AFMA SUBMISSION TO COAG WORKING GROUP ON CLIMATE CHANGE AND WATER

“Design Options for the Expanded National Renewable Energy Target Scheme”

By email: RET@climatechange.gov.au

30 July 2008
Design Options for the Expanded RET Scheme

AFMA represents participants in the wholesale financial markets and coordinates the efficient operation and effective management of the over-the-counter markets, including markets for environmental products. We appreciate the opportunity to provide input on the development of the expanded national renewable energy target (RET) scheme through the public consultation process.

AFMA has played a leading role in the development of trading in Renewable Energy Certificates (RECs), as well as NSW Greenhouse Abatement Certificates and other environmental product markets in Australia. Our members actively participate in the current MRET scheme and have a vital interest in the RET scheme from a compliance and trading perspective.

In our deliberations and contributions, AFMA distinguishes between the ‘Scheme’ and the ‘Market’. The Scheme is the entire body of policy, objectives, rules and procedures that define the RET. The Market is the transactional space wherein among a variety of participants, REC price discovery occurs, RECs are exchanged for value and REC transaction types and mechanisms are deployed to facilitate price discovery, exchange and risk management.

Whereas the Objectives of the Scheme can be generalised as achieving least-cost renewable energy increases according to targets, timeframes etc defined by the Government, the Objective of the Market is to deliver a credible and dealable price signal in its transaction space with low transaction costs, in order to support the achievement of the Objectives of the Scheme.

Members have reviewed the consultation paper and we present below their comments on its proposals. They reflect their views on the rules that would best support an efficient market for trading of RECs.

1. General Comments

Members have emphasised that RET scheme should be designed in conjunction with the Australian Carbon Pollution Reduction Scheme, or Emissions Trading System (ETS), given the close link between the two. For instance, any RET failure will increase the burden on the ETS as the shortfall would impose an extra cost on ETS liable entities.

Members also stated a preference to rely on an annual REC target rather than physical generation targets, which would draw on the ETS principles of certainty and simplicity, providing for greater operational flexibility within the framework of the policy objective. From our reading of the consultation paper, the focus on physical generation seems to drive consideration of a set of unnecessarily complex rules in order to ensure a one-touch 2020 outcome.
A key benefit to industry and consumers is the equitable absorption of state-based schemes into the RET scheme, as it would reduce administration and compliance costs and remove resource allocation distortions which arise from disparate state-based schemes.

2. Design Approach

Moving to matters of detail, the consultation paper suggests two design approaches to the expanded RET scheme. AFMA supports the course taken in Approach 1 of the consultation paper which is closely based on the current MRET scheme and is closest to a ‘business as usual’ model. Members believe there is benefit in keeping the same basic rules, whilst changing the target under the scheme to achieve the 2020 objective. Amongst other things, this would permit unlimited banking of permits and assist inter-temporal management of liabilities. We think this will provide sufficient incentive for early investment in renewable energy sources and will support an active market in RECs.

We note that limiting existing generators to 2020 and/or limiting creation eligibility to 15 years, as in Approach 2, would allow more projects and participants to enter the scheme which should further support liquidity. However, we do note that the REC Registry would need to be enhanced to make public information on when each individual generator’s eligibility expires in order to support more accurate supply forecasting.

3. Liability and Annual Targets

Members have emphasised the need for certainty during both the ‘ramp-up’ and ‘ramp-down’ periods. The target time profile should aim to avoid excessive price volatility, which suggests a slower ramp up of the target in early years given long lead times for new projects. The precise profile to achieve this outcome will need to be determined by analysis based on the modelling of likely responses to the investment incentives.

4. Eligible Sources

Members believe that, from a market efficiency viewpoint, all existing sources should be included to ensure there is sufficient volume and certainty, particularly in the early part of the scheme.

5. Banking

The RET scheme should permit unlimited banking to help smooth out price volatility and to lower compliance costs.

6. Compliance Mechanisms

Any increase in the penalty level will result in windfall gains/losses from parties to existing forward trades and Power Purchase Agreements, as forward prices adjust upwards in response to higher target levels.
Given the need for regulatory certainty and the associated windfall gains and losses that would arise from a substantially higher shortfall charge, the RET penalty rate should not be set to a very high level relative to the current shortfall charge until at least the 2015 review date.

At the time of that review, the need to adjust the penalty rate could be assessed with the benefit of more relevant information given experience with the ETS, including the market price for carbon permits.

7. NRET – AETS Compliance Underwriting

We note that, pre-supposing RET fulfilment is part of the “with-measures” view of future emissions below which AETS caps are set, then the AETS effectively underwrites the performance of RET – any failure of the RET scheme to deliver expected physical abatement in any given year effectively transfers a make-good obligation to AETS participants. AFMA believes that it is not equitable for AETS participants to underwrite RET performance. Rather, AFMA believes that government, as the owner of, and rule-setter for, RET, should also be the underwriter. In simple terms, rather than AETS participants being required to source additional permits for any RET underperformance, AFMA believes that the government, as proper underwriter of RET performance, should release the equivalent number of permits to the AETS free of charge.

8. Phasing out Options

Members consider that phase-out design should, aspirationally, support an ongoing effective market. However, it was felt that neither penalty ramp-down nor target ramp-down would specifically avoid the market reducing to a largely balancing activity from some years prior to the end-date. Given that likelihood, target ramp-down is favoured as it retains more market characteristics and explicitly favours the pre-eminence of the AETS as the long-term market instrument.

9. Scheme Review

Members were uncertain about the purpose of the review in 2015, as it would then be too late to build in the consequence of ETS design and operation.

Members also noted that a review date of 2015 may not provide sufficient time for an industry response prior to 2020 to sufficiently address any generation shortfall. This could lead to market speculation that changes will need to be made earlier, which could damage liquidity in the lead up to the review date.

Theses are matters that should be considered in the finalisation of the scheme design and can be clarified in the presentation of the finalised set of measures.

10. Concluding Comments
To discuss any of the issues raised in this letter, please contact Allen Young, Senior Policy Executive, on (02) 9776 7941 who can make the necessary arrangements.