



11 June 2009

The Secretary
Senate Standing Committee on Economics
PO Box 6100
Parliament House
CANBERRA ACT 2600

By email: economics.sen@aph.gov.au

Dear Sir

Carbon Pollution Reduction Scheme Bill 2009 and Related Bills

The Australian Financial Markets Association (AFMA) welcomes the opportunity to make this submission to the Senate Standing Committee on Economics in relation to the Carbon Pollution Reduction Scheme (CPRS) Bill 2009.

AFMA is the peak industry association for Australia's wholesale banking and financial markets. These markets play a pivotal role in the Australian economy by making it possible for Australian financial institutions and companies to conduct business with each other and with their counterparts overseas. AFMA represents industry participants in the wholesale banking and financial markets, including Australian and foreign banks, securities companies, fund managers, traders in electricity and other specialised markets and industry service providers.

AFMA has taken a close interest in the development of government policy on emissions trading. We have made submissions in response to both Garnaut Review papers, to the Government's Green Paper and to this Committee on 27 March in relation to the draft exposure legislation. AFMA has worked with the Department of Climate Change on the key design elements of an emissions trading scheme. Many of AFMA's members have experience in trading environmental/energy products (eg renewable energy certificates) and will be key enablers of an emissions trading market.

1. Summary Comments

An efficient market for carbon permits (eligible emissions units) is critical to meeting the Government's policy objective in introducing the CPRS. On 4 May, the Government announced a one year deferral of Scheme commencement and that the first year of the Scheme (2011/12) would be a fixed price regime, in effect postponing the start of emissions trading by two years. The deferral of the CPRS start date, coupled with the prospect that the CPRS legislation may not be passed by Parliament this year, has

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caused uncertainty about the form and timing of an emissions trading scheme, making forward planning and investment decision making problematic. We believe these changes, and the consequential uncertainty, are detrimental to the development of a fully effective carbon market.

This setback to the market's development places even greater importance on the role of the consequential tax and regulation measures in supporting development of an efficient market. Several matters, including the proposed GST rules for carbon transactions, need to be addressed in order to improve the orientation of government policy towards the development of the carbon market.

2. Scheme Deferral and Fixed Price Transition

After much consultation and deliberation, the Government has accepted that a market-based approach, which places a price on greenhouse emissions, is the most effective and economically efficient mechanism to achieve the Government's CPRS objective. This is consistent with the approach taken in Europe and that planned by the US Administration. However, the recent decision to defer introduction of the Scheme, combined with uncertainty about the passage of the CPRS legislation and continuing concern about aspects of the legislation, may compromise the launch of an emissions trading scheme.

In effect, the fixed price regime for 2011-12 means the cap and trade market start-up has been delayed for two years. A fixed price removes key motivating factors for the development of price discovery and risk management capabilities, which are essential to an efficient market and could not begin to operate effectively until at least 2012. Moreover, the transition from a fixed price to market determined price under a cap and trade scheme will inevitably present challenges, as there is likely to be a step-change in permit price. There is also the danger of the fixed price concept becoming entrenched and the Government being subject to pressure to retain a fixed low price regime or a further delay to market determined pricing.

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. 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. 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.

We understand from our members that forward trading of carbon in Australia has virtually ceased, which means that until the first auction of future vintages, there are unlikely to be reliable price signals as to the future cost of carbon. Even then, auction results are not an effective substitute for the absence of a liquid forward market.

We have cautioned against any delay in CPRS commencement, noting that it is very important that certainty be provided as soon as possible to other existing markets that will be impacted by the CPRS. In particular, liquidity in the market for term electricity

contracts (for both electricity supply and electricity derivatives) is restricted by participants' inability to accurately factor in a carbon price past the fixed price period.

The decision to defer implementation of the Scheme has imposed a direct cost on many electricity market participants that had taken prudent steps to cover their expected exposure to the price impact of the CPRS on National Electricity Market pool prices post 1 July 2010. Our analysis of Sydney Futures Exchange (SFE) price movements on 4 May indicates a transfer in the order of \$70m. It is not possible to determine the corresponding figure for over the counter transactions, but the amount would have been significant.

For fixed price contracts, such as the power price hedges on the SFE which reflect some of the anticipated price impact of the Scheme on power prices, the parties are essentially betting on whether or not the Scheme will be introduced during the term of their power hedge. If the Scheme is introduced, the buyer gets a windfall, and if the Scheme is delayed or not introduced at all, the seller gets a windfall. These significantly different outcomes are inhibiting the execution of transactions and preventing price certainty for businesses and consumers.

3. Matters that Require Further Attention

The setback to the development of the carbon market outlined above highlights the need for associated tax and regulation measures that do not present a further barrier to its growth and development. In this context, we remain concerned about several aspects of the CPRS bills that have been carried over from the exposure draft legislation, as outlined below.

1. GST treatment of carbon permits

Imposing the GST on carbon permits, as proposed in the CPRS (Consequential Amendments) Bill, will conflict with the objective of the Scheme in 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, which are generally treated as exempt. 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.

Some recent developments support reconsideration of the proposed GST treatment:

- On 19 March this year, the Minister for Climate Change and Water announced that Australia and New Zealand have agreed on terms of reference to explore harmonising the design of the CPRS and the New Zealand Emissions Trading Scheme. 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.

- 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.
- On 12 May this year, the Government announced a review of the GST treatment of financial supplies with a view to reducing their complexity and introducing more principled rules, while maintaining the existing policy.¹ Since the Government has proposed in the CPRS (Consequential Amendments) Bill that carbon permits will be considered to be a financial product for regulatory purposes, the GST review of financial supplies presents a timely opportunity to assess the significant administrative and market system challenges of imposing GST on carbon permits. This would enable the Government to improve the consistency of the interaction between its financial market regulation and taxation rules and take action to alleviate the problems identified.

In summary, the proposed GST treatment will create complexity and compliance cost which is not reflected in the Regulatory Impact Statement and will detract from the performance of the market. Complexity will arise because of the range of possible tax outcomes for trading in carbon permits and associated derivative products. Extra cost will arise through compliance measures that would otherwise not be necessary and through the need to modify financial dealing systems designed around financial supplies that are input taxed and currently do not require tax invoices or the ability to track GST payments. There may also be cost to some financial institutions through non-recoverable GST payments.

Since the CPRS will be a business to business market (with participants generally able to recover GST paid), there should be no significant loss of revenue by making carbon permit transactions GST free. GST free treatment would be easy for business to comply with and for the ATO to administer. This outcome can be achieved by applying Division 38 of the GST Act to eligible spot market transactions.

2. The designation of a carbon permit as a financial product

The Government has decided to treat carbon permits as financial products by inserting into paragraph 764A(1) of the Corporations Act both Australian emissions units and eligible international emissions units as things which are specifically defined to be financial products [schedule 1 of the CPRS (Consequential Amendments) Bill]. As a consequence of this decision, it will be necessary to introduce a number of legal clarifications and relief measures to ensure that the carbon market can operate in the manner contemplated by the Government in designing the CPRS.

¹ This follows a recommendation from the Board of Taxation's Review of the Legal Framework for the Administration of the Goods and Services Tax.

The Committee could assist the process by supporting measures (as outlined in more detail in our 27 March 2009 submission to this Committee) to:

- i. Remove the risk that an entity's participation in the auction process will cause it to require holding an Australian Financial Services licence;
- ii. Expand the 'own dealing exemption' in section 766C(3) of the Corporations Act to include dealing in 'eligible emissions units' on behalf of a group (as defined in National Greenhouse and Energy Reporting Act 2007);
- iii. Provide an exemption for market making where a controlling corporation is simply operating a trading desk to acquire permits on behalf of members of group companies;
- iv. Expand the Corporations Act² exemptions that enable foreign-regulated wholesale financial services providers to deal in the Australian market to cover carbon permits.

In the absence of specific regulatory relief as outlined above, designating carbon permits as a financial product would impose a considerable cost on Scheme participants and increase the regulatory burden on business. It would also reduce the quality of the market and curtail Australia's ambitions to be the 'carbon hub' in the Asia-Pacific region.

3. The setting of price caps.

As stated in our submission of 27 March to the Senate Economics Committee, an emissions trading scheme should be free to operate without the distorting intervention of a price cap. However, we drew some comfort from the Green Paper statement that the price cap would be set high enough above the expected permit price to ensure a very low probability of use and that it would operate only in the first 5 years of the CPRS. Now that assurance has been thrown into doubt given the Government's decision to impose a fixed price in the first 12 months of the scheme, meaning in effect there is no tradable market initially. We are concerned that once a fixed price is established, the Government will come under pressure to retain it and the same concern arises with regard to setting any reasonable price cap.

In the longer run, setting a price cap will inhibit the market from doing its job in placing a true value on carbon permits and sending price signals that will influence consumers and investors to make decisions in keeping with the overall objectives of the CPRS. Setting a price cap so high as to avoid this outcome raises the question of why set one in the first place.

AFMA's in-principle position is that the market should be free to operate without the potential distorting intervention of a price cap. Therefore, within the framework provided by the CPRS Bill, we think there is a good case to err more on the side of caution by setting a higher price cap.

² Section 911A(2)(h) enables ASIC to recognise substantially equivalent regulation of foreign wholesale financial services providers by overseas regulators. However, countries like the United Kingdom and New Zealand do not regulate carbon permits as a financial product and, as such, most likely will not be considered to have a sufficiently comparable regulatory regime for ASIC to grant relief.

4. Concluding Comments

Thank you for considering our comments above on this important matter. Please contact our Head of Policy & Markets, David Lynch, by telephone on (02) 9776 7991 or via email on dlynch@afma.com.au, with any queries. We would be happy to respond at your convenience.

Yours faithfully

A handwritten signature in blue ink that reads "Duncan Fairweather .". The signature is written in a cursive style.

Duncan Fairweather
Executive Director