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Consultation Support Team
Department of Climate Change and Energy Efficiency
GPO Box 854
Canberra ACT 2601

By email: carbonpricesubmissions@climatechange.gov.au

Dear Mr Comley

Carbon Pricing Mechanism Architecture and Implementation

The Australian Financial Markets Association (AFMA) welcomes the opportunity to make this submission to the Department of Climate Change and Energy Efficiency in relation to the proposed carbon pricing mechanism architecture and implementation arrangements.

AFMA has played a leading role in the development of spot and forward trading in Renewable Energy Certificates, NSW Greenhouse Abatement Certificates and other environmental product markets in Australia. As the national association for participants in the wholesale financial markets, we have established trading protocols and developed standard contract documentation, as well as providing data services, dealer accreditation, training and other services to facilitate the efficient operation and development of the markets.

AFMA's work on carbon trading involves work in policy development with the aim of ensuring that the emerging market will operate in an efficient and effective manner and in technical implementation measures including designing standardised documentation such as the Carbon Addendum to the ISDA Master Agreement, market revaluation data and trading protocols.

During the policy development of the Carbon Pollution Reduction Scheme AFMA made substantial submissions on a wide range of issues. This work informs AFMA's response to the Government's current proposals for a carbon pricing mechanism.

AFMA believes that a market based approach, which places a price on greenhouse emissions, is the most effective and economically efficient mechanism to lower our

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carbon intensity. Our view is consistent with the findings of a range of government reports in recent years. As such, the successful design of a market for trading carbon units (the Market) is critical to the success of the Government's carbon policy objectives including the minimum 5% reduction in emissions by 2020 and ultimately to the end environmental outcomes.

It is essential that the Market that emerges is recognised as having integrity. There must be an overarching confidence by participants and the public that the activity and the outcomes of that activity, within the transactional space, are exclusively aligned with the objective to deliver a credible and deal-able price signal in its transaction space with low transaction costs.

AFMA has developed principles to guide market development to achieve this outcome:

- a) The Market should have scale and scarcity;
sufficiently large and priced to attract risk capital, which is critical for liquidity.
- b) The Market should have many willing buyers and sellers;
so as to form prices efficiently; buyers and sellers can include liable emitters, traders, investors and offshore entities.
- c) The Market should facilitate competition in the provision of market services;
so as to increase trading opportunities, reduce transaction costs and promote innovation.
- d) The Market should not have asymmetric information or concentration of buy-side or sell-side demand;
so as to form prices efficiently.
- e) The Market should deliver credible price signals;
credible meaning that prices realistically reflect fundamental supply and demand for units and are not, by design features, forced artificially high or low; and that arbitrage forces are free to operate to reduce price extremes.
- f) The Market should deliver deal-able price signals;
deal-able meaning that prices reflect the level of liquidity over a term structure that meets the needs of end-buyers and sellers and that rules and regulations are clearly interpretable to allow market standardisation of terms and conditions.
- g) Market forward prices should be more meaningful than the spot price;
forward prices provide the focal investment signals; neither contangos nor backwardations are inherently objectionable but extreme or persistent occurrences risk forward price credibility. Scheme design should not contribute to persistent extreme contangos or backwardations.

- h) The Market should be able to create a wide variety of tradable products and instruments to satisfy the risk taking and risk management demands of participants and serve as building blocks in the design of products to meet the multifaceted needs of business and investors;
needs will emerge in a variety of risk products.
- i) The market governance process should support market integrity;
so as to support participant confidence in effective oversight by an autonomous authority to ensure an efficient, fair and orderly market.
- j) The Market, through market operators and the National Greenhouse and Energy Reporting System (NGERS), should provide information to facilitate research and market analysis;
so as to support effective trading decisions (eg market technical analysis), including about investments in projects and companies subject to a carbon constraint.
- k) The Market's design should be as simple as possible;
straightforward, transparent rules improve market access for potential participants and make market regulation easier.
- l) The Market should be designed such that its ancillary service providers in legal, funds management, risk consulting etc can readily develop export services via regional pre-eminence. This would be consistent with government-expressed desire to foster Australia as a regional financial services hub for carbon;

The overarching concern of business in relation to building a successful carbon market is certainty. This is required to provide the investment environment which will allow Australia to move to a less carbon intensive economy in an efficient manner. Conversely, a lack of certainty or confidence in the Market will ultimately mean Australia's emission policy objectives may not be met in full, and progress towards them will be more expensive.

Initial information from the Government on the design principles for the framework highlight a number of areas where AFMA believes certainty and confidence need to be enhanced in the detailed design process.

1. The Current Framework Proposal

The details released by the Multi-party Climate Change Committee on the framework of the scheme design are limited but from the information available so far we understand the following details:

- The scheme is proposed to start subject to legislative progress "as early as" 1 July 2012;

- The scheme will start with a fixed price for at least three to five years with the price increasing annually at a pre-determined rate;
- Transition from the fixed price to a market price determined by a cap and trade scheme is not certain and could be deferred;
- The scheme would cover all six greenhouse gases under the Kyoto Protocol and would cover emissions sources including:
 - Stationary energy sector;
 - Transport sector;
 - Industrial processes;
 - Fugitive emissions (excluding decommissioned mines); and
 - Emissions from non-legacy waste;
- Agriculture will be excluded but the Government is still evaluating the possible eligibility of Carbon Farming Initiative offsets (ACCU) for use in the scheme;
- International emissions units would not be usable during the fixed price period; and
- Assistance is to be determined for industry and households.

AFMA looks forward to engaging with further details of the proposed framework as they become available, but in the interim would like to recommend some initial proposals for key elements of the framework design.

1.1. Fixed Price Period and Transition Arrangements

AFMA's principle and over-riding preference is for there to be no fixed price period at the beginning of the emissions trading scheme. AFMA, however, recognises that this fixed price phase is part of the Government's Carbon Price Mechanism. If there is to be a fixed price period, then AFMA supports the following principles.

- *Duration:* The length of the fixed price period should be as short as possible. AFMA proposes that it be no longer than 12 months.

AFMA believes that scheme credibility is inversely related to the length of the fixed price period. A three to five year fixed price period means that the cap and trade market start-up will be delayed until at least July 2015, and possibly July 2017. The longer the period of a fixed price the more difficult the transition to a market price will become, and the longer forward market trading and therefore investment will likely be delayed.

With a three year fixed price period extending to mid 2015 it is quite possible that even a well functioning market could find it difficult to meet Australia's 2020 targets. A five year fixed price period would make meeting these targets even more difficult as the period available for market forces to arrive at the desired cap by 2020 would be even shorter and hence more volatile.

A fixed price removes key motivating factors for the development of price discovery and risk management capabilities, which are essential to an efficient

market. There is a subsequent danger of the fixed price concept becoming entrenched and the Government being subjected to pressure to retain a fixed low price regime or a further delay to market determined pricing.

- *Timing certainty:* It is critical that the timing and mechanics for the transition from the fixed price period is known, with certainty, *before* commencement of the scheme. The proposed option to delay the transition to a floating price means there is no certain date for the commencement of the cap and trade market. This option should be removed.

Certainty about the timing of the transition is required as to the length of any fixed period to enable a valid forward market to commence. It would be hard to overstate the contractual difficulties for two parties to undertake a forward transaction at an agreed price for a period which may or may not be within the floating price period. That is to say that there will be no forward price discovery or forward market of any significance.

Certainty about the timing of the transition is also required to promote timely investment in the infrastructure required to support the market. Effective financial markets depend on a range of core capabilities and competencies that promote efficient price discovery and, amongst other things, signal a price for carbon that can be factored into investment decisions involving expenditure and revenue streams over long periods.

The market development process involves the implementation of practical processes and infrastructure to bring together buyers and sellers in an efficient and orderly manner; research analysis and associated systems to estimate future prices and facilitate trading and investment decisions; and risk management products and markets to facilitate the transfer of risk and management of uncertainty. Uncertainty about the implementation schedule and transition fixed price arrangements will delay the building of trading skills and market depth, while the capital required to develop a market would be redirected to other activities. Again, forward trading that might occur would be made difficult by the fact that forward contracts would cut across both fixed and floating periods, but in the absence of the usual inter-temporal pricing relationships thus removing effective forward price signals.

- *Fixed Price:* The fixed price that is charged should be as close as possible to the estimated price that would be required to clear the market under normal market conditions. This is required for market credibility and efficiency, and to reduce the potential for any step change at the end of the fixed price period.
- *Cap-and-trade phase:* The transition from fixed to floating price itself risks market instability including a step change in permit price and must be carefully handled.

In support of this principle, the scheme design for the cap and trade phase needs to be fixed upfront. The rules about matters such as price caps, banking

and borrowing and governance need to be understood from the outset such that it is clear that the scheme will operate in a credible way towards achieving the Government's carbon target. An efficient forward market will form only if all parameters are clear and not subject to regulatory uncertainty.

- *Caps:* The scheme design and policy elements need to specify from the outset national trajectories, national scheme caps and gateways for a significant number of years which will provide reasonably high certainty to enable the development of a market.

In addition, the scheme design and policy elements need to accommodate the rolling forward of national trajectories, national scheme caps and gateways well in advance of their future year applicability with provision for a default scheme cap setting to provide a further level of certainty to the market.

- *Regulatory certainty:* As experience in Australia's existing markets for environmental products demonstrates, the effectiveness of an emissions trading scheme will be dependent on the existence of regulatory certainty - it is critical since the market is created by regulation. Regulatory certainty is in this instance dependent on the credibility of the ETS. If the scheme does not operate in a credible way towards achieving the Government's carbon target, this will create an expectation of change to scheme design (ie regulatory certainty will be compromised).

1.2. Fixed Price Implementation

AFMA would support a mechanism to introduce some limited market activity during the fixed price phase. It may for example be possible to have, in addition to an unlimited supply of permits at the Government-determined fixed price, an auction process for permits for the fixed price periods subject to the fixed price as a cap.

This would promote the development of the infrastructure to support secondary markets, provide a low risk test of the market infrastructure, enable development of the technical capacity of liable entities, and could lower the price of the scheme.

1.3. Carbon Farming Initiative and International Offsets

In relation to the Carbon Farming Initiative, AFMA would support the inclusion of Carbon Farming Initiative offset units that satisfy Kyoto criteria from the scheme commencement including during any fixed price introductory period. If the Government was concerned that the inclusion of these units could produce revenue uncertainty then their inclusion up to a capped level may be an appropriate measure. Their inclusion is critical to the success of the CFI sector and would accelerate development of this agricultural offset industry. The inclusion of CFI during any fixed price period could also lend weight to the positioning of the scheme as a nascent emissions trading scheme with a moving price component.

AFMA would also support the use of International Emissions Units from the

commencement of the scheme. To address concerns around relative abundance, quantitative import limits expressed on a per liable party basis and increasing each year could be appropriate. Following developments in the EU ETS, eligibility of International Units such as CERs on the basis of quality should mirror that of other major emissions trading schemes to remove risks of unwanted international transfers into Australia.

It is AFMA's view that while the Market could accommodate domestic or international offset units that are not Kyoto-compliant, as admission of such units could diminish international scheme linkage potential, the use of such units should be restricted to at most a small percentage of overall unit supply.

For regulatory certainty and forward pricing, arrangements for future inclusion of International Emission Units and Carbon Farming Initiative offsets should be announced before scheme commencement.

2. Desirable Scheme Design Elements

Beyond these comments on the current proposed framework AFMA has identified a number of desirable elements to include in any scheme design.

2.1. GST Treatment

Imposing the GST on carbon permits, as was proposed with the CPRS would conflict with the objective of developing a vibrant market to assist price discovery and improve investment certainty, increase compliance costs for market participants and make it more difficult for Australia to develop as a carbon trading hub.

It is also inconsistent with 'normal' GST approach to financial products (if that is how carbon permits are to be categorised), which are generally treated as exempt as these industries are input taxed. Having regard also to the matters outlined below, we believe that if the Government really wants to avoid imposing unnecessary costs on business, then carbon permits should be treated as GST free. Carbon derivatives would be input taxed in the normal course of business.

- As intermediaries prepare to facilitate carbon trading, it is apparent that the implementation of trading systems to facilitate trading in carbon permits will be more costly because existing systems are designed for financial products, like securities and derivatives, which are exempt from GST. For example, these systems do not have the capability to create tax invoices or to readily identify the GST status of counterparties (which will be a complex task under the proposed GST treatment anyway). This will increase transaction costs and potentially reduce liquidity.
- New Zealand applies a zero rating to ensure the GST has a neutral impact and does not hinder trade in emissions units across international borders. Australia's proposal to impose a tax on carbon permits will present a barrier to harmonisation, or at least create a bias for transactions in the harmonised market to be conducted in New Zealand.

- In 2009, France decided to exempt relevant transactions for VAT purposes, treating them as transactions involving financial products and the U.K. decided to zero-rate these transactions, meaning that the transactions fall within the scope of VAT but VAT is charged at 0%. The purpose of these changes is to prevent tax fraud whereby entities charge and collect VAT with no intention of remitting it to the revenue authorities. The combination of a strong secondary cross-border market in emissions allowances and the fact that emissions allowance are only surrendered once a year has created this risk to tax revenue. Given the expectation of a vibrant and open secondary market for permits, this development is highly relevant to Australia.

2.2. Stamp Duty

In order to ensure predictability of transaction expenses and reduce regulatory uncertainty it is desirable that permits are created in such a way that they are assured that state-based stamp duties will not apply or be capable of being levied at a future date.

2.3. Nature of Permits

In addition to the legal structural elements of the AEU's included in the original CPRS Bill, now that the Personal Property Securities Act has been passed, clarification that the units are personal property and investment instruments for its purposes would be important to facilitate financial market transactions.

AFMA considers that permits should be issued as a property right that once issued, whether as spot or forward, may not be cancelled. The units should be issued as Australian units which could then be exchangeable international units for sale offshore. Units should be vintage-stamped to enable firm issuance of forward-dated units and be bankable.

2.4. Security of Title

AFMA would support appropriate mechanisms within the scheme to promote security of title over tradeable permits. Security of title is a necessary precondition for confidence in a market. It is also a necessary pre-condition for an efficient financial market that the registry be indefeasible. The significance of this has been heightened by the recent theft of EUAs from a registry in Europe which essentially resulted in the effective closure of the market. Market activity became severely restricted due to the fear of purchasing units which could ultimately be found to be stolen.

3. Conclusion

AFMA views the Government's proposal of a cap and trade market for carbon that builds on the work done for CPRS as a positive development. We do, however, have a concern that any fixed price period should be as short as possible. In addition, if a viable trading market that in AFMA's view will be necessary to effectively meet the

Government's carbon objectives is to develop, there needs to be certainty of transition from the fixed price phase to the cap and trade phase.

It is AFMA's intention to continue to work with the Government to ensure that a successful market is developed for carbon. Thank you for considering our comments on the carbon pricing mechanism architecture and implementation details. Should you require further clarification please contact me on (02) 9776 7993 or at djeffree@afma.com.au.

Yours sincerely

A handwritten signature in black ink, appearing to read 'D. Jeffree', with a stylized flourish at the end.

Damian Jeffree
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