22 August 2011

Tas Sakellaris
Assistant Secretary at Climate Change
Department of Climate Change and Energy Efficiency
GPO Box 854
CANBERRA ACT 2601

By email: cleanenergybills@climatechange.gov.au

Dear Mr Sakellaris

Carbon Pricing Mechanism

The Australian Financial Markets Association (AFMA) welcomes the opportunity to make this submission to the Department of Climate Change and Energy Efficiency (DCCEE) in relation to the Clean Energy Legislative Package.

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, and provide data services, dealer accreditation, training and other services to facilitate the efficient operation and development of financial markets.

AFMA's involvement in the carbon field 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 a Carbon Addendum to the ISDA Master Agreement, market revaluation data and trading protocols.

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 carbon market will ultimately mean

Australian Financial Markets Association
ABN 69 793 968 987
Level 3, Plaza Building, 95 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7955 Fax: +61 2 9776 4488
Email: info@afma.com.au Web: www.afma.com.au

Australia's emission policy objectives may not be met in full, and progress towards them will be more expensive.

Through its Carbon Markets Committee, AFMA has reviewed the Government's Clean Energy Legislative Package. Given the large volume of legislative materials and the tight time frame for review and submissions, this submission should be viewed as part of an ongoing dialogue as we increase our understanding of the scheme.

There are many elements of the scheme design in the floating period that AFMA believes will go a long way to achieving the Government's goal of a successful carbon market. The scheme design in the floating period is for the most part in accord with the AFMA *Principles for Carbon Markets* (attached).

This submission presents a number of key areas of concern where AFMA is keen to continue working with the Government to find practical solutions. It should be read in the context of our previous submissions to the DCCEE and our direct discussions with the Department and Treasury. We have taken the approach of focusing on areas where we understand there remains scope for change rather than considering all aspects of the package against an ideal outcome.

AFMA has been an active participant in the Government's consultation process, and we appreciate the DCCEE and Treasury's recent meeting with us and our involvement in the Peak Stakeholders Liaison Group.

AFMA also appreciates the positive changes that have come about through the consultation process so far, with particular reference to:

- A fixed transition date;
- The GST free treatment of eligible emissions units;
- The setting of rolling 5 year out caps with a default methodology;
- The auctioning of permits during the fixed-price period; and
- International linking via eligible units.

These changes simplify the implementation of the scheme, reduce transaction costs, lower the total costs of the scheme, and will facilitate the development of a forward market which will provide meaningful price signals for investment decisions in lower carbon projects and technologies.

Nonetheless, AFMA considers there are a number of areas where adjustments to the scheme would better promote efficient development of a carbon market.

It is AFMA's intention to continue to work with the Government to ensure that a successful carbon market is developed supporting the transition to a clean energy future. Thank you for considering our comments on the Clean Energy Legislative Package.

Should you require further clarification please contact Damian Jeffree on (02) 9776 7993 or at djeffree@afma.com.au.

Yours sincerely

Damian Jeffree
Director - Policy

1. Scheme Design

1.1. International Floor Price

AFMA is not in favour of price floors or caps as they produce market distortions. While there are reasonable mechanisms for minimising distortions when implementing domestic and international caps via government permit supply domestically, and when implementing a domestic floor price via reserve prices in government auctions, there is no mechanism for implementing a floor price on international permits that is without serious adverse consequences.

All mechanisms for implementing a floor price on international permits introduce significant inefficiencies and erode investment certainty.

AFMA proposes that the requirement for the floor price to apply to international permits be removed as it is unworkable.

AFMA's preferred option, on a least-worst basis, is to implement an international floor price based on a top-up payment at time of surrender model. This approach is far from optimal as it creates difficulties for firms purchasing forward vintages in the international market to know their top-up liability at the time of purchase.

Most participants will likely be hedging their carbon exposure and trading international permits such as CERs in the forward market (out to 5 years in some cases). For this trading to be efficient, traders will need to know the total price they are paying for those CERs (i.e. including any top-up payment) at the time of the forward purchase so that hedging is effective. The top-up model will not achieve full price certainty until the delivery date potentially years in the future without additional intermediation.

A member has also noted a preliminary view that this uncertainty in the top-up payment, if unresolved, could also affect hedge accounting treatment of the international forward contracts leading to less willingness to participate in international forward markets.

If a top-up model is adopted it should involve frequent top-up price calculations with a high degree of granularity with regard to categories of international permits to allow those purchasing in the spot market for surrender the least risk with regard to their top-up price exposure.

Less frequent price calculations in comparison could result in the average market price moving, resulting in the top-up price varying significantly from that expected at the time of purchase even for those purchasing in the spot market. Infrequent top-up payment calculations may also create an additional and otherwise unnecessary requirement to hedge currency exposure to top-up payments.

AFMA's preferred approach would minimise the risks of an inappropriate or unfair top-up price due to market movements and would lower currency risk for spot market

participants. It would also preserve incentives to minimise cost of carry which would drive participants to seek least-cost international prices.

More work needs to be done around potential implementation details of a top-up price approach, particularly for the affected forward vintages. AFMA is keen to work with the Government to look at options in this regard and we anticipate submitting a more effective alternative for consideration for inclusion in the regulations.

AFMA views the second approach noted in the DCCEE paper where the Government would be the sole purchaser of international permits to on-sell at a price not below the floor as even less desirable. This is the least workable option as the paper implies and it would not take advantage of market efficiencies in sourcing lowest cost permits. In our opinion it should not be considered further.

The administrative burden on market participants of even the preferred approach would be high. Some degree of inadvertent misreporting is likely given the millions of permits required to be purchased, categorised and lodged, many of which will have passed through multiple hands via sophisticated purchasing arrangements. Enforcement provisions and arrangements should take a pragmatic approach to reflect this reality and avoid unmerited prosecutions.

While we are opposed to domestic caps and floors and international caps we are prepared to accept them as their implementation can be achieved reasonably. We note again our specific opposition, on the basis of implementation difficulties, to the international floor price and urge that this policy element be reconsidered.

1.2. Certainty of Title

Certainty of title is critical to investor confidence and the development of a successful market. Problems with stolen permits and a subsequent loss of market confidence in the EU, which led to the carbon market there coming to a virtual standstill for months, highlights the importance of ensuring that bona fide buyers, acting without fraud, are confident that they will receive effective title to permits purchased in the market.

In our view the protections afforded by the existing law are insufficient to confer enough investor confidence and could result in collapses in confidence later down the track should registry or fraud issues arise.

While indefeasibility of title would be ideal, on balance, modelling effective title provisions on the Commonwealth Inscribed Stock Act 1911 would produce a good outcome. We would be pleased to continue discussions on details of these proposals.

1.3. Cap Details Timing

AFMA supports auctioning flexible price permits in the fixed price period, as proposed by the Government, as a sensible step towards developing a forward market. The forward market may be more relevant than the spot market in driving investment decisions. It is important to note that a successful start to the forward market that

delivers optimal price signals for potential investors in clean energy requires well informed participants.

However, the current timing arrangements for release of the first five years of caps will be subsequent to early auctions. Not providing details of the first five years of caps until the 2015 Budget (and the significance of that particular date is not evident) will mean participants in auctions prior to then will be bidding with incomplete information. It is likely this lack of information will factor into bids which may be lower as a result.

Releasing cap details before the first auction should result in higher prices as the uncertainty premium will be removed.

AFMA recommends releasing details of caps prior to the first auction, by moving the release date of the caps forward.

1.4. Certainty of Eligibility

The capacity to vary the list of eligible international units (particularly to disallow surrender of a specific unit at any time), whilst understandable, introduces considerable uncertainty.

We understand that the provisions around denying eligibility of units are for use in 'emergency' situations, and accept that in some circumstances there may be particularly rapid international changes requiring expedited local changes. However, the currently proposed arrangements do not provide sufficient structure or confidence to the market that there will be adequate notification of changes, and so guidance is needed as to what type of changes would be notified and within what timeframe notifications will be made.

We understand also that many, and perhaps most, changes would go through the normal consultative processes undertaken by the Regulator and adequate notice may result through this process. However, it is important to note that pricing and presence of markets is determined not only on what is probable but also on what is possible and as such the more certainty and guidance that can be provided, the less risk-premium will be attached to bids to allow for unexpected regulatory changes to eligibility.

In view of the critical importance of developing a successful forward market we would therefore suggest that guidance be given as to the timing of bans or limitations for different categories of changes and that this should have regard to international practices, with the aim of granting as much certainty to the market as reasonably possible.

1.5. Mechanism to Link to Fuel

With regard to the exclusion of fuel and linking to a reference price, AFMA would argue that any reference pricing mechanism should not be hard-coded into the legislation at this stage, such as is the case in the *Fuel Tax Legislation Amendment (Clean Energy) Bill*

2011 and the *Excise Tariff Legislation Amendment (Clean Energy) Bill 2011*, in order to ensure that there is flexibility for future innovation by the market or government.

Should a liquid daily market develop, as might be reasonably expected, then daily reference pricing may become available, the use of which could move excessive pressure away from auction dates, resulting in more accurate pricing.

It is worth noting that a daily reference price would align with international standards of a daily fixing price for grades of oil.

AFMA holds that arrangements for calculating the effective carbon price should be kept to the regulations to allow this future flexibility.

1.6. Clause 102 Clarification of Oversupply Situation

As discussed with DCCEE representatives it would be preferable to clarify that auctions and units are not invalid where clause 102 is breached; and perhaps allow for truing up if the cap is overshot.

Such a situation could occur in the event of an adverse ruling against a regulator determined allocation where a subsequent auction or allocation had, as a result, exceeded the cap. Purchasers at such an auction or subsequent allocation should be entitled to confidence in their title.

1.7. Limitations on Unit Auctions with Default Caps in Effect

Section 101(1) limits the number of permits which can be auctioned more than 12 months in advance to 15 million carbon units per forward year where there are no regulations in effect declaring the carbon cap. The commentary implies that this limit falls away in the 12 months leading up to a vintage year, yet 101(2) contains a restriction on auctioning more than 15 million in the first six months of a financial year immediately before the vintage year if there are no regulations specifying the cap. By way of example, this means that in the absence of a cap and where the default position in section 17 and 18 apply, 2015/16 liable parties will need to wait until 6 months before the start of the 2015/16 year to buy 2015 vintage permits.

It would be preferable for the limit to fall way on either publication of a Regulation or activation of the default position, i.e. after 31 May 2014 for 2015 vintage and after 31 May 2015 for the 2016 vintage.

The commentary implies the limit is to ensure the integrity of the cap. However, the limit of 3% of total emissions or around 6% of covered emissions still seems overly restrictive, particularly as the international permits are at risk of exclusion by Regulation.

The Bill does not oblige the auction of future permits by any particular date - it only limits the amount. It would be preferable for the Bill to oblige the auction of a specified number of forward vintage permits before a specified date.

A higher quantity of auctioned permits at an early date would also assist with forward project planning and would increase industry commitment to the scheme, which in turn would contribute to confidence in the scheme's ongoing nature.

1.8. GGAS Compensation Arrangements

AFMA seeks changes to the Government's position on compensation for the holders of unused GGAS certificates as a result of the commencement of the Securing a Clean Energy Future program. Under the previous CPRS proposal GGAS participants were to be compensated by the Federal Government for the surplus of certificates that remained, and it is AFMA's view that similar arrangements must be in place during the current transition period.

Environmental schemes in Australia fundamentally rely on the support of market participants. AFMA is strongly of the view that those market participants that have supported the GGAS scheme throughout the uncertainty that has existed should not be unduly impacted by the commencement of a national carbon scheme. To ensure that the future of environmental policy in Australia is successful, it is essential that the confidence of participants to invest remains and therefore transitional arrangements similar to those tabled for the CPRS must be incorporated into the current carbon policy. There is currently a substantial issue around sovereign risk when it comes to investment in environmental schemes within Australia. The Government needs to make certain that the transitional arrangements into the new carbon program are sufficient to ensure future investment is forthcoming particularly from those participants that have been at the forefront of previous environmental industry developments.

1.9. Significant Holdings - Publication

AFMA supports measures that ensure market efficiency and integrity. However, we do not believe that the 5% holding reporting requirement proposed in the exposure draft Bill will effectively support these objectives.

The provision appears to have been borrowed from the share market where the substantial shareholder reporting provisions are primarily aimed at ensuring an informed market in the context of competition for corporate control. The focus of the reporting requirement in the share market is in the same dimension as the underlying market – that is, it involves the reporting of physical holdings of equities which can be used to vote and influence corporate control.

The carbon price formation process, the efficiency of which is the objective of the reporting requirement, will occur to a much greater degree in the derivatives market. In particular, market activity in emissions units will likely exhibit a significantly higher ratio of forward settlement trading to cash or spot physical trading.

Consequently, the proposed 5% holding reporting requirement will be of limited value as a market information tool, as it will not reflect underlying market activity.

Indeed, the proposed reporting threshold is likely to be counterproductive, leading to "false positive" reporting in the context of common inventory financing transactions, wherein a substantial holding does not have a bearing on the economically effective position nor give any true guide to market cornering activity. For example, a permit holder may enter into a spot sale transaction and simultaneously a forward buy transaction in order to finance a holding until nearer the targeted surrender date; the spot purchaser may have a substantial holding (particularly if in aggregate it enters many such transactions) but would not have an economic interest or risk in the price of the permits, as these have already been committed to be sold back to the market at a fixed price. More generally, traders typically seek to hedge their market exposures, which gives rise to gross holding positions (especially in derivatives) that bear no relationship to their net market exposure.

The value of having partial information about a subset of units able to be acquitted is doubtful. Significantly, there are a range of other measures to prevent attempts to corner the market or significantly limit the benefit from so doing. These include the government control of the auction process, access to participant holding information by the authorities through the Registry, the ability of scheme participants to bank permits and to borrow up to 5% of following vintage permits to ameliorate supply and demand imbalances, and the price cap.

The partial information revealed by the proposed 5% holding requirement can be readily rendered, at best, meaningless and, at worst, misleading, apart from which it will generate additional compliance costs.

Further, for some firms there will be an effective legislated requirement to purchase quantities of permits that may pass the significant holding threshold. These firms would be required by the combination of the significant holdings provisions and their liabilities under the scheme to have published what could be market sensitive confidential corporate information. This information may well then be used against them in the market. This is an undesirable and unjustified obligation.

Therefore, having regard to these considerations and the substance of the other protections available, we recommend that this requirement be deleted from the Bill or at a minimum the Bill be amended by the removal of the publication requirements and the insertion of a requirement to protect the confidentiality of the information.

1.10. Auction Design

Good auction design is an important part of creating a successful and accessible market. We note the intention of the Government to implement the details of the auction process through regulation. AFMA supports this approach to retaining flexibility with regard to auction design and would be keen to work with the Government on auction design to ensure an equitable and efficient outcome.

AFMA supports the auctioning of future vintages commencing during the fixed price period as discussed. We note that auctioning of future vintages should, in order to align

with the announced caps, go out to five years rather than three. This would contribute to the development of the forward market price curve and investor certainty.

1.11. Financial Services Regulation

We note that the Bills provide for the units to be regulated as financial products under the Corporations Act. Although we expect that detail on these matters will be reserved for the regulations, rather than the Bills themselves, we recommend that the exemptions from licensing determined to be appropriate for the CPRS be implemented for this scheme (such as the exemptions for offshore entities dealing with wholesale clients).

In addition, in order to facilitate the development of a forward market, we suggest that consultation be engaged in before any decision to extend short selling prohibitions to the units through the Regulations. This is because features of the units (in particular their non-existence until issue, and the vintage structure) make them quite different from other financial products to which short selling prohibitions apply and will make it practically difficult to have any "presently exercisable and unconditional right" to future vintages which are the subject of a forward sale.

2. Taxation Issues

AFMA is supportive of the stated intention of Schedule 2 of *Clean Energy (Consequential Amendments) Bill 2011* exposure draft to ensure that the tax treatment of registered emissions units is simple, clear and efficient.

The intention of this submission is to identify discreet areas of potential tax uncertainty that warrant further legislative or interpretational clarification in the final bill and supporting commentary on the provisions.

In support of these objectives, AFMA has identified a number of areas in Schedule 2 that require further clarification to enhance the operation of the tax legislation to reflect the important role that financial intermediaries and traders will play in the development of an active carbon market. We have also identified several other specific items that will enhance the operation of the proposed tax law to achieve the aims of simplicity, clarity and efficiency. These matters are noted below.

2.1. Tax Deductibility of Penalty Payments

AFMA holds that making the shortfall charge non-deductible is inequitable for income tax and leads to perverse outcomes. It effectively creates different shortfall costs for 3 different classes of liable entities:

- those who are tax-positive and paying income tax presently, for whom it hurts the most;
- those who have a deferred tax position (say due to carried forward losses or depreciation allowances), for whom it does not hurt as much, because they do not have a present need for the deduction; and

- those who are not liable for income tax.

It is a perverse outcome, because the businesses with a high effective rate of income tax incur a higher effective shortfall charge, whilst businesses who have minimised their income tax (or pay no income tax) incur a lower effective shortfall charge.

It would be fairer to put all liable entities on the same footing, as preferred by the Tax Commissioner where possible, by allowing the usual detectability provisions to apply to the shortfall charge (and for this no special provision or amendment to the Tax Act is required).

2.2. Application of Division 420 to Financial Institutions

AFMA submits that financial instructions should treat eligible permit transactions as financial arrangements subject to the operation of Division 230 of the *Income Tax Assessment Act 1997* (i.e. TOFA treatment). This is explored in further detail below.

AFMA has previously supported the creation of a separate tax code for the taxation of carbon permits, provided that the code adequately addresses the interaction with other parts of the tax law and considers the character of participants in the carbon market and provided that taxpayers within the Taxation of Financial Arrangements (TOFA) regime can use the TOFA rules rather than any separate code.

In this context, AFMA has been concerned to ensure that the tax rules are developed taking into account the critical role that financial intermediaries and brokers will play in the development of a liquid carbon trading market in Australia. AFMA is also mindful of the importance of the international tax aspects of the Australian system in achieving an effective integration with the global carbon emissions market.

Whilst the Commentary does contemplate how trading activities would be treated under existing law, AFMA is concerned that proposed Division 420 and associated Commentary does not adequately address the role that financial institutions will play in facilitating carbon trading. AFMA is concerned that a “one size fits all” approach has the potential to result in tax uncertainty and introduce inefficiencies into the carbon market for financial intermediaries.

This manifests itself in Schedule 2 of the exposure draft in a number of important ways.

2.2.1. The Rolling Balance Method

Firstly, the “rolling balance method” has been proposed as the key mechanism for the taxation of carbon units. Consistent with our previous submissions, we again submit this may in principle be adequate for many participants but it is too basic to serve as a model for taxing intermediaries in the market.

For example, it is contemplated that financial intermediaries will undertake sale and repurchase transactions over registered emissions units to facilitate lending and borrowing activities. Absent specific rules to take account of the commercial substance

of repo transactions for financial intermediaries, the rolling balance method will apply to sale and repurchase arrangements over registered emissions units.

Example

An Australian resident ADI carries on a banking business in Australia. In the ordinary course of its business, it offers a loan to large corporate client (Company A). Company A operates a carbon intensive business and has registered emissions units. In order to raise finance for its business, Company A enters into a sale and repurchase arrangement whereby the registered emissions units are sold to the bank and there is an agreement to repurchase the registered emissions units at a point in the future. All transactions take place at market value. As part of the arrangement, Company A agrees to 'pay' the Bank additional carbon units calculated by reference to the period of the arrangement but physically delivered at the end of the arrangement (for example, at the end of 3 years).

In the example, Company A will cease to hold a registered emissions unit and therefore be assessable on the disposal proceeds under proposed section 420-25 of the exposure draft legislation. The subsequent 'payment' of registered emissions units will not be assessable for Company A as there will be no amount paid by the Bank for the transfer of the units from Company A. As the parties will be dealing with each other at arm's length, section 420-30 should have no application.

Subsection 420-15(5) should also have no application to deny Company A a deduction for the expenditure incurred to become the holder of a registered emissions unit, as that section applies a hypothetical test, requiring that any sale proceeds would be assessable under section 420-25.

From the Bank's perspective, the costs of acquiring the registered emissions units from Company A should be deductible and the receipt of the 'payment' in the form of registered emissions units will be assessable at the end of the arrangement (per the rolling balance method calculations and assessable at the time of receipt in section 420-45). The proceeds on sale of registered emissions units back to Company A should be assessable under proposed section 420-25.

The example above demonstrates that what is commercially a loan arrangement would be subject to the operation of proposed rolling balance method in Division 420. Typically, such a sale and repurchase arrangement would be treated as a collateralised loan transaction pursuant to Division 230 of the *Income Tax Assessment Act 1997* (the TOFA rules).

In the absence of rules to deal with such financing transactions, Division 420 is likely to result in treatments that are inconsistent with the commercial treatment of the transaction. Arguably, Division 420 provides for up-front deductibility of the cost of the carbon units for Company A and deferral of taxable income for the Bank (assessable in the period when the carbon units are registered).

AFMA submits that further guidance is warranted in the Commentary on the expected treatment of typical carbon unit financing transactions such as sale and repurchase

transactions and 'eligible carbon unit lending transactions'. This may warrant the introduction of a provision in proposed Division 420 broadly equivalent to the securities lending provisions in section 26BC of the Income Tax Assessment Act 1936.

2.2.2. System Limitations

AFMA also notes that many financial intermediaries have traditionally not adopted a trading stock approach to their trading activities. Accordingly, the adoption of the rolling balance method will necessitate the development and implementation of separate processes and systems for tracking eligible emissions unit trades.

The tax law will require these processes purely to satisfy the tax reporting obligations associated with the rolling balance method.

AFMA submits that the need to develop separate reporting systems to support the tax treatment of carbon units is not consistent with the intended objectives of efficiency and simplicity.

2.2.3. Trading Derivatives or Carbon Units

Whilst the exposure draft legislation amends the operation of Division 230 to make it clear that the TOFA rules do not apply to tax gains or losses from registered emissions units, the commentary identifies that Division 230 may nonetheless apply to derivatives of registered emissions units.

The consequence of this will be that financial intermediaries will have different tax consequences for carbon unit trading depending on the particular type of trading activity undertaken. For example:

- Traditional sale and acquisitions of registered emissions units by a financial intermediary on its 'own account' will be subject to Division 420 rolling balance treatment.
- Transactions involving cash settled derivatives over registered emissions units will likely be treated as financial arrangements subject to the operation of the TOFA provisions. The financial intermediary will likely be subject to gains and losses that are recognised in its accounts to determine the tax position.
- Due to the punitive nature of penalties from failing to surrender registered emissions units, it is contemplated that a portion of the trade of eligible emissions units will result in physically delivered carbon derivative contracts. As physically settled derivatives are unlikely to be 'cash settleable', it is possible that these derivative contracts are unlikely to be financial arrangements subject to the TOFA rules.
- In the circumstances where the derivative is not a financial arrangement to which Division 230 applies, the tax treatment will be determined by ordinary taxing principles in the Tax Act.

AFMA submits that the complexity of tax treatment from eligible emissions unit activities to be undertaken by financial intermediaries is not consistent with the stated aims of proposed Division 420 – namely simplicity, clarity and efficiency.

2.3. Other Division 420 Issues

2.3.1. Timing of Deductions

During both the fixed charge years and the flexible charge years a liable entity must meet its liability for emissions for a financial year (30 June) by the following February.

A person may meet these obligations by surrendering eligible emissions units by electronic notice transmitted to the Regulator. When a carbon unit is surrendered, it is cancelled and the Regulator must remove the entry for the unit from the Registry account of the person who has surrendered it.

For tax purposes, a taxpayer is entitled to a deduction to the extent that expenditure is incurred for the purposes of a holder of a registered emissions unit. The rolling balance method then takes into account any movements in the market value of the registered emissions units held on the Register at the start of the income year and held at the end of the income year.

As units may be surrendered at any time during the financial year, it would appear that a taxpayer would be entitled to a tax deduction (under the rolling balance method) if they were to surrender units by the end of the financial year rather than the time at which the final liability must be satisfied (i.e. the February in the following year). This is on the basis that they will be removed from the Register and therefore excluded in working out any rolling balance movements.

However, it is noted that the tax treatment of registered emissions units is subject to a claw back provision in subsection 420-40(1), which stipulates that if an entity ceases to hold a registered emissions unit and that cessation is unrelated to gaining assessable income, then any amount that the entity has deducted to acquire or dispose of the unit is included as assessable income in that year.

It is also noted that an emissions liability will be based on the emissions number that liable entities must report in their report to the Regulator in accordance with the NGER Act. Generally this is not required to be reported until October following the financial year.

AFMA seeks confirmation that an entity will be entitled to an income tax deduction under proposed Division 420 when it surrenders registered emissions units (pursuant to the rolling balance method) notwithstanding that the units may be surrendered prior to the final emissions liability being determined.

AFMA also seeks confirmation that subsection 420-40(1) will have no application in these circumstances.

2.3.2. Taxable Purpose – Deductibility of Costs

As noted above, proposed subsection 240-40(1) provides a claw back for expenditure in becoming the holder or ceasing to hold a registered emissions unit that has been deducted under either proposed sections 420-15 or 420-42 where it is determined that the cessation is neither in gaining or producing assessable income or in carrying on a business for the purpose of gaining or producing assessable income.

Section 420-15 is limited to expenditure incurred in becoming a holder of the registered emissions unit, and it is noted that I paragraph 2.100 of the Commentary states that "... interest expenses incurred in financing the acquisition of registered emissions units are considered under the general deduction provision."

For the avoidance of doubt, AFMA seeks confirmation that the operation of subsection 420-40(1) is limited in its application to the costs to become a holder of the units, and does not impact the purpose determined by a taxpayer incurring other costs to acquire registered emissions units (for example, where a taxpayer takes out a loan to acquire emissions units, any income producing purpose is determined at the time of taking out the loan).

2.3.3. Nominee Provisions

AFMA notes that Division 420 contemplates a specific 'look–through' rule dealing with the income tax treatment where the registered holder of a registered emissions unit is a mere nominee for another entity.

AFMA submits that the look through approach should not be limited to one level of nominee as this unnecessarily restricts operations.

2.4. Division 420 - International Tax Rules

As international trading of eligible carbon units is an important element of the carbon trading scheme, AFMA is of the view that it will be important to ensure that the international tax considerations of carbon trading arrangements are considered and to ensure that there are no disincentives to undertake trading activities.

In this regard, it is anticipated that financial intermediaries will likely undertake trading activities both domestically and offshore. This will likely involve the sale and purchase of carbon credit units outside of Australia.

It will therefore be important to ensure that the Australian tax rules deal with the tax treatment of the carbon units whilst they are located offshore. In this regard, the Commentary states that:

> *"Division 420 provides specific rules for registered emissions units once they become registered on the National Registry.* ***The general income tax provisions apply to international emissions units and to carbon units and ACCUs that have been transferred to a foreign account until the time the units are registered on***

> ***the National Registry and become subject to Division 420 treatment*** *(that is, when they are transferred from your foreign account)... [emphasis added]*

This indicates that the rolling balance method is therefore only relevant for registered carbon units that by definition are located in Australia and entered onto the Registry account in accordance with the *Australian National Register of Emissions Units Act 2011*.

In this context, AFMA seeks confirmation that Division 420 will not have any extraterritorial application, for example in calculating the attributable income of a CFC and the application of the foreign hybrid rules for non-Australian registered units.

2.5. Taxation of Financial Arrangements

Notwithstanding that the CPRS White Paper set out the Government's intention that Division 230 will not apply to the acquisition, holding and disposal of registered emissions units, AFMA again notes that one of the key objectives accompanying the introduction of the TOFA rules was to minimise taxpayer compliance costs.

The proposed Division 420 rules will result in exclusion of one part of a financial intermediary's trading book from the operation of rules that are specifically designed to minimise compliance costs. As noted above, whilst it is accepted that Division 420 will result in broadly similar tax outcomes for carbon unit trading activities, the Division 420 rules will nevertheless require new tax systems to be implemented to capture trading activity.

The adoption of separate tax rules for trading activities that require implementation of new purpose built systems to capture carbon trading activity would seem inconsistent with the stated objectives of simplicity, clarity and efficiency.

AFMA again recommends that it would be appropriate that:

- Entities may elect that eligible permits should be included as financial arrangements for the purpose of Division 230; and
- Entities that would otherwise not be required by law to apply TOFA rules should not be required to do so.

2.6. GST Rules for the Emissions Pricing Mechanism

AFMA supports the Government's decision to treat the supply of an eligible emissions unit as being GST-free. We agree that the GST outcomes should not compromise the main objective of the clean energy policy.

This approach also makes sense from a broader tax policy perspective because the market for eligible emissions units will be a business-to-business market, so it should not be subject to a consumer tax. Moreover, in keeping with the principle that the tax treatment should be based on simplicity, efficiency and equity, a key objective of the GST arrangements for the carbon market should be to provide an easy regime for business to comply with and for the ATO to administer.

The easier it is for business and the ATO to apply, the more likely that operational problems and costs will be minimised. It is particularly important to the development of trading systems and arrangements to support the market that GST treatment does not otherwise impede the operation of a liquid market.

While the central GST proposition in the draft Bill supports these objectives, we have identified a number of matters need to be further considered and modified in order to achieve this outcome, as outlined below.

2.6.1. Treatment of Deliverable Derivatives

Once the market based carbon pricing mechanism is established, it is likely that trading in derivatives will exceed trading in the market for physical eligible emissions units. This is typical of many developed markets and reflects a desire by liable entities to manage their carbon exposures in a flexible and cost effective manner.

We understand that Treasury contemplates that deliverable derivatives will take the same character as the underlying eligible emissions unit and will be treated as GST-free. Indeed, this treatment is necessary if the Government's policy objectives in developing the carbon pricing mechanism are to be achieved. However, we are concerned that the current law does not provide this outcome in a sufficiently clear and certain way.

The GST regulations exclude certain deliverable derivatives from input taxation and, instead, make the character of the underlying commodity or item:

- Regulation 40-5.12 (item 7) excludes an item from being input taxed if it is an "option or right to make or receive a *taxable supply*";
- Regulation 40-5.12 (item 8) excludes an item from being input taxed if it is a supply made as a result of the exercise of an option or right, or the performance of an obligation, to make or receive a *taxable supply*.

Since Regulation 40-5.12 (items 7 and 8) apply specifically to *taxable supplies*, they do no operate to exclude deliverable derivatives for which the underlining is a GST-free supply; hence, these regulations will not apply to eligible emissions units and, consequently, deliverable derivatives based on them may be input taxed.

It would appear that reliance is instead being placed on s.9.30 of the GST Act and, more specifically, the tie breaker rule in subsection 9-30(3). However, the language in section 9-30(1)(b) that primarily determines a supply to be GST-free refers to the "supply of a right to receive a supply that would be GST-free", so technically it does not refer to "obligations". As a consequence, the situation where an entity writes a put option on a carbon unit and has an obligation to deliver a unit under this contract is not unambiguously a GST-free supply. The only sensible policy intention is that the deliverable put option should be GST-free but the various provisions dealing with "rights and options" are complicated and do not interact with the smoothness and precision required to give a sufficiently certain tax outcome.

Accordingly, the law or the regulations should be amended to ensure that trading in deliverable derivatives based on eligible emissions units reflects the policy that rights to acquire and sell property is treated the same way as the underlying property.

2.6.2. Treatment of Cash Settled Derivatives

We expect that derivatives market interest in the near term will be orientated primarily towards deliverable instruments but we also expect that demand for cash settled derivatives will grow over time and its significance will increase as a source of price discovery. Against this backdrop, in order to achieve the desired simplicity and efficiency objectives for business under a market based mechanism, it will be necessary to give GST-free treatment to all carbon derivatives. If this approach were taken, a business would not be penalised through higher tax costs for choosing to manage its exposure under the clean energy policy by using cash settled rather than deliverable eligible emissions units – the business would be penalised under the draft rules.

We understand that there is a concern held by some in government that if GST-free status was granted to all derivatives based on eligible emissions units, there is a risk that financial engineering techniques might be employed to generate GST-free treatment for derivatives that are unrelated to carbon. While it is not immediately obvious to us how this would be done, careful drafting will provide a high level of comfort to government and the broader community that GST revenue is fully protected.

We propose that this outcome could be achieved by defining eligible emissions unit derivatives in a sufficiently precise and narrow manner. This could be implemented efficiently through the Regulations and/or specific clarification via a bespoke example in the relevant supporting Schedules to the Regulations. The design of the necessary measures could be determined in conjunction with an industry consultation process. It is important to market participants, including liable entities and traders, that the integrity of the market is preserved and that well-balanced and prudent rules apply to derivatives trading. AFMA's members need an effective market place in which to conduct legitimate business and it would be contrary to their interests if gaming of the GST rules for carbon to occur.

2.6.3. Other Issues

If an effective solution is not found to the above derivatives issues, then it may be necessary to adjust the financial supplies threshold to exclude carbon related derivatives in order to avoid liable entities from being drawn into the GST input taxation regime. This could occur, for example, where an entity actively manages its exposure under the clean energy policy.

Applying a GST-free treatment to derivatives would ensure that the competitiveness of the clean energy pricing mechanism is maintained as competing jurisdictions develop their carbon trading regimes (including associated GST/VAT rules). More generally, it will support a more stable GST environment over the course of time.

2.6.4. GST Summary

AFMA welcomes the Government's decision to make supplies of eligible emission units GST-free, as it is one of the significant steps required to facilitate develop of an efficient carbon market in Australia. This approach also has international precedent.

Having regard to the desire promote development of an effective carbon pricing mechanism and to minimise tax compliance costs and, AFMA recommends that spot and derivatives transactions in eligible emission units should be treated as GST-free by applying Division 38 of the GST Act to them. We appreciate that it may be technically and practically efficient to achieve some aspects of this through the GST regulations.

The nature of the GST-free treatment we seek would provide certain, consistent and economically sensible tax outcomes that will support the development of a vibrant and internationally competitive carbon market in Australia. The proposed rules are a significant step in this direction in their current form they do not fully contribute to this outcome.

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Attachment - AFMA Principles for Carbon Markets

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;