

O s b o r n e A s s o c i a t e s

8 February 2000

The Secretary
Emissions Trading Team
Australian Greenhouse Office
GPO Box 621
Canberra ACT 2601

Dear Secretary

4th Discussion Paper on Emissions Trading

Introduction

This Submission is provided by Osborne Associates with respect to the Australian Greenhouse Office (AGO) 4th Discussion Paper on Emissions Trading.

Osborne Associates Submission

Osborne Associates was not asked to provide this Submission nor received any remuneration.

Disclosure

Since the beginning of 1999, Osborne Associates has acted as the Interim Secretariat for the Melbourne Financial Services Task Force. This private sector initiative (comprising representatives from leading financial services organizations, the City of Melbourne, Department of State and Regional Development and the Committee for Melbourne) continues to research and make representations to the Victorian and Commonwealth Government and Australian Centre for Global Finance on the capabilities and growth prospects of Melbourne's and Australia's financial services sector within the Asia Pacific financial services grid.

Details of 1999 Task Force activities are noted at Appendix 1. If desired, the various Research Reports and other Studies can be obtained from the National Library of Australia or otherwise made available for the AGO's consideration.

In September 1999, the Task Force recognised the broad range of skills and expertise with respect to the development of an efficient Carbon Credits trading system. The Task Force assisted with the establishment of a Melbourne Greenhouse Group to specifically investigate the establishment of a Carbon Credits Trading Scheme in Australia by linking the finance sector to industry participants and other interested organisations.

This Osborne Associates Submission has not been made in conjunction with the Melbourne Financial Services Task Force or the Greenhouse Group.

In Sum

- The AGO should actively and sooner rather than later, facilitate the development of a *Shadow Carbon Credits* trading system or Pilot Scheme.
- The *Shadow Carbon Credits* trading system should be developed as an Over the Counter (OTC) market and form the basis for the ongoing development of an exchange traded product(s).
- Funding of the OTC market development should be a Policy objective.
- In conjunction with Agencies such as the Australian Centre for Global Finance, there is the opportunity for the development of regional profile in carbon credits trading.
- The market will develop as a two tiered structure with Greenhouse Challenge Group participants seeking to adopt international standards in trading.
- The size and scale of Greenhouse Challenge transactions will be sizeable and form the basis for OTC market transactions.
- The number of transactions will initially be small and it is vital that transaction costs "*Market Noise*" be internationally competitive and facilitate cross border trading.
- Market transactions must be internationally consistent with models already in place in markets such as the Chicago Board of Trade (CBOT) and the Chicago Mercantile Exchange (CME).
- Market documentation should be internationally understandable and incorporate for example the ISDA contractual format.
- Consistent with international trends, *Cap & Trade* should be promoted.
- *Cap & Trade* will ensure OTC market transactions are readily understood by the financial markets both in Australia and internationally.
- To facilitate price discovery, the role of the Australian Government should stress market transparency.
- A second tier market, focused on small/medium sized transactions should be developed with scope for a domestic market characteristics that do not detract from the global integration of the market.

Early Action & Adjustment Path

Except for a limited number of global businesses operating in Australia, Carbon Credits Trading continues to be a little understood concept. Sophisticated communications are urgently required to start the education process. The 4th Discussion Paper provides detailed analysis of the broad range of issues that need to be addressed.

A timely start to the development of a Carbon Credits Trading system should be encouraged.

Consistent with the development of an efficient market and thus leading to market prices being established, the *Adjustment Path* process should be transparent. In this context, Osborne Associates recommends Government mandated interim targets be established. Without such a framework, the financial markets are unlikely to neither develop at a fast clip nor lead to transparent pricing.

Shadow Carbon Credits Trading

However, the complexities suggest lengthy decision making processes and there is no clear path and time frames to indicate how and when the market can develop.

Osborne Associates recommends that Policy should focus on the development of a *Shadow Carbon Credits Trading System* or *Pilot Scheme* as a means of education and linked to the financial services sector.

Establishing the Permit Cost

Until the “*Cost*” of a permit is transparent, the development of the market will be impeded. Market participants will need direction as to:

- The penalty structure that can be evaluated by market participants.
- Understandable transaction costs. This means that participants will need to understand the permit cost charge for maintenance of the National Registry.
- Ongoing compliance arrangements including reporting and acquittal protocols.

Modelling of indicative cost structures would assist market participants to establish the overall cost scenarios and taking into consideration risk abatement costs. In this context, Policy should be directed to establishing such cost elements as a priority.

Market Trading Vs Permit Cost

Market dynamics will dictate different perceptions of permit values that will be unrelated to the permit cost calculation. Firms will form different views as to the overall cost structures and arbitrage by market participants will also provide for anomalies.

However, the market makers holding carbon credits or emission reduction units will require information on the cost structures to assist with development of pricing scenarios.

Transparent Markets

The Discussion Paper refers to the need for *timely and comprehensive information on emission levels and the identity of emitters for allocation and acquittal purposes.*

These is also reference to ensure *the integrity of national emission estimates and minimise the size of any “buffer stock” of permits held by the government to ensure compliance with the Kyoto objectives.”*

Osborne Associates concurs with these objectives as being vital to efficient pricing structure being developed. At a minimum, Policy should ensure the market is fully informed and in a timely manner.

The financial markets would view any substantial “*buffer stock of permits*” held by the government as a negative factor leading to increased cost structures and reduced levels of trading activity.

Osborne Associates recommends that any build up in *buffer stock* should be auctioned. This approach will lead to enhance liquidity and trading activity in the primary and secondary markets.

Cap & Trade

The *Cap and Trade* approach can be expected to be:

- Internationally recognized and facilitate international trading.
- Cost efficient and lead to lower transaction costs or *Market Noise*.
- Market driven and lessen the involvement of Government in the development of the market.

From a markets perspective, Osborne Associates supports Cap & Trade.

Greenhouse Challenge

Osborne Associates agrees with the Industry Commission in that the reporting requirements associated with any future national emissions trading system *should make use of the existing institutions and infrastructure.*

In this context, it is noted that the Greenhouse Challenge provides a useful starting point for the development of carbon credits trading.

It is recognised that other layers of industry will require different approaches and more importantly longer time frames to develop the necessary market conditions.

Australian Centre for Global Finance

The Australian Centre for Global Finance provides an appropriate linkage between the development of the local market and to explore the regional and global opportunities for Carbon Credits Trading.

In an Asia Pacific context, the AGO's involvement in the development of the market provides an opportunity to place Australia at the forefront of the development of new financial products.

A faster pace of development would thus achieve the twin objectives of encouraging carbon credits trading and strengthening Australia's positioning within the regional financial services grid.

Melbourne Advantage

The Melbourne Financial Services Task Force research and other activities have already highlighted a wide range of expertise (recognised nationally and internationally) in Carbon Credits Trading. These skills and expertise place Melbourne's financial services sector at the forefront of developments in various issues associated with the implementation of the Kyoto Protocol.

Osborne Associates would be pleased to assist the Australian Greenhouse Office – Emissions Trading Team with any questions on the Firm's Submission.

Yours sincerely



Bradley Treadwell
Managing Director

**Melbourne Financial Services Task Force
1999 Activities**

- Melbourne Financial Services – Charting the Future Survey.
- Melbourne Financial Services Symposium.
- Formation of Melbourne Financial Services Teams:
 - Funds Management
 - Venture Capital
 - Research & Education
 - Tax
 - Competitive Advantage
 - Structure & Strategy
 - Government Submissions
- Melbourne Financial Services – Clustering & Business Development Surveys:
 - Funds Management
 - Venture Capital
- Documenting Melbourne’s tertiary sector’s skill base in financial services.
- Australian Tax Priorities in Financial Services – A Melbourne Perspective.
- Melbourne’s Competitive Advantages in Financial Services Survey.
- Melbourne’s Funds Management and Venture Capital Directories.
- Melbourne Financial Services Monthly e-mail Newsletter.
- Representations and submissions to the Victorian and Commonwealth Government Ministers and the Australian Centre for Global Finance.