

Comments on the Proposal to Allow Lending

Bravo! The design proposed for an Australian ETS in the *Emissions Trading Scheme Discussion Paper* is excellent. You may, however, wish to reconsider the proposal to allow lending (borrowing).

Lending is intended to assist a participant that has a permit shortfall during the current period, but expects a surplus in future periods. This function, to the extent that it is needed, is better performed by the market than the independent authority.

- First, a current shortage and future surplus is more likely to occur if permits are distributed free. If all (or even most) permits are auctioned as proposed such a situation is unlikely because all of the permits for future periods would not have been auctioned in the current period. If it does arise, the firm has simply made some poor purchase decisions. Should there be rules to protect participants from making poor decisions?
- Second, lending can be handled efficiently by the market. The participant can sell the surplus future period permits through a forward contract and apply the proceeds to the purchase of current period permits. The risks of non-compliance are borne by the parties to the forward contract. The proposed design has the effect of making the independent authority the counterparty to the forward contract with the borrower – it assesses the creditworthiness of the creditor, decides on the quantum of permits that can be borrowed and sets the interest rate – making it responsible in the event of default.
- Third, being both a lender and a regulator creates a conflict of interest for the independent authority. Its role is to regulate the trading scheme, including compliance enforcement. If a participant is likely to be out of compliance for the current period, does the independent authority enforce the non-compliance penalty or lend the participant enough permits to achieve compliance?
- Fourth, lending distorts the market price. The current period price is distorted because it is not known whether participants will borrow (lowering the price) or repay permits (raising the price). The forward price curve is distorted because the interest rate for borrowed permits caps (or distorts, if there is a limit on borrowing) the forward price curve based on expected marginal abatement costs. This leads to inefficient behaviour.
- Fifth, as noted in the discussion paper, lending could inhibit links with other trading schemes, which is an important long-term objective. Lending would not prevent unilateral links, but it could preclude bilateral links. Borrowing is not part of any existing or proposed scheme except GGAS and a few American proposals.
- Sixth, lending conflicts with some of the criteria established for the design of the scheme. Scarcity during each period is no longer aligned with the emissions target for the period. Unnecessary complexity is added; rules for lending need to be developed when the market could perform this function better than the independent authority. And integration with other emissions trading schemes is potentially jeopardized. All of the arguments presented in the discussion paper against price floors and ceilings apply equally to lending.

Lending could also be used in unintended ways. It is a way to defer non-compliance penalties. If due to poor planning or other reasons a participant does not have sufficient permits to achieve compliance, the necessary permits are borrowed (as long as the interest rate for borrowed permits is lower than the financial component of the non-compliance penalty). Thus lending can be used to defer non-compliance penalties. Lending can also be used for permit price speculation. A participant that expects the price to fall can “short” permits and borrow permits for compliance if the price does not fall as expected. The market offers appropriate contracts for price speculation. The trading scheme rules should not be used for this purpose.

The main reason to allow lending is the risk that quantity of available permits will not be sufficient to enable participants to comply, especially during the early years of the scheme. This risk can be addressed in several ways. First, recognize that it is only a small risk. A declining cap encourages hoarding as noted in the discussion paper. And the experience of virtually every trading scheme is that a permit surplus is accumulated during the initial years. Indeed, the more common problem is to prevent the surplus from becoming so large that it diminishes the incentive for continued emission reductions. Second, domestic offsets and a unilateral link with the Clean Development Mechanism (even with a cap of about 10% of actual emissions) would ensure a sufficient supply of permits. Finally, sale of the permits for the first five years could be “front loaded”, for example sell 106% of the total in year 1, 100% in year 2, and 98% in years 3 through 5. If the extra permits are not needed in the first year, they can be hoarded for later use. If they are needed, the quantity used and price for the first year will provide the signal needed to implement further reductions to facilitate compliance later in the period.

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