Westpac

Submission by Westpac Banking Corporation

Carbon Pollution Reduction Scheme: Green Paper

10 September 2008

Overview

Westpac strongly supports the need to implement robust, deep and liquid emissions trading mechanisms as the most effective means of reducing greenhouse gas emissions in a responsible and cost effective manner.

Doing nothing is not an option. Failure to implement an effective response to the challenges posed by climate change will endanger Australia's future economic prosperity.

As a financial institution with a strong track record for prudent fiscal management, Westpac believes that market based mechanisms such as emissions trading are the most effective means of achieving least cost emissions reductions across the economy.

There is no doubt that the impact of the introduction of a price on carbon will be felt across industry and across the economy. There is a case for a number of adjustment support mechanisms to be established with the introduction the scheme to allow business and members of the community to transition into a carbon-constrained economy. However utmost care must be exercised that compensation measures do not undermine the integrity of the scheme or alleviate the impact of the introduction of a carbon market.

Overall, Westpac welcomes the model as set out in the Green Paper and supports most of the specific provisions detailed in the Carbon Pollution Reduction Scheme (CPRS). Establishing a new financial market, in any form, is inevitably a difficult undertaking. This is particularly so with the carbon market, as it involves the complex interaction of financial trading tools and processes, international and domestic politics, broad impacts on economic interests fundamental to Australia's future economic growth and future-focused climatic modelling.

Westpac would strongly emphasise that the Carbon Pollution Reduction Scheme is fundamentally a financial market. In seeking to apply a market mechanism to achieve greenhouse gas emission reductions across the economy, the market must be allowed to function effectively, without overt interference from buffering policy mechanisms or overly-generous compensation allocations which distort the market, undermine the intent or integrity of the scheme or which provide market participants with the means of avoiding the medium to long-term behavioural change intended by the introduction of a price on carbon.

Westpac strongly supports the involvement of financial markets participants in discussions around the implementation of emissions trading in Australia for the following reasons:

1. Financial institutions have the pre-requisite knowledge and direct experience of trading in financial markets, including in international carbon markets, to comment on the practical implications of various design elements and transitional arrangements as Australian organisations move into a carbon constrained economy;
2. Many of the practical aspects of the CPRS will follow the same or similar behavioural and price patterns of existing financial markets, thereby putting financial institutions in an excellent position to prove commentary on how the CPRS is likely to develop in practice following the implementation of different design proposals; and

3. It is financial markets participants who will develop the financial products and services which will facilitate greenhouse gas mitigation at the least cost for organisations covered by the CPRS.

Westpac recognises the consultation undertaken with the financial services sector to date by the Government, and looks forward to ongoing dialogue on the design and implementation of the forthcoming Carbon Pollution Reduction Scheme.

Westpac's submission draws upon the bank's considerable, market leading experience in factoring environmental considerations into business policies, systems, and procedures as well as our practical participation in environmental markets to date. Westpac has been trading in the EU ETS since late 2006 and in May 2008 undertook the first trade of permits to be issued under the CPRS, agreeing to purchase 10,000 permits from AGL for delivery 2012 at a price of $19 a tonne.

In commenting on the preferred positions set out in the Green Paper, Westpac has sought to propose measures aimed at ensuring an efficient, liquid and transparent carbon market with a smooth process of price discovery and avoiding the sudden market shocks which beset the early stages of the EU ETS.

This submission provides some initial commentary on the potential operation of the scheme as a whole as well as some detailed comments in response to specific provisions set out in the Green Paper. Westpac would be happy to provide any additional commentary or respond to any questions on the comments set out below in further dialogue.

Detailed comments on preferred positions

Westpac has sought to comment on the following aspects of the proposed CPRS:

i. Coverage
ii. Carbon Markets
iii. Emission targets and scheme caps
iv. Reporting and compliance
v. Linking to international markets
vi. Auctioning of permits
vii. Assistance for EITE and strongly affected industries
viii. Tax and accounting issues
ix. Governance arrangements and implementation

It should be noted however, that the scheme must ultimately be evaluated as a whole entity and not merely a sum of the parts. Should a key feature change, it would undoubtedly affect the operation of other elements and preferred positions may need to be re-assessed.

Where no additional detailed commentary is provided, support for the preferred position set out in the Green Paper can be inferred.

(i) Coverage

Westpac supports the proposal to make the scheme as broad as possible, incorporating all six greenhouse gases specified under the Kyoto Protocol and across key contributing industry sectors. In addition, the threshold of 25,000 tCO_2 p.a appears to be reasonable.

This will benefit the functioning of the market by creating additional depth and liquidity in trading activity, thereby providing more opportunities to identify lower cost mitigation.

Without genuine opportunities to manage their carbon risks in a competitive fashion, companies are more likely to hold onto their permit allocations to meet compliance requirements without realising the benefits of the market to achieve lowest cost abatement.

For this reason, Westpac continues to support including a broad range of industry sectors while establishing short term transitional buffering arrangements around price impacts (such as the fuel tax offset). In Westpac's view it is preferable to establish broad industry sector coverage from the outset and gradually wind back transitional arrangements, then to seek to expand industry sector coverage at a later date. However, Westpac would still caution against establishing an excessive number of buffering mechanisms for the price impacts of the scheme in specific sectors at the risk of undermining the intent of the scheme.

Westpac supports the delayed inclusion of the agricultural sector within the scheme, but would support greater clarity on the role and responsibilities of the agricultural sector sooner than the 2013 date indicated in the Green Paper to remove ongoing uncertainty across the sector.

Westpac would specifically support an increased focus on education and awareness raising for the agricultural sector to assist property owners understand future liabilities and opportunities embedded within their farming practices. Similarly, Westpac would recommend greater clarity in the relationship between regulations surrounding land clearing and the exclusion of deforestation and inclusion of reforestation activities within the scheme.

Westpac would also support the inclusion of offset credits generated in industry sectors not covered by the scheme. Westpac believes that there is a continuing role for the voluntary market within Australia and in correlation with the mandatory market. This would need to be supported by an appropriate certification and verification regime under Government auspices.

(ii) Carbon markets

Permit characteristics

Westpac supports the broad permit characteristics set out in the Green Paper under 3.1 and 3.2. However, Westpac does not believe that it is necessary for a permit to be designated as a financial product for the purposes of the *Corporations Act 2001*. In the same way that Renewable Energy Certificates, or indeed any other commodity is not itself treated as a financial product, the underlying commodity in carbon trading (the AEU) should not be treated as a financial product.

Designating an Australia Emissions Unit (AEU) as a financial product will introduce overly onerous licensing implementation costs, restrict market participants and establish unnecessary and lengthy conduct, advice and disclosure requirements.

However, Westpac would support the application of market rules similar to other Over-the-Counter (OTC) markets, that is contracts in respect of an AEU may be a financial product and therefore governed by the *Corporations Act*. This would ensure that the various obligations associated with a permit being a class of financial product are appropriate for the market and the market participants. Regulations governing the conduct of the auction process would also be appropriate.

Banking and borrowing
Westpac supports the use of banking within the CPRS. Banking provides compliance flexibility, encourages early emission reductions and reduces compliance costs. It also allows firms to manage emissions profiles more smoothly from year to year to reflect production variations and the business cycle.

The ability to bank carbon permits for use in future years would also serve to smooth out price volatility, helping to avoid situations where an excess of permits at any given time might depress the carbon price.

Westpac has consistently raised concerns about allowing emitters to 'borrow' from their future allocations of permits, in the expectation that it would weaken the price signal and undermine the need for active participation in the market, as well as potentially distort market behaviour to the detriment of the stated intent of the ETS to reduce overall greenhouse gas emissions. This remains our position.

However, we believe that the provision of a limited amount of 'short-fall' borrowing (less than 5 per cent) of obligations from the following year would be acceptable. The use of this method of safety valve will need to be clarified, however, to demonstrate that use of the subsequent year's vintage for up to 5% of current year obligations <u>would constitute compliance under the scheme</u>. This would need to clarify when penalty provisions would subsequently be triggered as well as averting any potential ambiguity about cross-default into other financial products.

Westpac recommends that greater clarity be provided on what implications 'short-fall borrowing' would have for the designation of 'non-compliance' under the scheme and the ensuing penalty provisions.

Price cap
<u>Westpac does not support the application of a price cap for the first five years of the scheme</u> on the grounds that it will weaken the integrity of the market.

Westpac believes that the compensation provisions and transitional measures outlined in the Green Paper, coupled with access to international market mechanisms, would be sufficient to buffer cost impacts accompanying the introduction of the scheme.

This is particularly the case considering the price cap would be established in addition to the proposed combination of compensation and price offset arrangements, free permit allocation, direct assistance, access to the Climate Change Action Fund, permit banking and allowance for borrowing from future allocations and access to international offset credits.

As has been the case in other compliance markets, the presence of a cap on the price of carbon has the potential to distort market behaviour. The price cap, or any fixed price in the early stages of the scheme, could provide significant opportunities for arbitrage behaviour, as market players seek to take advantage of the differential between pricing pre and post the review point. Arbitrage behaviour could disadvantage smaller market participants and less experienced financial market participants.

The application of a cap on the price also has implications for international linkages and would take the Australian scheme out of step with other significant markets, such as the EU ETS. This would competitively disadvantage Australian banks currently establishing international trading operations, and would therefore limit the ability of Australian banks to provide the most competitive financial products and solutions for market participants.

The use of market mechanisms to achieve emission reductions at least cost across the economy will only be effective if the CPRS is allowed to function as a market. By ensuring that scheme design is sound from the outset, Westpac believes that there would be no need for a price cap as the CPRS would avoid the price spikes experienced in the EUETS.

Experience in the EUETS has shown that policy decisions around the form and function of the emission trading scheme are one of the most significant factors influencing pricing in the market. The establishment of a fixed review point with the potential to significantly alter the market could be seen as delaying the inevitable at best, and a primary source of price shock at worst.

If the CPRS were to proceed with a price cap, two main conditions must be precedent. Firstly, it is vital that the cap is for a limited period only, and that any adjustments to the cap or ultimately the decision to remove the cap, be telegraphed to financial markets in advance and that this commitment be strictly adhered to. Secondly, the price cap would have to be set at such a level as to avoid any possibility of the market trading up to this price under business as usual market conditions. The intent would have to be that the price cap is only for the purposes of unforseen or extreme market conditions.

Having said this, Westpac would strongly discourage the application of any price setting mechanisms, such as a cap or a fixed price as was flagged recently by Professor Garnaut.

Designing an ETS with price ceilings or floors built in fundamentally undermines the trust in and functioning of the market by weakening incentives for market participants to pursue responsible and efficient trading behaviour. As such Westpac does not support the imposition of price controls onto the market.

(iii) Emission targets and scheme caps
While not seeking to comment directly on what the most appropriate target or emission reduction trajectory Australia should adopt over the medium and longer term, Westpac would advocate that any emission reduction trajectory strongly references the climate change science, minimises the amount of complexity and politicking around ongoing adjustments to the trajectory to ensure maximum market certainty and that any changes to the trajectory are telegraphed well in advance to avoid market volatility.

Westpac is broadly supportive of the approach to setting the scheme cap and indicative national emission reductions trajectories, as well as the timeframes around decisions on emission targets and scheme caps. Westpac recognises that further detail on specific emission reduction targets and scheme caps will be released at the end of 2008 and look forward to providing further feedback at this time.

(iv) Reporting and compliance

As with any financial market maximum disclosure of robust supply and demand data minimises volatility and reduces price spikes. As such, Westpac does not believe that the market disclosure provisions set out in the Green Paper are sufficient to meet this intent – specifically in relation to the timing of information reporting and release.

Westpac would strongly advocate that data be released to the market on a quarterly basis. While recognising that this may be onerous for some companies in the initial stages of the scheme, the regular, transparent provision of supply and demand information to the market is crucial – particularly in the early stages of the scheme – to ensure that market shocks and price spikes are avoided.

Restricting reporting obligations to an annual basis purely on the basis of the initial workload poses the risk of designing the scheme for transition and not for longevity. While this data need only be audited annually, quarterly disclosure is crucial to smooth price discovery and efficiency functioning of the market.

It should be noted that annual-only reporting of emission data to the market within the EU ETS was one of the contributing factors to the massive price movements experienced in the early years of the scheme. Australia would do well to learn from this experience.

More broadly, Westpac would recommend that the following published information would be sufficient for the purposes of market analysis:

- Volume and price of permits at auction;
- Volume of permits allocated free by sector;
- Shortfalls in surrender of permits by sector; and
- Extent of non-compliance for market participants for the scheme in total and potentially by sector.

Westpac does not believe that data need be disaggregated to the entity level, as supply and demand information at the sectoral level will provide sufficient detail to support ongoing market analysis and price forecasting.

Westpac supports the use of the National Greenhouse and Energy Reporting (NGER) framework as the basis for measurement and reporting of emissions. Emissions measurement and reporting should be simple and straightforward as is practical and Westpac would support the centralisation and unification of emissions and energy data reporting wherever possible. Westpac would also support moves towards a standardised carbon accounting model for the incorporation of carbon into financial reporting aimed at promoting greater carbon risk disclosure.

Westpac supports the use of compliance and penalty provisions which are sufficiently punitive to ensure market participants to meet their acquittal obligations. It is important that these provisions not be considered an attractive alternative to engaging with the market to meet compliance requirements. Westpac recognises that compliance and enforcement provisions are yet to be finalised, and looks forward to receiving additional information on this aspect of the scheme.

(v) Linking to international markets

Westpac strongly supports proposals to ensure scheme design allows for linking to international markets. Any transitional measures established around the introduction of the scheme must, therefore, be short term and not undermine the integrity of this fundamental principle.

Westpac <u>strongly supports the use of international offset credits through the market mechanisms set out in the Kyoto Protocol</u> through the Clean Development Mechanism (CDM) and Joint Implementation (JI) mechanisms. Allowing the use of international offset credits provides additional depth to the market, links into existing liquid markets internationally and allows Australian companies with international operations to access greater low cost abatement opportunities. It will also help support greater investment in clean technology in developing countries promoting stronger environmental outcomes.

It will be important to ensure that any price control or suppression mechanisms established around the scheme do not undermine the value of ensuring access to international market mechanisms.

<u>Westpac promotes the rapid establishment of supporting infrastructure</u>, to support the holding and trade of international offset credits through these mechanisms as a priority for Government, and strongly supports providing access to international offset credits.

Westpac also recognises the need to minimise added complexity and volatility by avoiding direct linking to existing international markets in the early stages of the scheme's operation, with a long-term view to reviewing linking opportunities in the future. It is worth noting that if the market is successfully established there will be further scope for Australia to play a niche role in carbon trading for the region, consistent with the Government's desire to become a regional financial services hub.

Westpac supports active engagement with the policy dialogue internationally to ensure that an international agreement is reached within a reasonable timeframe and that Australia's best interests are well-represented. Australia has a role to play in ensuring that market mechanisms, such as the Clean Development Mechanism, which are so important to economic growth in our region, are rolled into the post-2012 agreement. International market mechanisms also have a valuable role to play in helping Australian business achieve least-cost emission reductions across their entire portfolio of operations.

(vi) Auctioning of permits

Westpac supports the establishment of frequent permit auctions conducted quarterly, or preferably monthly. Smaller, more frequent auctions supports permit supply, smooth price discovery, minimises cash flow shocks for participating companies, promotes accessibility to the market and minimises price shocks.

Westpac would also support the advance auction of future year vintages several times a year, rather than once a year as proposed in the Green paper. The rolling availability of future vintages would help develop secondary markets, such as the 'repo' market, and promote smooth carbon price discovery. By way of example, if auctions were held monthly, the auctioning of each of the subsequent three vintages could be held quarterly, resulting in only two vintages auctioned at each of the 12 auctions.

In reviewing the proposal to hold at least one auction following the end of the financial year and prior to the relevant surrender date, Westpac believes that this would only need to be short term measure at the start up of the scheme, if fundamental scheme design is sound.

While acknowledging that some commentators may have concerns over the potential complexity and resource-intensity of the ascending clock approach for auctions proposed in the Green Paper, Westpac believes that this is the most efficient and transparent approach for this kind of market.

Ascending clock auctions are the most equitable of auction types, limiting the probability of inexperienced entities to be disadvantaged by the auction process and is not necessarily more onerous than other approaches. Should an entity wish to replicate a sealed-bid single-clearing-price auction behaviour, for example, they can still do so within an ascending clock approach.

<u>Westpac does not support the proposal that only those entities that receive free allocations be allowed to sell them through the auction process.</u> This appears to be inequitable to any other seller not in receipt of free permits. Having already received the permits free of cost, it does not appear to benefit the market in any way to then allow these entities to sell them through the auction process. In fact, it may actually increase price volatility. Ensuring that the maximum number of permits enter the market through standard channels will also increase liquidity in secondary markets.

Finally, Westpac <u>supports the move to 100% auctioning of permit as the scheme matures</u>.

(vii) Assistance for Energy Intense Trade Exposed (EITE) industries and other assistance measures for strongly affected industries

As a large financial institution with relationships at all levels of the economy and the community, Westpac recognises that all industries will face some change in their cost structures as a result of the introduction of the Carbon Pollution Reduction Scheme. The extent to which this impacts their financial bottom line will be determined by their ability to pass the cost through. For entities which are exposed to international trade competitiveness considerations, the ability to pass these new costs through will be limited.

As stated in the introduction to this submission, Westpac recognises that there is clearly a case for a number of adjustment support mechanisms to be established with the introduction the scheme to allow business and members of the community to transition into a carbon-constrained economy. However utmost care must be exercised that these do not undermine the integrity of the scheme or alleviate the impact of the introduction of a carbon market.

While acknowledging that the inclusion of any free allocation of permits in the scheme will impact the market, the proposal set out in the Green Paper to allocate approximately 20% of permits free in the initial stages of the scheme, rising to 30% with the inclusion of the agricultural sector, does not appear likely to have an overly significant impact on projected liquidity under the scheme.

While not commentating in detail on the specific methodology outlined in the Green Paper for determining EITE status or eligibility for strongly affected industries, Westpac would strongly support the consistent application of a robust and uniform approach for determining EITE status and eligibility for assistance. This would need to be subject to ongoing and regular review, telegraphed five years in advance, to ensure that compensation or assistance measures applied around the scheme do not undermine either the integrity of the market or the environmental intent of the scheme.

(viii) Tax and accounting issues

Westpac broadly supports the tax and accounting proposals put forward in the Green Paper, subject to ongoing clarification and greater detail in the White Paper to be released at the end of 2008.

However, we do not support the proposal to subject transactions to normal GST rules, and believes that transactions under the CPRS should be GST-free. This is the approach which has recently been adopted by New Zealand in regards to the operation of the New Zealand Emissions Trading Scheme. Westpac would also argue that tax treatment rules for trading in permits and associated derivatives should be aligned with the treatment applied to other derivatives markets.

(ix) Governance arrangements and implementation

Experience of the EU ETS indicates that carbon markets continue to be very sensitive to policy signals, changes in process or technical administration and new developments in international policy.

There is no doubt that the Government will have a number of roles to play within the AETS, including establishing the rules and the ETS framework, administering the ETS, issuing permits, certifying offset credits and potentially purchasing credits for national compliance purposes. Therefore the delineation of responsibilities between different entities responsible for the various roles must be open and transparent from the outset to provide the market with a clear understanding of how the CPRS will function.

It is vital that administrative decisions affecting the operational functioning of the market be undertaken in an environment as independently as possible, free from political sensitivities or representation from impacted industry sectors.

Therefore, Westpac supports the proposal mooted in the discussion paper, that an independent body oversee the administrative functions of the market, analogous to the Reserve Bank of Australia (RBA). Furthermore, Westpac supports the summary of administrative and government functions, as set out in the submission by the Australian Financial Markets Association (AFMA) on this discussion paper.