



4 December 2007

Climate Change Group
Department of the Prime Minister & Cabinet
PO Box 6500
Canberra ACT 2600

By email: emissiontrading@pmc.gov.au

Dear Sir/Madam

Submission on “Abatement Incentives Prior to the Commencement of the Australian Emissions Trading Scheme” Discussion Paper

The Australian Financial Markets Association (AFMA) is pleased to make this submission on the “Early Abatement Incentives” Discussion Paper.

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.

This submission focuses on issues related to markets rather than particular platforms on the intricacies of the scheme that are not directly related to positive market outcomes. Therefore, we comment only on those areas of the Discussion Paper which will directly impact financial markets.

Box 1.1 Key concepts and definitions

There seems to be an assumption that all offset credits are 100% fungible with Permits with no implied limits in terms of the mix. Based on the EU ETS experience, offset credits (Certified Emission Reductions (CERs) and Emission Reduction Units (ERUs)) trade at a discount in the secondary market to permits (EU Emission Allowances) – particularly in the forward market because participants treat them differently. This is because there are restrictions on the number of offset credits that can be held alongside permits to meet a company’s liabilities and project credits carry delivery and credit risk.

Given that the Kyoto Protocol has now been ratified, we assume that Early Action Credits (EACs) and Offset Credits (OCs) may become Joint Implementation (JI) Emission Reduction Units. The question then is whether Australia will adopt a JI Track 1 initiative, as has New Zealand, and allow companies to choose whether their EACs and OCs can be issued (by the Australian “Designated National Authority”) as either ERUs or some form of “Australian Emission Permits”.

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Although probably subject to discussions as the scheme is further developed, we question whether the scheme should give uncovered entities the option to voluntarily elect to become covered (eg if a price difference does develop between credits and permits, an entity with significant abatement potential may well be economically better off exchanging EACs for permits, rather than being forced to receive only OCs).

We believe that voluntary carbon markets should be able to trade any of the three categories of certificates: Emission Permits, OCs and EACs.

Box 2.1 Free permit allocation under the Australian Emissions Trading Scheme

We note that the experience of the first phase of the EU scheme, where free allocations exceeded the actual level of emissions resulting in the EU prices falling to almost zero, provides a salutary warning about the risk of excessive permit allocations. This was partly due to the poor quality of emissions data on hand when the allocation decisions were made. The timing of Australian ETS allocations will be dependent on access to the first complete emissions reporting data for 2008/09 collected by October 2009.

In this context, it is preferable for the market to be marginally short of permits. More generally, it is important to the establishment of confidence in the market that any shortcomings which become apparent in the allocation process are not interpreted as general failure of the AETS market.

2.2 Assets eligible for compensation

We consider that the National Electricity Market definition, minimally modified for other sectors where necessary, is appropriate and should be used.

3.1 Standards for abatement recognised by the scheme

That early abatement credits must represent abatement that is qualitatively equivalent to emissions permits (as they will be used interchangeably once recognised within the scheme), is critical to ensuring that an Australian scheme can be linked with other schemes.

We note that equivalent face value in early abatement credits and emission permits does not guarantee that forward prices for the two will be the same. Price formation of permits in the forward market may well be strongly influenced by participants' views on the Government's allocation/issuance plan, whereas forward price formation of credits might be more strongly influenced by the prospects for the range of abatement projects to deliver expected abatement. For example, the price differential between EUAs and CERs extends to spot trades in the secondary market due to a perception of increased risk holding credits versus permits.

It is important that the definitions of "additional, permanent, measurable, and verifiable" are unequivocal.

3.2 Eligible activities

AFMA is generally predisposed to EACs and OCs being eligible for credits under the scheme. Projects in uncovered sectors that become covered should have a five year notice period prior to them being made ineligible for offset

creation. Creation rules for offsets should follow CDM/JI guidelines to allow for future fungibility with international schemes.

3.3.1 Approval via Greenhouse Friendly

We agree that the existing Greenhouse Friendly structure should be used as the initial administrative mechanism and support active creation of additional protocols.

With the Kyoto Protocol now ratified, we expect that approved Kyoto CDM (and JI) will become explicitly approved methodologies and can thus be utilised as "protocols" in the Australian scheme.

3.4 National Register for offsets and early action credit

A full registry for offsets should be created, with the capacity for voluntary surrender. It should be in the public domain and contain individual certificate data inclusive of all fields identified within current schemes, eg the REC registry or global CER registries.

We note the submission by Australian Securities Exchange (ASX) proposes a government registry for emission permits and fungible credits, with an ASX Austraclear interface. AFMA fully supports this concept and agrees with the assertions in the ASX submission as to the clear benefits of a linked Delivery versus Payment system, in terms of reducing settlement risk, thereby enhancing market efficiency.

3.6 Transitioning early action credits into the emissions trading scheme

We agree that EACs should be eligible to be turned into permits or permit equivalents in the first year of the scheme and that they remain fully bankable. The quantum of EACs outstanding should be made public and taken into account when setting early ETS targets.

3.8 Voluntary market access

We agree that EACs and standard offsets should be allowed to be used in the voluntary market.

To discuss any of the issues raised in this letter, please contact Allen Young, Senior Policy Executive, on (02) 9776 7941 who can make the necessary arrangements.

Yours sincerely



Duncan Fairweather
Executive Director