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### **Price floor for Australia's carbon pricing mechanism – Implementing a surrender charge for international units**

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Department of Climate Change and Energy Efficiency's discussion paper for the development of a surrender charge for international units under the carbon pricing mechanism.

esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 38 electricity and downstream natural gas businesses. These businesses own and operate some \$120 billion in assets, employ more than 61,000 people and contribute \$19.3 billion directly to the nation's Gross Domestic Product.

#### **Summary**

##### *Establishing a price floor for carbon*

The Clean Energy Future package has imposed a price ceiling and price floor for carbon permits during the first three years of the flexible price period (commencing 1 July 2015). The price floor will establish a minimum carbon price of \$15 for the sale of domestic permits in 2015-16. The price floor will increase by four per cent (real) each year.

The Clean Energy Future package has also allowed international linking of permits, with the stated objective of allowing Australian businesses "to access international emissions reduction opportunities that lower the costs of meeting Australia's emissions targets".

From 1 July 2015, up to 50 per cent of an entity's liability can be met using international permits. The government will impose a surrender charge to the cost of these international permits to ensure liable parties pay a total price equivalent to at least the price floor.

### *The importance of international carbon markets*

Although the flexible price period doesn't begin until 1 July 2015, energy companies will need to secure a price for carbon three to five years in advance to ensure they can continue to offer fixed price electricity contracts. Independent modelling shows that reduced electricity contracting could lead to increased wholesale market volatility and much higher prices for customers.<sup>1</sup>

To support normal levels of forward electricity contracting, in 2012-13 the energy industry will need to secure a price for around 175 million tonnes of carbon. A further 280 million tonnes will be required in 2013-14. Under the Clean Energy Future scheme, the Federal Government will not auction a single tonne of carbon in 2012-13. In 2013-14 the Government can only auction 30 million tonnes of carbon unless a regulation is made agreeing to Australia's 2020 emissions cap.

If this regulation is made, greater volumes of permits will be auctioned for future years. However, the proposed volumes will never be sufficient to cover the 400 million tonnes of future permits per year the energy sector will need. In addition, the Government will require payment upfront and in full for these permits – years in advance of when the permit is actually required and revenues from the electricity market have been recovered.

In this context, international carbon markets along with deep and liquid domestic secondary markets will be critical to ensure the energy sector can continue to secure a future price for carbon and continue to offer fixed price electricity contracts.

#### *Applying the price floor to international units so that the total cost is known*

To ensure that at least the price floor is paid for all units surrendered, the Government intends to apply a surrender charge to international units if their purchase price is less than the price floor.

In designing this surrender charge, it is critical to ensure that liable entities can calculate the cost of this surrender charge at the time of purchasing the international unit. If the total cost of carbon is unknown, then electricity generators may be unable to continue to offer fixed price electricity contracts.

For example, if the price of Certified Emission Reduction (CER) units is \$10 in 2012-13 then the energy industry needs to know in purchasing those units that the surrender charge will be \$5 (subject to a known time value of money calculation) if they are used for surrender in 2015-16. Electricity contracts can then be offered for 2015-16 that account for a \$15 cost of carbon.

However, if the surrender charge is not locked in, energy companies might pay \$10 for these units in 2012-13 but their price may then fall to \$5 by 2015-16. The surrender charge would then be calculated at \$10 and the energy company would have paid \$20 for carbon instead of \$15. Fixed price electricity contracts could not be made available which could increase volatility in the electricity market and further increase electricity prices.

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<sup>1</sup> See footnote 5 in Attachment A.

### *Ensuring a deep and liquid forward carbon market*

The Government has consistently argued through the development of the Clean Energy Future that a “liquid forwards market is crucial as it can help smooth out and reduce costs”.

To promote this depth and liquidity, it will be important to ensure that liable entities (and not just financial market speculators) have the flexibility to adjust their carbon positions in response to changing market circumstances. In this way, the energy industry can ensure that the lowest possible carbon cost is passed on to consumers while continuing to meet Australia’s carbon abatement objectives.

Energy companies may buy and sell both international and domestic carbon units in the lead up to a surrender year – either to cover their forward electricity market contracts or simply as speculative trade (as the financial sector will do). This will enhance and promote the depth and liquidity of Australia’s secondary carbon markets.

It is therefore imperative that the Government enable this flexibility and not require liable entities to lock-up hundreds of millions of units, years before surrender. The Government’s objective should be simply to ensure that for each unit that is surrendered (in the three transition years) the purchase price for those types of units is at least equal to the price floor in that year.

### *Options for applying a surrender charge for international units*

Of the four options set out in the discussion paper, only Option 2 will effectively enable liable entities to secure a future price for carbon while promoting depth and liquidity in secondary carbon markets. Option 2 is in fact the least-cost way of applying a price floor to international units.

Under Option 2, liable entities will be able to purchase international units and reference a published index to calculate the relevant surrender charge. Although option 1 is similar in design, the price paid for every individual unit would need to be examined (rather than referring to an index) and, while possible, the compliance costs could be considerable and may deter liable entities from directly investing in overseas carbon reduction projects.

As discussed, securing a future price for carbon is critical to underpin future electricity contracting. Option 3 uses the spot price on the day of surrender (rather than the day of purchase) to calculate the surrender charge and therefore creates volatility in this charge making it impossible to calculate the total carbon cost when purchasing international units.

Under Option 3 the discussion paper assumes the development of “financial markets...to assist liable entities to hedge against this risk [of surrender charge volatility] by providing products such as options.” The functioning of the price floor **should not** require the development of a new secondary market.

Rather than developing an unnecessarily complex system that relies on new financial markets in order to hedge a regulatory instrument, the approach should be to

implement a system that most simply delivers the policy objective in a way that works for liable entities.

Option 4 allows liable entities to enter a legal undertaking to surrender an amount of international units on a particular day in the future at a given surrender charge. While this has the advantage of allowing certainty, it would prevent liable entities from adjusting their carbon positions in response to changing carbon and electricity market circumstances. This would reduce the depth and liquidity of the carbon markets and prevent possible cost savings from being passed on to customers.

The Association considers that if a surrender charge is implemented it should be well-designed and meet the needs of liable parties. All of the options have weaknesses and complications and more detail is required to make a full assessment. However, based on the information presented in the discussion paper:

- We do not prefer Option 1. We do not agree with the discussion paper's conclusions on this option.
- Option 2 is strongly preferred. It most effectively minimises the interference of the surrender charge on the operation of the energy industry. We disagree with the discussion paper's reservations with this option and consider that it is the most suitable of the options for further development.
- We consider Option 3 to be the least appropriate of the four options as it relies on the development of a new secondary market to hedge the floating surrender charge price risk, incurring additional cost for liable entities.
- We regard Option 4 as almost a variant of Option 2 but with a number of weaknesses and complications.

Our arguments for and against the different options are set out in further detail in Attachment 1.

We also support the proposal raised at the technical meeting by the Department to insert an interim step ahead of the draft regulations to allow industry to consider a fully worked out proposal.

Any questions about our submission should be addressed to Kieran Donoghue, by email to [kieran.donoghue@esaa.com.au](mailto:kieran.donoghue@esaa.com.au) or by telephone on (03) 9670 0188.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Matthew Warren', with a long horizontal flourish extending to the right.

**Matthew Warren**  
Chief Executive Officer

## **Attachment 1: Detailed evaluation of the options presented in the Discussion Paper**

### **Introduction**

In our submission to the Department on the exposure draft legislation in August 2011 we said on the surrender charge:

“The energy industry considers that lower cost abatement would be better achieved without this charge artificially increasing the marginal cost of overseas abatement. The charge is likely to present a number of practical issues. It seems overly burdensome to implement and unnecessary to maintain the scheme’s integrity.”<sup>2</sup>

For these reasons, we continue to oppose an international unit surrender charge and consider that no Regulations to create one should be made.

However, if a surrender charge is regulated, then we consider it should be well designed and limited to the three years specified in the legislation. In this submission we respond to the Department’s discussion paper and provide our views on appropriate assessment criteria, the four implementation options, and design issues.

We appreciate the Department’s engagement with industry in this process so far and we look forward to the opportunity to provide comment on a fully worked out proposal for the surrender charge before the drafting of the Regulations.

### **Assessment criteria**

In this section we outline our assessment criteria for developing the surrender charge model and comment on the three assessment criteria in the discussion paper.

#### Industry’s assessment criteria for developing the surrender charge model

*It should be designed to minimise the impact on the energy industry*

In choosing a market-based mechanism to reduce Australia’s emissions – an emissions trading scheme (ETS) – the Government proposes that the best way for Australia to achieve its abatement goals is to incentivise businesses to integrate decisions about emissions and abatement into their regular activities and decisions.

As such, a key consideration in developing a surrender charge mechanism should be minimising any interference with the commercial activities of liable parties. The energy industry bears the largest liability in Australia and will surrender the majority of non-administratively allocated emissions units. Based on publicly available government figures<sup>3</sup>, our analysis suggests that once administratively allocated

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<sup>2</sup> Joint esaa/ERAA submission to the Clean Energy Future legislative package, available at: [http://www.esaa.com.au/Library/PageContentFiles/cef5404e-2cd2-403c-ab17-2f9752c6f03a/110822\\_Carbon\\_Legislation\\_submission.pdf](http://www.esaa.com.au/Library/PageContentFiles/cef5404e-2cd2-403c-ab17-2f9752c6f03a/110822_Carbon_Legislation_submission.pdf)

<sup>3</sup> Using data provided in the Securing a clean energy future document and the 2011-12 Mid-Year Economic and Fiscal Outlook.

permits are netted out, the stationary energy industry will account for around 85 per cent of directly covered emissions over the three years of the surrender charge. We therefore consider it reasonable that minimising the impact on the operation of the energy industry should be an overarching objective in the development of the surrender charge.

The surrender charge model should also be designed so that energy businesses can meet their regulatory obligation without needing to change the way they approach their core business of buying and selling energy. In contrast, any model that imposes a burden upon business that threatens to change a fundamental component of their operations would undermine the goals of the Clean Energy Future package.<sup>4</sup>

*It should provide certainty to support contracting*

Energy companies operate in a complex commercial environment. A fundamental part of the energy market is forward-contracting across interrelated markets for inputs (fuel) and outputs (electricity and gas) in order to manage risks. Energy contracting is typically three to five years in advance, which means that businesses will already be looking to hedge their carbon exposure during the period of the surrender charge. Given that in the future carbon will be a significant input into business costs,<sup>5</sup> energy companies will require as much certainty as possible about their carbon costs so they can effectively lock in spreads at the time of contracting. As the surrender charge is a part of a firm's carbon cost, the design of the charge should promote cost certainty for the liable party. This in turn reduces the overall risk profile of the sector, which will ultimately benefit consumers.

*It should not inhibit businesses' flexibility to manage their risks*

The surrender charge model should allow liable businesses flexibility in managing their price risks. As an example, an energy company may hold a range of hedge positions on fuel inputs, its energy output and carbon in order to facilitate a possible energy market transaction in the future. However, a development in a related market – for example, a change in a counterparty's circumstances – may mean the business wishes to adjust its position. It may then seek to unwind its hedge positions across its inputs and outputs. The design of the surrender charge should not constrain the business's flexibility to do this.

If the design of the surrender charge does inhibit flexibility, this could have the unintended consequence of reducing contracting in the energy industry. This could

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<sup>4</sup> We note that the carbon pricing mechanism legislation failed in this regard in a number of instances. For instance, a well designed carbon pricing mechanism would have reflected the commercial realities of liable parties and ensured, through appropriate settlement arrangements, that units bought at auction would not hinder the energy forward-contracting market.

<sup>5</sup> For example, ACIL Tasman found that at a price of \$25/tonne, carbon units would be expected to increase coal-fired generation total operating costs by between 100 and 300 per cent. See National Electricity Market modelling: Projecting changes to prices with changes to electricity contracting levels, ACIL Tasman, August 2011, page 11. Available at: [http://www.esaa.com.au/Library/PageContentFiles/305dd0f1-d2f7-41c4-927e-75473c3d967b/20110830\\_ACIL\\_Tasman\\_report\\_ESAA.pdf](http://www.esaa.com.au/Library/PageContentFiles/305dd0f1-d2f7-41c4-927e-75473c3d967b/20110830_ACIL_Tasman_report_ESAA.pdf)

have wider consequences for the community and economy. For example, modelling commissioned by the Association in 2011 found that a five per cent reduction in the level of contracting in the National Electricity Market could lead to a 10 per cent increase in retail electricity prices for households and 15 per cent for large users in a single year.<sup>6</sup>

*It should not prejudice carbon trading activity*

Businesses may trade in international carbon markets to meet their Australian carbon liabilities; they may also do so for reasons unrelated to meeting their Australian obligations. These are legitimate business activities, and the design of the surrender charge, therefore, should not prejudice businesses' carbon trading activities.

It follows that for the purposes of demonstrating compliance with the surrender charge, the regulator should take into account only the purchase price (or deemed purchase if an index model is used) of the surrendered international unit and not any trade of that or other units prior to surrender. All other activity in international carbon markets by the business, beyond the surrendered unit, should be beyond the regulator's remit.

*It should seek to minimise the scope for government/regulatory involvement*

The introduction of the Clean Energy Future package has introduced a raft of new regulatory risks for businesses. We consider the surrender charge model should minimise any additional regulatory risk for business by minimising the scope for government/regulatory involvement where possible.

As a specific example, the Regulator should not require the business to commit at the time of purchase of each unit whether it is being held for surrender or other purposes (e.g. for trading).

*It should minimise compliance costs*

In addition to the charge itself, there will be an increase in costs to liable firms to comply with the surrender charge regime. We consider that the model should aim to minimise these costs. For instance, there should be no increase in working capital costs from the surrender charge. This would imply no requirement to pay the surrender charge ahead of surrender date.

Similarly, while there is a need for appropriate compliance enforcement measures, the regulatory obligation should be proportionate to the non-compliance risk.

Comments on the discussion paper's assessment criteria

We consider the three criteria in the discussion paper a good starting point. However, they are insufficient (as indicated by our additional assessment criteria listed above), applied inconsistently and, in parts, are inappropriate, as we explain below.

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<sup>6</sup> See ACIL Tasman study.

## *Effectiveness*

The discussion paper considers that an effective floor price on surrendered international units is: “when liable entities make decisions about whether to abate or surrender eligible units, they face an opportunity cost of surrendering units that is equal to the floor price.”

We do not support this definition of effectiveness. Liable entities in the energy industry make abatement decisions primarily through investment in new plant and equipment and in the terms of contracting supply from other generators. These decisions are made, in most cases, months and years ahead of the final reconciliation of carbon liability and the surrender of permits. An effective floor on surrendered international units relates to the purchase price (or deemed purchase, if an index model is used) of the surrendered international unit. As we note above, as long as the price paid for the surrendered unit plus the surrender charge (appropriately discounted for the time value of money) is not less than the floor price, then the floor price should be considered effectively imposed.

It is not possible to design a model that will perfectly deliver a price floor in all cases. As we said in our August 2011 submission to the Department:

“Almost all mechanisms to implement the price floor will be inaccurate...”

For instance, due to slight variations between any index used and the actual price paid by the entity (as features in three of the four options) or between the assumed and actual time value of money, there will be a minor discrepancy between the floor price and the actual price paid. This is an unavoidable consequence of inserting a complex regulatory mechanism into a complex market. As such, we would caution the Government against striving for an unrealistic degree of perfection in its model, especially if the price of the marginal degree of accuracy is a reduction in the workability for liable parties.

## *Efficiency*

Including efficiency as an assessment criterion is imperative. We consider that market-based arrangements are the best way to achieve efficiency. However, we do not consider that the discussion paper’s definition of efficiency is broad enough. As outlined above, we consider that preserving the efficiency of the energy market and the wider carbon pricing scheme to also be important.

We agree with the discussion paper that liable parties’ ability to access markets to manage carbon risk is an important part of an efficient scheme. However, we do not agree with the notion in the discussion paper that the efficiency objective of the surrender charge model should include directly supporting the development of new markets to manage the risk of volatility in the surrender charge itself (which seems to be a reason the discussion adduces for Option 3). We consider a more efficient outcome would be designing a model where liable entities are not exposed to an unnecessary risk of surrender charge volatility and which does not require the development of a specific secondary market which has the scale, liquidity and competitiveness to function effectively. Rather, we consider the Government’s aim should be to ensure the primary market is structured in an effective manner.

### *Workability*

We consider this an important criterion. However, as outlined above, the definition should be broadened to include the workability of the surrender charge model with respect to the wider activities of liable businesses, such as the interaction between the surrender charge and energy market contracting practices.

### *An implicit criterion?*

While not explicitly mentioned in the discussion paper, we observe that the commentary on the options seems to imply the model should not cause liable entities to prefer international units over domestic units. If this is indeed a criterion of the government, we consider it should be made explicit. However, we reject this as a relevant criterion for assessing implementation options for a number of reasons. We explain our reasoning further in the context of Option 3 below.

### **Implementation options**

Below we discuss the four options in the discussion paper using our assessment criteria. As a fully informed opinion on the merit of any implementation option is only possible with knowledge of the detailed design features that would apply, our views below are necessarily subject to the detailed design features that would apply to each option.

The discussion paper does not appear to countenance the possibility of implementing more than one model. Such an approach could provide liable entities with the flexibility of choosing the model that best suited their circumstances. While we are not endorsing this approach at this stage – our views would naturally depend on the suite of models made available – we encourage the Government to consider multiple models.

### Option 1

Under Option 1, the surrender charge for any unit is based on the actual price paid.

This is not our preferred option. However, we do not agree with the conclusion that it is “not viable in practice” because challenges with compliance verification “cannot practically be overcome.”

Energy businesses must comply with numerous legal and regulatory obligations, and there is a range of ways that businesses demonstrate their compliance with these obligations to relevant authorities. As such, we do not think the discussion paper has sufficiently made the argument that this option is not viable.

We also contend that care should be taken in characterising business activities. For instance, it is inappropriate to misconstrue business practices as attempting to game the system when in fact they are commercially logical practices to achieve other objectives, such as managing market risks.

In addition, we consider irrelevant the discussion of businesses’ trading activities under the efficiency subheading for this option. As discussed above, the fact that

businesses can trade units prior to their surrender is not relevant to designing the surrender charge.

## Option 2

Under Option 2, the surrender charge for a class of international units is based on an index at the time the contract to purchase is entered into.

Of the models presented in the discussion paper, Option 2 best meets the industry's assessment criteria. In particular, it has the features that will best minimise the impact of the surrender charge on the industry without compromising wider carbon pricing scheme efficiency.

The key advantage is that it provides certainty<sup>7</sup> to businesses of the surrender charge that would be applicable if they ultimately chose to use these units to acquit their carbon liability when they are making the decision of whether to purchase international units. As such, it allows a fully considered decision to be made by a business in purchasing international units. This would benefit the energy sector overall by supporting contracting and other activities.

At the same time, the model does not inhibit the flexibility for liable parties to manage their risks and conduct their core business as no particular use of that unit is required to be 'locked in' (e.g. as it is with the undertaking feature of Option 4).

As the charge is based on the deemed purchase price of the surrendered unit and is paid at the time of surrender, it does not prejudice carbon trading activity or increase working capital costs.

Furthermore, while we are still working through the details, our view at this stage is that this model can be practically implemented.

We note that the discussion paper has identified some drawbacks with this option. Below we outline why we do not agree with the paper's reasoning.

### *Response to the discussion paper's concern about the preference for international units*

As explained above, we observe that the discussion paper implies that a preference for international units should be prevented. We consider this a spurious consideration in the context of developing the surrender charge for a number of reasons.

Firstly, the Government's policy makes clear that access to international units (of appropriate quality) is both economically and environmentally effective in that they lower the cost of achieving the scheme's objectives and are equivalent to domestic units from an environmental perspective. The Government's acceptance of international units as an important part of achieving Australia's abatement goals at least cost is demonstrated in Treasury's modelling, which estimates that around 170 Mt of international units would be acquitted in the first three years of the floating

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<sup>7</sup> Assuming the detailed design features are sensible.

price.<sup>8</sup> As such, the surrender charge should not aim to introduce a prejudice against international units in a way that the Government's carbon policy does not.

Secondly, given the rationale for a market-based scheme such as an ETS is to allow markets to determine the best way to achieve abatement goals, there is no reason to use regulatory mechanisms to force businesses to favour either domestic or international units. However, the legislation does not reflect this principle, as it constrains the amount of international units that can be surrendered up to 2020 to 50 per cent of an entity's liability. While we do not support the 50 per cent limit, we nonetheless consider that it represents the Government's policy on the 'appropriate' amount of international abatement. As the law prevents liable parties from exceeding this limit, there is no reason the international surrender charge should try to introduce an additional constraint on the use of international units.

For these two reasons we do not think that a preference for one unit type over another is relevant to designing the surrender charge.

We also note that it is incorrect to presume that the design of the surrender charge is the only or most relevant factor in a business's choice about whether to acquit domestic or international units.

A range of other factors influences this decision. For instance, domestic and international units have completely different risk profiles that businesses would compare in deciding which market to deal in. Some of the sources of risk are more relevant to international units, e.g., international regulatory risk, risk from unfamiliar foreign counterparties and exchange rate risk. On the other hand, international units are inherently more versatile than domestic units, as they can be sold on international markets or used by multinational business groups to acquit international obligations.

International units are also more flexible than domestic units. A critical reason for this is that international units can be forward-settled. The Government decided not to provide for appropriate settlement arrangements for the auction of future vintage domestic units in the legislation, choosing instead to rely on the development of suitable secondary markets to enable participants to manage their future exposures. The energy industry advocated strongly for appropriate settlement arrangements to be enshrined in the legislation.

As such, any preference towards international units that might be given by Option 2 is dwarfed by the government's choices in designing an ETS that fundamentally biases liable parties' preferences against domestic units.

The Association notes that this element of entrenched bias could be reduced by developing Regulations for auction design that allow for appropriate settlement arrangements and the issuance of future vintage units earlier.

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<sup>8</sup> This is based on modelled international imports over 2015-16, 2016-17 and 2017-18 in the Treasury's carbon price modelling. See Chart 5.2, *Australian emissions the core policy scenario* available at:

[http://www.treasury.gov.au/carbonpricemodelling/content/chart\\_table\\_data/chapter5.asp](http://www.treasury.gov.au/carbonpricemodelling/content/chart_table_data/chapter5.asp)

*Response to the discussion paper's concern on getting the uplift factor right*

The paper raises a concern that the uplift factor used to reflect the time value of money for units purchased in advance of surrender should be correct. Otherwise, it argues, the effective floor price may not be exactly \$15. We do not consider this a material concern. As noted in the discussion paper, different entities will have different time values of money. It is therefore impossible to have the 'right' uplift factor for all liable entities in the model. So striving for perfection in this design element is, firstly, unattainable and, secondly, inconsistent, given that other elements of the model unavoidably will be slightly different from actual values; for example, the market index under Option 2 is unlikely to be precisely the same price as entities paid.

More important is a straightforward and transparent methodology that reasonably reflects the likely time value of money for liable parties. There is range of information that could be drawn upon, such as forward markets. We note that the Government took such an approach in specifying a discount factor for the buyback of administratively allocated units ahead of surrender date during the fixed price period.<sup>9</sup>

As we note above, striving for an unrealistic degree of perfection is unwarranted, and thus we do not consider the uplift factor should be used as a reason to dismiss Option 2, especially given its broader attractiveness.

Given the strong advantages of Option 2 and the lack of strong reasons against it, the Association considers that of the options in the discussion paper, Option 2 is most suitable for draft Regulations.

Option 3

Under Option 3, the surrender charge for a class of international units is based on the observed market price at the time of surrender.

We consider Option 3 the least appropriate and the one that least meets the industry's assessment criteria.

In some ways, Option 3 is the opposite of Option 2. By design, it creates volatility in the surrender charge, making it impossible for the liable entity to know what its surrender charge is, and hence its carbon cost, at the time it decides whether to purchase international units. As such, it provides no certainty and risks interfering with the operation of the energy industry and the efficiency of the carbon scheme in general. As described above, a surrender charge model that hinders contracting could lead to unwarranted increases in energy prices.

For example, assume under Option 3 a liable entity was to purchase an international unit at \$20, but by the surrender date the international price was \$10. This liable entity would then pay a \$5 surrender charge. Under the discussion paper's criterion, this would be considered an effective floor price, as the opportunity cost of the unit at the time of surrender was the floor price (i.e., surrendering the unit would require the

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<sup>9</sup>To be clear we are not saying that this particular methodology is necessarily the right one for the surrender charge; but the general approach is appropriate.

liable entity to give up a unit worth \$10 at that date and \$5 cash to pay the surrender charge). However, the surrendered unit has cost the liable entity a total of \$25, which is more than the floor price.

The discussion paper assumes the development of “financial markets...to assist liable entities to hedge against this risk [of surrender charge volatility] by providing products such as options.”

We have concerns with this assumption. As a principle, we consider the functioning of the floor price should not require the development of a new secondary market. As such, rather than develop an unnecessarily complex system that relies on new financial markets in order to hedge a regulatory instrument, the approach should be to implement a system that most simply delivers the policy objective in a way that works for liable entities.

Firstly, financial markets may not emerge or may not provide the required depth, liquidity and tenors to support energy contracting given that theoretically all international units (even those purchased above the floor price) would require the volatility hedge. We note in this regard that financial markets for existing environmental obligations are relatively immature in Australia. It is very unlikely that any secondary market player has a natural exposure to the surrender charge price risk (the Government holds this risk) so it is a reasonable assumption that the size of any secondary market will be limited. Furthermore, secondary markets will place additional trading collateral requirements on liable entities, increasing costs and potentially constraining the ability of participants to manage their risk.

If the secondary market does not develop with sufficient depth and liquidity and liable parties do not have the ability to manage the risk of a volatile surrender charge, this option could significantly interfere with the successful functioning of the carbon and other emissions related markets.

We note that this market would need to be available immediately after Regulations were made as liable entities are already looking to hedge their carbon exposure for the relevant period.

It could also compromise wider carbon pricing scheme efficiency. For instance, if this option effectively precluded the use of international units, then all liable parties would need to surrender domestic units. Noting Treasury’s estimates that 170 Mt of international units will be acquitted in the first three years of the floating price, this would lead to a significant increase in demand for domestic units. This would raise their price, unnecessarily driving up energy prices and the cost of the ETS for no additional abatement gain.<sup>10</sup> Additionally, forward contracting would be inhibited as there will not be enough forward domestic permits auctioned to support current levels of forward contracting (even after the temporary restriction of 15 Mt per year is lifted when the annual caps are determined) .

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<sup>10</sup> We note, however, that a by-product of redirecting demand away from international units would be increased revenue for the Government. As discussed above, we regard the 50 per cent limit on international permits as the driving statement of policy.

Given the acute uncertainty of whether means to manage surrender charge volatility will emerge, Option 3 poses significant implementation risks and thus clearly fails the discussion paper's workability criterion of minimising implementation risk.

Secondly, if sufficient hedge products do develop, they will be at a cost. This will add unnecessary cost to the acquisition (and surrender) of international units. It is difficult to predict the magnitude of this cost. However, given: the inherent difficulty of hedging a regulatory instrument that has no natural counterparty (other than the government) and the likelihood that only a few entities could offer the product; the need to hedge the charge up to three to five years in advance to support energy contracting; and the added regulatory risk and financial impairment to the energy sector from carbon pricing, it will likely be a significant proportion of the underlying unit costs. Conservative estimates quickly push this cost into the hundreds of millions of dollars. As such, Option 3 fails the industry's criterion that the method should minimise compliance costs.

Option 3 also fails the discussion paper's effectiveness criterion, in that it has increased the cost of surrendering an international unit to more than the floor price. This is because it now includes the cost of the unit, the surrender charge *and* the cost of the hedge product. However, the discussion paper appears to dismiss this failure to meet the effectiveness criterion by simply noting that this would "increase the incentive to abate." We do not consider that incentivising inefficient abatement is a desirable outcome, nor does it reflect the medium to long-term abatement timeframe for the stationary energy industry.

Finally, we disagree with the discussion paper's assessment that this option has high workability for liable parties by lowering their administrative costs. It is correct that this model does not require liable parties to maintain records of purchase dates/costs for the purposes of compliance. However, any savings would likely be more than offset by the new classes of administrative cost it creates: acquiring and managing risk management devices (if such markets exist) and/or managing the adjustment to core energy supply activities that are affected by this model (if financial markets do not develop).

Given the serious weaknesses with Option 3, we do not support it being progressed further.

#### Option 4

Under Option 4, the surrender charge for a class of international units is based on the observed market price at the time of surrender. However, liable entities could also enter into a legal undertaking to surrender international units on a particular day in the future.

We regard Option 4 as a variant of Option 2, which has the particular strength of removing the requirement for the Regulator to monitor the trade records of participants. Option 4 does, however, have a number of weaknesses and complications compared to Option 2. For instance, while the ability to enter into an undertaking with the regulator would provide participants with cost certainty for the surrender charge, it would inhibit their flexibility, which as noted above may affect their ability to conduct their broader energy supply activities. It also introduces a

range of compliance and enforcement issues surrounding the undertaking. Nonetheless, a model that combined the strengths of Option 4 – the removal of the requirement for the Regulator to monitor the trade records of participants – with Option 2 would be worth exploring. This may have the advantage of avoiding any requirement for legislative amendment, as is necessary to implement Option 4.

### **Design features**

Given the difficulty of considering design features without knowing the implementation option each feature pertains to, we provide limited comment at this stage. We expect to provide a more detailed response once a fully worked out proposal for the surrender charge is available for comment.

In general, our approach to design features is the same as our criteria for assessing the implementation options. As such, we encourage the Department, in developing Regulations, to approach design features with regard to making them workable for liable parties and not interfere with their ability to undertake their core energy supply activities.

For instance, the use of market indices under Option 2 should facilitate businesses' certainty about their surrender charges when they decide whether to purchase international units. Similarly, the assumed time value of money should be a reasonable, accessible rate that does not strive for perfect accuracy (which is impossible) but rather reasonably reflects the circumstances of liable parties; it should not, for example, be based on the cost of capital of non-liable parties.

At this stage, we would like to propose that any indices refer to secondary markets and not to primary Certified Emission Reduction (CER) units, so as to not discourage Australian businesses from participating in the primary CER market.

### **Conclusion**

The Association does not support an international unit surrender charge but considers that if one is implemented it should be well designed and meet the needs of liable parties. On this basis, our preferred option from the discussion paper to progress to draft Regulations is Option 2. We strongly reject Option 3.