefore decrease the auction price, and depending on the allocation methodology to the TEEI firm could result in an increased permit allocation and an unintended transfer of wealth.

With this risk in mind I believe that TEEI firms should participate fully in the auction and market process, and that any compensation be handled outside of the ETS, limiting any potential distortion. TEEI firms should be accountable for their emissions and only through full participation will they be cognisant of the costs that emissions have on their operations. Full participation will also increase the level of price-discovery that the auction process has, and depending on the auction system utilised maximise the auction revenue that accrues to the Government.

Land Use, Land Use Change and Forestry ('LULUCF')

The issues that LULUCF activities generate are amongst the most contentious surrounding climate change, and ETS design. Given that the Paper comments that offsets can lead to a 'potential watering down of overall effort' it is surprising to see such a relaxed view towards LULUCF activities. The ability for LULUCF to generate offsets correlates to 'picking winners' by inherently selecting LULUCF as a preferred source of emissions reductions, which is against the underlying premise that the ETS will allow the market to determine the best way to reduce emissions. The potential offsets from LULUCF would distort the market by valuing activities that do not decrease gross emissions.

As I noted in my submission to Issues Paper 2 I believe that the issue of forestation is best managed in a non-ETS environment. An extension of this could result in a separate market for offsets, rather than directly mitigating emission requirements. Given the level of uncertainty around the derivation of emission reductions from LULUCF activities this would enable emitters to better account for and value their outstanding emission obligations and potential emission reduction credits (from the derivation of offsets under LULUCF efforts). This would have the added benefit of aligning the Australian ETS with the EU and New Zealand ETS on LULUCF offsets and explicitly place a different value on an emission and an offset credit which would emphasise that the aim of the ETS is to cap the levels of gross emissions.

It also seems somewhat incongruent that a market participant would be rewarded for not doing something, which in the case of a forestry holder is the case where forestry is not logged or land use not changed. Should the ETS not be established to ensure that all participants are equally treated, such that detrimental LULUCF activities that generate carbon emissions (through say the release of sequestered carbon in forestry) require the

acquisition of appropriate permits? Thus the financial incentives of competing LULUCF activities will be on equal footing with other market participants. If government or the community determine further action is required this can be completed outside the framework of the ETS, providing less distortion to the market and a more encompassing (and consequently meaningful) carbon price.

It should also be emphasised that the importance of LULUCF is not decreased by the EU not allowing land-use-related emission units into trading. Similarly it should not be taken as given that just because Australia has previously had a large portion of its emissions from LULUCF that we should automatically insist on their recognition in an ETS. The fact that Australia may or may not reach its Kyoto commitment, despite a significant decrease in LULUCF emissions, shows how a poorly performing countries effort in emissions reduction can be accounted for in an almost deceptive manner. We should commit to emission reductions as well as sink and reservoir creation, and not settle for an offsetting mentality that will not solve the problem at hand.

Essentially I believe the ETS should concentrate on the level of emissions, and the activities that result in emissions, with other mechanisms being used to manage the overall Greenhouse Gas levels in the atmosphere. The linkage between the two being the level of emissions allowed within the construct of the ETS.

Lending

I am concerned that the Review is minded to firstly allow lending, and secondly to recommend the establishment of a regulatory body to oversee the lending operations. The arbitrary nature of certain decisions that any lending authority will need to make will in fact add to the complexity of the lending market. For example, the Paper indicates that the authority would place restrictions on the amount of lending if stability was an issue. This may create the perverse incentive to utilise any lending opportunities (if available on a first severed basis) when available to ensure a firm has this capability if lending is subsequently constrained. The effect of which will distort both the physical and lending markets.

In turn the Paper indicates that 'highly rated financial institutions' will be the focus of any lending from an Independent Carbon Bank ('ICB'). However, the recent credit issues that have impacted the international financial community should make any lending authority wary of the counter-party risk that will exist even with large financial institutions. The very fact that credit-worthiness needs to be considered by the ICB implies that the potential for default on lent permits exists, which I believe is too big a risk for the market to bear, and one that individual firms should themselves consider without an official body being a party to the arrangement.

Adjustment of the lending rate by the lending authority will result in a market function that undermines the independence of the market. If deemed desirable to allow lending the market may be better served through private sector lending being allowed, thus allowing the authorities to concentrate on regulating the market and allowing banks and other financial intermediaries to resolve credit-worthiness and information asymmetry issues associated with permit lending. Appropriate governance could then be at both the market and individual firm level, where restrictions on the total level of market and firm level lending could be implemented and enforced.

In practical terms it is likely that the development of derivative markets operating in conjunction with the ETS will enable the synthetic replication of a lending arrangement (with market determined funding costs) and consequently enable this market attribute to be available without the official involvement of the ICB.

The argument that fluctuations in annual supply and demand forcing large short-term structural change should allow flexibility, and in particular lending is debatable. The issue is that a firm will not have to purchase emission permits in the open market, which in turn will decrease the market price (and price-discovery capability of the market) and provide a reduced incentive for other firms to partake in emission reducing

behaviour immediately. Essentially the borrowing firm will be using what belongs to tomorrow earlier than they should.

Any lending that is conducted with the ICB will be costly to monitor, which will increase transaction costs associated with the ETS, thereby undermining its cost-effectiveness aim. If it is concluded that a regulatory body should oversee lending then these costs should be explicitly borne by the borrowing entity, and not by the market as a whole.

Lending vs Borrowing – Lending appears the worst of two evils, whereby not only will the proposed lending allow parties to utilise future entitlements, but they will essentially be ‘un-covered’ positions. At least borrowing ensures parties hold future permits, and only a timing risk eventuates. Instead the proposed lending capabilities will allow parties to emit now what they are not entitled to. This decreases the markets ability to disclose an accurate value of the price of emissions by allowing deferral of the financial liability associated with the emission. This will allow market participants to take tomorrow’s emission allowances and use them today. Surely the time has come to force emitters to recognise that emission issues can not be deferred any longer!

My recommendation below regarding date stamped permits would enable Borrowing to be implemented with appropriate forward cover through a requirement to hold future stamped permits to emit in an earlier period.

Date Stamped Permits

I am of the belief that the supply of date stamped permits, which have an explicit expiration date, would contribute meaningfully to the ETS design and should be further considered by the Review. They would enable forward markets to appropriately reference a fixed duration product and therefore create definitive price discovery around the value of a permit expiring in a certain period. As well they would ensure a minimum emission decline in a period, which in turn adds to the credibility of the ETS in achieving its stated environmental objective.

While I acknowledge that date stamped permits create banking/borrowing questions that the Paper has not considered, these issues would be manageable in the context of the design envisaged by the Paper and any issues are offset by the positive environmental effect that the rigidity of the date stamping creates. Date stamped permits will also provide a degree of certainty around the post 2012 period by signalling to market participants the level of emissions reduction that are set in stone at the commencement of the ETS.

Compensation

While not dealing directly with the potential compensation options being demanded by interest groups the Paper notes that ‘the associated loss in profit has led some to argue for compensation from government’ and that an ETS needs to be ‘robust in the face of pressures from vested interests’. It is imperative that the Review explicitly discuss the potential political minefield that the ETS determination process will create. Already industry groups are positioning and posturing for compensation, yet the simple reality is that no person, group or business is entitled to absolute certainty in any of its activities. While there may be businesses that lose shareholder value as a result of the introduction of an ETS this risk has been well flagged, and if they have not already asked the question then shareholders should be pressuring the management of these groups to explain how they will respond to the challenge of climate change (of which an ETS is but a mechanism for allocating a scarce resource).

In respect of property rights associated with permits industry will, and has, argued for full property rights (and resultant compensation if confiscated). However, the reality is no one can have the ‘right’ to pollute. It is the community’s decision, via its government, to determine the framework for emissions and no permit holder

should have an absolute guarantee that property rights would convey, there may be a situation where a scale back of emissions necessitates government interjection and this should not be prevented in the ETS design.

Carbon Capture and Storage

Overall the Paper has noted the key issues being faced by the Government in respect of the recycling of the auction revenues. The one point I wish to make is the perceived bias towards Carbon Capture and Storage ('CCS') that the Report has (in comparison no direct call for 'substantial commitments' to renewable energy R&D is present). While CCS may ultimately have a significant impact on the ability for Australia, and the World, to decrease carbon emissions it remains an unproven technology. For the Government to pander to the commercial needs of one industry (coal utilising energy producers) would be tantamount to picking winners and would not enable the ETS to be technology neutral. Investment in CCS can be completed by the incumbent energy industry (and any other entrepreneurial groups) in the same way that renewable producers have been investing for years – at their own risk. The fact that we currently generate the majority of our energy from coal does not mean that we must in the future, yet without a level playing field for all participants we will simply maintain the status quo of being a high emission country.

In conclusion I would like to thank the Review for the opportunity to contribute to the current debate on climate change, and the introduction of an Emissions Trading Scheme. The task of the Review is demanding and I hope that the opportunities presented to it are not wasted. Australia has for too long been comfortable to hide behind empty rhetoric and to delay playing any meaningful part in the climate change debate. Now is the opportunity to right the wrongs of the past.

Should you require further elaboration on any of the above please feel free to contact me.

Yours faithfully

Jeremy Burke