



19 February 2016

Submissions
Climate Change Authority
GPO Box 1944
Melbourne VIC 3001

By email: submissions@climatechangeauthority.gov.au

Dear Sir/Madam

The Australian Financial Markets Association (AFMA) welcomes the opportunity to make this submission commenting on the Special Review, Second Draft Report, Australia's Climate Policy Options.

AFMA is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets. AFMA has more than 120 members reflecting the broad range of participants in financial markets, including Australian and international banks, leading brokers, securities companies, fund managers, energy traders and industry service providers.

AFMA's previous work in relation to environment-related initiatives involves two principal areas:

- Policy development and promotion – Seeking to influence the market design process (including the institutional framework, market rules and regulation) to ensure that the emerging market will operate in an efficient manner (especially in regard to pricing and resource allocation); and
- Technical implementation measures – Designing standardised documentation, market revaluation data and trading protocols to support the over-the-counter (OTC) markets.

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. Hence, AFMA is well-placed to assist the Government with the development of environmental market products.

AFMA does not hold policy positions on specific climate change policy options. AFMA agrees with the proposition that markets offer the best mechanism to cost-effectively reduce emissions. AFMA's main interest is in ensuring that any market-based mechanisms work efficiently and effectively. AFMA notes that the development of secondary trading may assist the Government to achieve its primary objective of reducing emissions in a cost effective manner. In addition, secondary markets act as a conduit for the efficient distribution and management of financial risks among the various participants in the marketplace.

Principles for Assessing Policies

The Second Draft Report seeks feedback in relation to the proposed evaluation framework for assessing Australia's climate policy options. AFMA make the following general observations on the proposed evaluation framework.

1. Climate change policy options should be assessed on the basis of the net benefits of all feasible policy options. The government's preferred policy approach should be based on those policy instruments that deliver emissions reductions at the lowest economic cost based on cost-benefit analysis across the full set of feasible policies. Such analysis will assist the government in making the case for its chosen policy approach.

2. Market-based mechanisms have important implications for the cost effectiveness of other "complementary" policies. An important efficiency benefit of schemes such as cap and trade is that other, potentially more costly, policy approaches will not lead to further reductions in overall emissions. These complementary policy approaches will need to be evaluated for their continued effectiveness in the presence of a market-based emissions reduction scheme.

3. The costs and benefits of emissions reduction need to be assessed against the risk of carbon leakage. As the consultation paper notes, "Australian firms could face higher policy-related costs than those of their international competitors, putting them at a disadvantage" (p. 35) in the presence of carbon leakage. The robustness of national and international commitments to reduce emissions should be part of the policy evaluation framework.

4. Climate change policy options should be politically-robust to provide certainty for market participants. For market-based approaches to emissions reduction to be successful, they need to generate credible price signals. This will only occur if the chosen policy options are perceived to be politically secure and not subject to continuous change driven by the political process. Australia's recent experience with an emissions reduction scheme and carbon tax demonstrates the harmful effects of political uncertainty on investment and secondary market development.

Recent experience with emissions reduction policies is notable for the uncertainty created by the political process. A summary timeline shows that the former emissions reduction framework was subject to seven major changes in five years:

May 2009: Emissions trading scheme legislation introduced with 1 July 2010 start date.

April 2010: Legislation withdrawn, no scheme to be introduced before 2012.

August 2010: Government promises not to introduce a carbon tax during election campaign

February 2011: Government announces carbon tax

1 July 2012: carbon tax commences with fixed price for three years

28 August 2012: government removes carbon price floor

17 July 2014: carbon tax retrospectively repealed from 1 July 2014.

The retrospective repeal of the carbon tax caused significant issues for market participants. Legislative changes with retrospective effect should be avoided as a general principle of policymaking and adherence to the rule of law.

Creating a Framework for the Development of Secondary Markets in Emissions Reduction

The development of secondary markets in emissions and emissions-related financial instruments may be a useful complement to a variety of approaches to emission reduction.

In order to create a framework for the development of a secondary market, the definition of some key terms will provide a coherent and consistent framework for this task. In this context, it is useful to draw a distinction between the Government's Policy and the "Market mechanism" that it adopts to achieve the related policy objectives.

The **Policy** comprises the entire body of objectives, institutions, rules, etc that define the Emissions Reduction Fund.

The **Market** is the transactional space beyond the primary auction process wherein among a variety of participants, unit price discovery occurs, units are exchanged for value and unit transaction types and mechanisms are deployed to facilitate price discovery, exchange and risk management.

The **Objectives of the Policy** can be generalised as achieving least-cost emissions abatement.

The **Objectives of the Market** are to deliver a credible and dealable price signal in its transaction space with low transaction costs in order to allocate units to entities which place greatest economic value on them and, thus, support the achievement of the Objectives of the Policy.

Policy Integrity refers to an overarching confidence by participants and the public that the body of rules and operations are, and will be, governed and managed in a manner that is exclusively aligned with unchanged Policy objectives.

Market Integrity refers to an overarching confidence by participants and the public that the activity, and the outcomes of that activity, within the transactional space is exclusively aligned with Market Objectives.

Principles to Guide Market Development

Having regard to the above definitions of the Market, Market Objectives and Market Integrity, the following high-level principles can be articulated:

- The Market should have scale and scarcity
 - *sufficiently large and priced to attract risk capital, which is critical for liquidity*
- The Market should have many willing buyers and sellers
 - *so as to form prices efficiently*
- The Market should facilitate competition in the provision of market services
 - *so as to increase trading opportunities, reduce transaction costs and promote innovation*
- The Market should not have asymmetric information or concentration of buy-side or sell-side demand
 - *so as to form prices efficiently*
- The Market should deliver credible price signals
 - *credible meaning that prices realistically reflect fundamental supply and demand for units and are not, by design features, forced artificially high or low; and that arbitrage forces are free to operate to reduce price extremes*
- The Market should deliver dealable price signals
 - *deable meaning that prices reflect the level of liquidity over a term structure that meets the needs of end-buyers and sellers and that rules and regulations are clearly interpretable to allow market standardisation of terms and conditions*
- Market forward prices should be more meaningful than the spot price
 - *forward prices provide the focal investment signals; neither contangos nor backwardations are inherently objectionable but extreme or persistent occurrences risk forward price credibility; Policy design should not contribute to persistent extreme contangos or backwardations*
- The Market should be able to create a wide variety of tradable products and instruments to satisfy the risk taking and risk management demands of participants and serve as building blocks in the design of products to meet the multifaceted needs of business and investors
 - *needs will emerge in a variety of risk products*
- The market governance process should support market integrity
 - *so as to support participant confidence in effective oversight by an autonomous authority to ensure an efficient, fair and orderly market*
- The Market should provide information to facilitate research and market analysis
 - *so as to support effective trading decisions (eg market technical analysis) and investment decisions, including about investments in projects and companies subject to a carbon constraint*
- The Market's design should be as simple as possible
 - *straightforward, transparent rules improve market access for potential participants and make market regulation easier*
- The Market and its ancillary service providers in legal, funds management, risk consulting etc is an industry that can readily develop export services via regional pre-eminence
- The Market should be able to operate in an environment with as much regulatory, financial and investment certainty possible.
 - *so as to ensure that investment decisions can be made with a high degree of certainty that changes in the underlying environment (such as the regulatory environment) will not produce unintended consequences.*

Conclusion

The development of secondary markets in emissions and emissions-related financial instruments may be a useful complement to a variety of approaches to emission reduction and assist the Government to achieve its primary objective of reducing emissions in a cost effective manner.

We hope that the Market Policy and Principles provided above are useful for your consideration in this regard and we look forward to working with the Government to achieve its environmental objectives.

Thank you for considering our comments in relation to this submission. Should you require further clarification on any matters raised here please contact me on (02) 9776 7941 or at mchadwick@afma.com.au.

Yours sincerely

A handwritten signature in black ink, appearing to read "M. Chadwick". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Mike Chadwick
Director – Markets