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Friday 18 April 2008

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Attention: Garnaut Review Secretariat

Re: the Garnaut Review's Emissions Trading Scheme Discussion Paper

Further to its participation at the Garnaut Climate Change Review Public Forum on 31 October 2007 and submission to Issues Paper 2 (Financial Services for Managing Risk: Climate Change and Carbon Trading) on 22 February 2008, the Australian Securities Exchange (ASX) welcomes the opportunity to respond to the above referenced Discussion Paper.

ASX commends the proposed approach to developing and delivering an effective ETS, and more broadly the informed discussion and debate on ETS design that the Garnaut Climate Change Review has stimulated.

Rather than re-iterate or summarise ASX's earlier submissions, the attached submission provides ASX's feedback on the Discussion Paper, particularly in relation to how ETS design will impact the efficiency of the resulting spot and forward markets.

We look forward to providing any further support or feedback required as the Garnaut Review completes its work.

Yours sincerely

A handwritten signature in black ink that reads 'Anthony Collins'. The signature is written in a cursive style and is positioned above a rectangular area with a light grey dotted background.

Anthony Collins
General Manager – Emerging Markets
Australian Securities Exchange



ASX Submission to the Garnaut Review's Emissions Trading Scheme Discussion Paper

Auctioning, Compensation & Transitional Assistance

In developing and delivering an effective Emissions Trading Scheme (ETS), the Australian Government will have to make some politically difficult decisions in order to minimise the impact of ETS design on: Australia's international competitiveness; and, inappropriate wealth transfers within the domestic economy. The relative merits and disadvantages of free allocation and auctioning of emission permits, particularly in relation to national competitiveness and wealth transfers, are well documented.

Less well documented is the extent to which the use of auctioning would better facilitate price discovery and risk transfer in the spot and forward markets. The more efficient the spot and forward markets the more effective the ETS will be at reducing emissions at least cost. Specifically, the use of auctioning in the allocation process for emission permits would:

- focus the attention of firms on their marginal cost of abatement, and in turn the identification of early abatement and offset opportunities and use of spot and forward markets to manage the associated price, counter-party and settlement risks;
- reduce the risk of emission permits being over-allocated to any given firm or sector (an in turn the credibility and efficiency of the scheme); and
- enable a diverse range of market participants without liabilities in the ETS to acquire permits to underpin their involvement in the forward market.

In relation to the first point, only a firm can estimate its own marginal cost of abatement. Hence, it would be to the detriment of discovering the marginal cost of abatement across the economy if firms were freely allocated permits. Moreover, notwithstanding the quality of baseline data that may be established through the National Greenhouse and Emissions Reporting (NGER) legislation, any process to freely allocate permits is likely to be imperfect (as will any mechanism to distribute compensation or transitional assistance outside of the scheme).

Any distortions in compensation and/ or transitional assistance may distort the efficiency of the markets servicing the ETS. Hence, wherever possible such arrangements should be dealt with outside the scheme and not paid in the form of free permits.

In summary, only the auctioning of permits will establish the true marginal cost of abatement, avoid gaming, over-allocation and windfall gains.

The Significance of the Forward Market

It will be the forward markets supporting Australia's forthcoming ETS that facilitate the price discovery needed to underpin informed investment and risk transfer. The larger the critical mass of permits on issue the more efficient the forward market will become, hence broader scheme coverage, offsets from non-covered sectors and linkages are advantageous in this respect.

Prior to the auctioning and/or free allocation of emission permits, firms will be able to manage their price, counterparty and settlement risks in the forward markets. In any efficient market: liquidity will gravitate to the forward markets. The forward markets will generate a continuous price signal whereas auctions will be periodic in nature.

If auctions were used to allocate emission permits, the forward market would help smooth supply and demand to the benefit of price discovery. An example of this in Australia's financial markets would be the use of futures contracts on baskets of Commonwealth Government Securities (CGS) by market participants when participating in auctions for State Government-issued securities, or book builds for corporate bond issuance.

Linkages

There are only three countries in the Asia-Pacific region with emission caps in the Kyoto Period (2008 to 2012). Linking Australian and New Zealand in a 'trading bloc' would create additional market liquidity and risk management opportunities for firms in both countries. Due to the significance of our respective agricultural and forestry sectors, Australia and NZ have a mutual interest to operate as a trading bloc (like the EU ETS) to achieve a critical mass of liquidity (and bargaining power in the international negotiation process). If the EU can cooperate to devise a single ETS, it would be a poor reflection on Australia and New Zealand if sovereignty issues alone were to delay a direct link between our respective ETSs at the earliest opportunity.

The CDM represents an existing pool of liquidity that Australia can leverage to its advantage. Notwithstanding that the CDM may represent a patchwork of emission reductions overwhelmed by increases in emissions within developing economies, it does represent a meaningful step towards a global market.

Over time, if separate ETSs link with each other, the international 'carbon market' will become more fungible, liquid and efficient. Linkages between different national or regional cap and trade schemes are desirable on efficiency grounds and, subject to compatibility, should be sought at the earliest opportunity.

Trajectories

Changing trajectories or introducing linkages without sufficient notice represents a risk that will be difficult for the financial markets to price. The Discussion Paper therefore rightly acknowledges that 'conditions which would lead to a movement from one trajectory to a more stringent trajectory would be specified in advance' and that 'once on one trajectory, government provides five years notice before movement to another'. It should be noted that new linkages will fundamentally change the supply constraint and therefore advance notice of linkages should be provided through the same mechanism as for a new trajectory.

A fixed trajectory for more than 5 years would be more beneficial for investment certainty, however there is an obvious trade-off in that (say) a 10 year fixed term would reduce the flexibility to adjust the trajectory to reflect the status of international negotiations and linkages with other ETS and Kyoto trading mechanisms.

If the notice period is 5 years, as proposed in the Discussion Paper, then a robust forward markets is unlikely to extend beyond this timeframe. For example, liquidity in the forward market supporting the EU ETS is almost exclusively for the period covering 2008 – 2012 for which there is regulatory certainty and an emissions cap. Draft legislations and targets for different outcomes in the international negotiation process is insufficient to support a robust forward market beyond 2012. Given liquidity in most forward markets servicing commodity and energy markets do not trade forward more than 4 years (the EU ETS being on exception), 5 years notice appears to be an appropriate compromise.

The Government Registry

It will be important that the Kyoto compliant national registry for emission permits and any fungible credits is operational prior to the formal commencement of the ETS, and that the mechanism for access is more efficient than the web-based key stroke title transfer mechanisms that currently support the much smaller NSW Greenhouse Gas Abatement Certificate Scheme (NGACS) and the Mandatory Renewable Energy Target (MRET) scheme. Any delays to the development of stand-alone registries will impede title transfer pursuant to trades in spot and forward markets.

Scarcity

When it comes to the trajectory for Australia's emission caps over the period to 2020 the fact that Australia is on-track to meet its Kyoto commitment for the period 2008 to 2012 is a moot point. Any credible 5 or 10 year trajectory will, assuming permits can be banked, imply greater scarcity than our Kyoto target. This is important because in the absence of sufficient scarcity the market will not function.

Banking and Borrowing

The credibility and efficiency of a scheme would not be diminished if the proposed Independent Central Bank were to administer a 'lender of last resort' function on the proviso that the extent of lending is transparent and the process robust.

The commercial lending of permits of the same date stamp via repurchase agreements should not be restricted in any way. Repurchase agreements will enable firms to derive an income from permits (in effect the permits become working capital) and in turn liquidity providers to hedge forward selling activity that will underpin a liquid forward market. The importance of auctioning a critical mass of future year stamped permits into the market at the earliest opportunity to underpin liquidity in the spot and forward markets can not be understated.

Governance

The administration of the ETS would be best performed by an independent institution that operates within policy parameters established by legislation.

Market Evolution

It is appropriate that any forthcoming legislation to underpin Australia's ETS does not prescribe how the financial markets evolve; be it on or off-exchange or through the mandatory reporting of spot or forward trades. Successful over-the-counter markets and exchanged based spot and futures markets with their own rules will emerge when there is a critical mass of support for their value proposition.